

THE REGULATION OF BANKERS' REMUNERATION

A COMPARATIVE STUDY BETWEEN THE UK AND CHINA

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The candidate confirms that the work submitted is her own and that appropriate credit has been given where reference has been made to the work of others.

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Abstract

During the Global Financial Crisis, the bank failures that spread across major Western economies have exposed severe flaws in bankers' remuneration. It has been extensively acknowledged that the excessive risk-taking in banks which resulted from inappropriate and distorted remuneration incentives significantly contributed to the catastrophe. As a consequence, bankers' remuneration has become an essential issue of banking regulation. After the Crisis, banking regulators in many economies have been working on establishing a productive regulatory framework for bankers' remuneration. Nevertheless, due to the diversities among different economies, the issues of bankers' remuneration are divergent from each other, particularly between developed and emerging financial markets. In many developed economies, the problem was that the liberal market model of bankers' remuneration ran out of control before the Crisis. Therefore, regulation is necessary for correcting market failures. In contrast, the problems in some emerging markets have lain in the difficulties to decouple from non-market forces, such as state control. Therefore, establishing a professional regulatory framework with reference to the modern experience of developed markets has been considered as a feasible way to push forward the marketisation and modernisation of bankers' remuneration.

This thesis aims for a comprehensive and analytical comparative study on the differences in bankers' remuneration and its regulation between developed and emerging markets, as well as the institutional origins of these differences. For concreteness, the thesis illustrates the UK, a leading developed market and China, the fastest-growing emerging market to probe into their policies and practices of regulating bankers' remuneration.

The thesis finds out that the UK's approach of regulating bankers' remuneration is market-based while in China it is state-oriented. In the UK, the failure of bankers' remuneration resulted from the defects in market operation. Nevertheless, the regulatory philosophy insists that liberal market should still be the primary mechanism to decide bankers' remuneration while regulation is the supplementary mechanism to rectify market imperfections. In China, bankers' remuneration has long been controlled by the government in an administrative and politicised approach. Despite some regulatory efforts to introduce modern and market-based remuneration methods, the regulators still tend to play a dominant and intrusive role in arranging bankers' remuneration and incentives. By examining and comparing the financial institutional frameworks in the UK and China, the thesis proves that both approaches have been inherently embedded in the existing institutions, which have profoundly shaped the structure of interests among different parties in society and the ideology of interpreting the 'market-state' relationship. Therefore, the regulatory reform of bankers' remuneration is subject to path dependence and should be expected as a long course of institutional change, through gradual and incremental improvements.

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List of Abbreviations

International / EU/ UK (Part II)

AG	Advocate General
AGM	Annual General Meeting
Barclays	Barclays Bank plc
BCBS	Basel Committee on Banking Supervision
BHCs	Banking Holding Companies
BIS	Department of Business, Innovation and Skills
BOD	Board of Directors
BoE	Bank of England
CAR	Capital Adequacy Ratio
CET 1	Common Equity Tier 1
CJEU	Court of Justice of the European Union
CRD IV	Capital Requirements Directive IV
CRR	Capital Requirements Regulation
EBA	European Banking Authority
ECB	European Central Bank
ECON	Committee on Economic and Monetary Affairs
EP	Economic Profit
EPS	Earnings per Share
FCA	Financial Conduct Authority
FOS	Financial Ombudsman Services
FRC	Financial Reporting Council
FSA	Financial Services Authority
FSB	Financial Stability Board
FSMA 2000	Financial Services and Markets Act 2000
GBP	Great Britain Pound
GFC	Global Financial Crisis
GFCI	Global Financial Centres Index
HBOS	HBOS Group
HC	House of Commons
HL	House of Lords
HPC	High Pay Centre
HSBC	HSBC Bank plc
IMF	International Monetary Fund
Lloyds	Lloyds Banking Group plc
Lloyds TBS	Lloyds TBS Group
LTIPs	Long-term Incentive Plans
NAO	National Audit Office
NEDs	Non-executive Directors
NPLs	Non-performing Loans
OECD	Organisation for Economic Co-operation and Development
OP	Operating Profit
PBT	Profit before Tax
PCBS	Parliamentary Commission on Banking Standards
PRA	Prudential Regulation Authority
RBS	Royal Bank of Scotland
ROE	Return on Equity
RoRWA	Return on Risk-weighted Assets
RoTE	Return on Tangible Equity
RPI	Retail Price Index
RWA	Risk-weighted Assets
SYSC	Senior Management Arrangements, Systems and Controls
The Turner Review	The Turner Review: A Regulatory Response to the Global Banking Crisis
The Walker Review	A Review of Corporate Governance in UK Banks and Other Financial Industry Entities - Final Recommendations
TSR	Total Shareholder Return

China (Part III)

ABC	Agricultural Bank of China
AMCs	Asset Management Corporations
BCM	Bank of Communications
BOC	Bank of China
CBRC	China Banking Regulatory Commission
CBRC Guidelines	Regulatory Guidelines on Sound Remuneration in Commercial Banks
CCB	China Construction Bank
CCDI	Central Commission for Discipline Inspection
CCEs	Central-controlled Enterprises
CCFIs	Central-controlled Financial Institutions
CCP	Chinese Communist Party
CDB	China Development Bank
CDI	Commission for Discipline Inspection
CFO	Chief Financial Officer
CHI Ltd.	Central Huijin Investment Ltd.
CIO	Chief Information Officer
CIRC	China Insurance Regulatory Commission
COD	Central Organisation Department
CRO	Chief Risk Officer
CSRC	China Securities Regulatory Commission
CSRC Code	Code of Corporate Governance for Listed Companies
G-SIBs	Global Systemically Important Banks
Guidelines for Bank Corporate Governance	Guidelines on Corporate Governance for Commercial Banks
HKD	Hong Kong Dollar
HKSE	Hong Kong Stock Exchange
ICBC	Industrial and Commercial Bank of China
IPOs	Initial Public Offerings
JSCBs	Joint-Stock Commercial Banks
Leading Group	Central Leading Group for Comprehensively Deepening Reforms
MHRSS	Ministry of Human Resources and Social Security
MOF	Ministry of Finance
MOF Measures	Measures for the Regulation of Managers' Remuneration in Central-controlled Financial Institutions
MOF Performance Assessment Measures	Interim Regulatory Measures for the Performance Assessment in State-owned and State-controlled Financial Institutions
NBS	National Bureau of Statistics
NGO	Non-government Organisation
PBOC	People's Bank of China
PRC	People's Republic of China
RCBs	Rural Commercial / Cooperative Banks
RMB	Renminbi
SARs	Stock Appreciation Rights
SASAC	State-owned Assets Supervision and Administration Commission
SCRES	State Commission for Restructuring the Economic Systems
SHSE	Shanghai Stock Exchange
SMS	Small and Medium-sized
SOCBs	State-owned Commercial Banks
SOEs	State-owned Enterprises
SPDB	Shanghai Pudong Development Bank
UCBs	Urban Commercial Banks
USD	United States Dollar

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Chapter 1

Introduction

1.1 Research Background and Overview

The Global Financial Crisis (GFC) which swept through the world's major economies from 2007 to 2009, resulted in a flurry of banking collapses and a long-term, disastrous depression in the global financial markets.

In major Western economies, the failures of many world-leading banks caused serious detrimental effects, including huge economic losses incurred by investors and customers, and enormous amounts spent by national governments in order to bail out the failed banks, which was ultimately assumed by individual taxpayers.¹ Therefore, the public became angered by the failed banks and the executives who operated the banks' businesses. In particular, public condemnation targeted bankers' 'sky-high' remuneration packages.²

Through increasing media coverage and academic discussions, public condemnation brought the issue of bankers' remuneration to the attention of international regulatory organisations and national governments. After the GFC, they have immediately launched investigations into the reasons for the Crisis and bankers' remuneration has been admitted as one factor among many that contributed to the Crisis.³ Among the international and national banking regulators, there was widespread concern that the pre-crisis arrangements for bankers' remuneration were problematic and distorted. However, different from the public, who only focused on the high remuneration levels, regulators were more concerned about how bankers' remuneration contributed towards the banking failures. For this reason, they have paid more attention to the structural arrangements and incentive mechanisms of bankers' remuneration.

¹ Graeme Wearden, 'Government to Spend £50bn to Part-nationalise UK's Banks' *The Guardian* (London, 8 October 2008) <https://www.theguardian.com/business/2008/oct/08/creditrunch.banking> accessed 14 November 2017; House of Commons (HC) Treasury Committee, *Banking Crisis: Reforming Corporate Governance and Pay in the City* (Ninth Report of Session 2008-09, HC519) 8

² 'Would Top Bankers Work for Less Money?' *The Economist* (London, 11 January 2011) https://www.economist.com/blogs/bagehot/2011/01/bankers_and_their_bonuses accessed 14 November 2017

³ HC Treasury Committee, *Banking Crisis: Reforming Corporate Governance and Pay in the City* (n1) 8; International Monetary Fund (IMF), *Global Financial Stability Report: Risk Taking, Liquidity, and Shadow Banking - Curbing Excess While Promoting Growth* (October 2014) 105

Specifically, many official reports have pointed out that the pre-crisis remuneration system drove bankers to take excessive risks in the short run, at the expense of banks' sustainability and financial stability in the long run.⁴

The banking sector plays a fundamental role in promoting business prosperity, economic growth and social welfare. The decisions made by bankers are of crucial importance to a bank's operation. Moreover, the behaviours of bankers are shaped by the bank's corporate governance mechanism, within which the remuneration system is a key aspect. Therefore, a properly and effectively functioning remuneration system is one of the prerequisites for ensuring the soundness of the banking sector.

In learning the lessons from the GFC, banking regulators in many major economies have launched stringent overhauls of banking regulation. In this sense, bankers' remuneration has become one of the core issues subject to comprehensive regulatory intervention.⁵

As the home to the City of London, the UK is one of the world's top financial markets and at the frontline of cutting-edge financial technology and advanced regulatory tools. However, the UK financial industry was so exposed to the global financial markets that it was hit by serious collapses, including the failures of several top banks. In official reports that have probed into the decision-making processes and corporate governance mechanisms of those failed UK banks, the UK government has pointed out that bankers' remuneration and incentives, which aimed at increasing banks' short-term profits and share prices, was one of the causes of the unduly risky and reckless strategies.⁶

In order to maintain financial stability and public confidence in the financial system, the UK has established a regulatory framework for bankers' remuneration, with an emphasis on effective risk management and prudential risk-taking. In doing so, the UK regulation has

⁴ Emilios Avgouleas and Jay Cullen, 'Excessive Leverage and Bankers' Incentives: Refocusing the Debate' (2015) 3 (1) *The Journal of Financial Perspectives* 1, 3; Simone M. Sepe and Charles K. Whitehead, 'Paying for Risk: Bankers, Compensation, and Competition' (2015) 100 (3) *Cornell Law Review* 655, 656; Lucian A. Bebchuk and Holger Spamman, 'Regulating Bankers' Pay' (2010) 98 (2) *Georgetown Law Journal* 247, 247; Kevin J. Murphy, 'Regulating Banking Bonuses in the European Union: A Case Study in Unintended Consequences' (2013) 19 (4) *European Financial Management* 631, 636

⁵ The international banking regulatory bodies mainly refer to the Basel Committee on Banking Supervision (BCBS) and the Financial Stability Board (FSB). Their regulations of bankers' remuneration include: BCBS, *Compensation Principles and Standards Assessment Methodology* (January 2010); FSB, *Principles for Sound Compensation Practices* (April 2009) and *the Implementation Standards* (September 2009). The BCBS and the FSB encourage their member jurisdictions to implement the principles and the standards into their domestic financial regulatory frameworks. The regulation of bankers' remuneration at the EU level is included in the Capital Requirements Directive IV (CRD IV), which has a binding effect on the member states' regulatory activities. In addition, many national regulators have taken initiatives to strengthen the control over bankers' remuneration. See Joseph Lee, 'Regulatory Regimes and Norms for Directors' Remuneration: EU, UK and Belgian Law Compared' (2012) 13 (4) *European Business Organisation Law Review* 599; Jay Cullen and Gudrun Johnsen, 'Promoting Bank Stability Through Compensation Reform: Lessons from Iceland' (2015) 11 (2) *Icelandic Review of Politics and Administration* 333

⁶ Financial Services Authority (FSA), *The Turner Review: A Regulatory Response to the Global Banking Crisis* (March 2009, hereafter 'The Turner Review') 79

referred to international principles and standards and complied with EU legislation. At the same time, the UK banking regulators have taken steps to enhance the regulation.

Across the major industrialised economies, the causes of banking failures, including the problem of bankers' remuneration were to a large extent analogous to each other. The UK is one of the world's leading financial markets, and the UK government is one of the many national governments that have resolutely and actively taken measures to cope with the failure of bankers' remuneration. Therefore, the practice and regulation of bankers' remuneration in the UK can typically represent this issue in other industrialised economies. After the GFC, there have been many debates among academics and regulators about bankers' remuneration in the UK.

In striking contrast, the issues of bankers' remuneration in emerging financial markets have been paid very little attention by the international financial regulators. Emerging markets play a less important or influential role in the global financial markets, and their bankers' remuneration systems are not the mainstream focus of academic discussions. Usually, emerging financial markets are immature, and their corporate governance mechanisms have not been fully developed. As a consequence, the policies and practices of bankers' remuneration are very different from those in developed financial markets. Moreover, different from the homogeneity among developed markets, bankers' remuneration policies and practices among emerging markets are heterogeneous due to the diversities in their financial systems, and their legal and business traditions.

Emerging financial markets are usually progressing at high speed and under bold reforms. On the one hand, they have huge potential to push forward the development of the global financial industry. On the other hand, their transitional reforms may generate many uncertainties and unstable factors. If banking conduct and bank corporate governance are not properly regulated, the failures in emerging markets will threaten the safety and soundness of the global financial industry. Therefore, it is necessary for the international banking sector to develop an overall understanding of the banking reforms undertaken in emerging markets, which will also facilitate international cooperation on financial development and regulation.

In recent years, China has been the largest and fastest-growing emerging financial market.⁷ In some areas, the Chinese financial market has even transcended developed financial markets. For instance, since 2015, the top four banks in the world have all been Chinese.⁸

⁷ Josh Robinson, 'The 20 Fastest-growing Economies This Year' (*Bloomberg*, 25 February 2015) <http://www.bloomberg.com/news/articles/2015-02-25/the-20-fastest-growing-economies-this-year> accessed 10 July 2015; 'The Top 20 Emerging Markets' (*Bloomberg*, 31 January 2013) <https://www.bloomberg.com/news/photo-essays/2013-01-31/the-top-20-emerging-markets> accessed 10 July 2015

⁸ The data is available at 'Banks Around the World' <https://www.relbanks.com/worlds-top-banks> accessed 06 December 2015

Due to its increasingly important and dynamic role in the global financial markets, it is worthy of more studies of China's banking reform and the key issues in its banks' corporate governance mechanisms.

The Chinese banking system weathered the GFC, and the problem of bankers' remuneration in developed markets was not observed in Chinese banks. Nevertheless, as an emerging market, the banking regulatory system and corporate governance mechanism in China are still in the modernisation and marketisation stage of reform. Therefore, the Chinese banking system has been confronted with other types of problems. Bankers' remuneration, is one of the issues that has not been materially progressed towards modernisation and marketisation.

The Chinese authorities clearly know that in order to be more integrated into the global financial industry and more influential in the post-GFC financial order, it is necessary to learn from international and other countries' experience in order to deepen and consolidate the ongoing banking reform in China. In this context, many international regulatory standards issued in the Basel III era have been incorporated into China's banking regulatory system. Besides, along with the trend of regulatory tightening of bankers' remuneration, the Chinese banking regulators have introduced the international standards and the experience of developed markets to push forward the reform of bankers' remuneration.⁹

It has been a decade since the occurrence of the GFC. The regulatory reforms of bankers' remuneration in the UK and China have also been undertaken for several years. Of the two economies, one is the top developed market and the other is the leading emerging market. In particular, China's financial system is at a transitional stage. The approaches of financial development and financial regulation have obviously been different from those in Western industrialised economies. Therefore, a comparative study on the problems and regulatory approaches of bankers' remuneration in these two markets, will be invaluable in broadening and deepening the academic research on this issue. Moreover, it will provide a comprehensive overview and insights for national banking regulators to promote their further reforms.

1.2 Research Objectives and Questions

Despite the broad acknowledgement on the necessity to regulate bankers' remuneration and the generic instructions provided by the international banking regulators, the specific rules and actions adopted by different national regulators may vary. In particular, it is reasonable

⁹ 'CBRC Managers Responded the Media About the Regulatory Guidelines on Sound Remuneration in Commercial Banks' (银监会有关负责人就《商业银行稳健薪酬监管指引》答记者问) (*The PRC Government website*, 10 March 2010) http://www.gov.cn/zwhd/2010-03/10/content_1552368.htm accessed 26 July 2017

to hypothesise that there will be some divergent factors between developed and emerging markets.

The thesis aims to comprehensively and systemically compare the practices and regulations of bankers' remuneration between developed and emerging financial markets in order to find out whether there are significant divergences between them. For concreteness, the thesis will illustrate the UK and China to probe into the problems of bankers' remuneration in these two economies. It will then examine the post-crisis institutional frameworks adopted by the UK and Chinese banking regulators to deal with the problems, and analyse the implementation and practical effects of the two regulatory frameworks. Based on the comparative study, the thesis will highlight the divergences, or similarities if there are any, between the regulations of bankers' remuneration in the UK and China. With regard to any divergences, the thesis will further dig into the two countries' economic, political, and legal institutions to provide an institutionalism interpretation of the origins of the divergences. Moreover, according to the particularities of the two regulatory frameworks, the thesis aims at providing reasonable and feasible policy recommendations to improve the reforms of bankers' remuneration in the UK and China.

In order to achieve the research objectives, the thesis will answer the following research questions (classified as main questions and sub-questions).

Main question 1: How is bankers' remuneration regulated and practiced in the UK?

Sub-question (1): What was the problem of bankers' remuneration in the UK before the GFC?

Sub-question (2): What regulatory actions have been taken after the GFC to reform bankers' remuneration in the UK?

Sub-question (3): How is bankers' remuneration practiced in the UK after the GFC and how does the regulation work?

Main question 2: How is bankers' remuneration regulated and practiced in China?

Sub-question (1): What has been the problem of bankers' remuneration in China in the context of transitional banking reform?

Sub-question (2): What regulatory actions have been taken recently to reform bankers' remuneration in China?

Sub-question (3): How is bankers' remuneration practiced in China after the regulatory actions have been taken and how does the regulation work?

Main question 3: What are the divergences or similarities between the UK and China in regulating bankers' remuneration? What are the reasons for the divergences?

Sub-question (1): How are the regulatory approaches of bankers' remuneration in the UK and China different from each other?

Sub-question (2): Why are the regulatory approaches of bankers' remuneration in the UK and China different from each other?

1.3 Research Methodologies

The methodologies of this thesis mainly include library-based and doctrinal research, comparative legal and institutional analysis and empirical study.

The method of library-based and doctrinal research is applied throughout the thesis to bolster the analytical interpretations and theoretical discussions. The issue of bankers' remuneration is an interdisciplinary topic between banking regulation and corporate governance. Moreover, studies about either banking regulation or corporate governance are also interdisciplinary, which combine the knowledge in the subjects of law, finance, economics, management and political science. Thus, to comprehensively and systemically develop this research, the author will summarise and synthesise the theories that have been developed in previous studies pertaining to banking and finance, banking regulation, corporate governance and executive remuneration. More importantly, to clearly explain the causal relationship and mechanism between bankers' remuneration and bank failures, the thesis will refer to and synthesise the information and arguments in existing academic articles, governmental and industrial reports, banks' annual reports and media comments. It will also examine the legal rules and regulatory policies relevant to bankers' remuneration, and synthetically assess the reasonability and effectiveness of them. In order to accomplish all of these tasks, library-based and doctrinal research is fundamental and essential.

The comparative legal and institutional analysis is another important approach to constructing and synthesising the work of the entire thesis. Comparative legal and institutional studies usually compare the legal, economic and political institutions, or a specific aspect of these institutions between different jurisdictions or countries. This method offers the only way by which the studies of law and institutions can become international. It provides scholars with the global insight to probe into the different solutions offered by different legal and institutional systems to certain problems. Therefore, the 'supply of solutions' can be enriched to allow scholars and policy makers to find out the proper and efficient solutions to their particular problems.¹⁰ However, a legal system cannot be fully understood without understanding the culture on which it sits. Therefore, undertaking comparative legal studies requires comparatists to possess the technique of 'immersion'

¹⁰ Edward Eberle, 'The Method and Role of Comparative Law' (2009) 8(3) Washington University Global Studies Law Review 451, 452-3

into the political, historical, economic, and linguistic contexts that moulded the legal system, and in which the legal system operates.¹¹

The thesis primarily aims at comparing the practices and regulations of bankers' remuneration in the UK and China. The comparative legal and institutional analysis will serve this research objective in three dimensions. First, it will examine and reveal the differences and similarities between the two regulatory frameworks of bankers' remuneration, as well as their implementation processes and practical effects. Secondly, it will compare the legal, economic and political systems in the UK and China to shed light on the underlying institutional origins of their differences in regulating bankers' remuneration. Finally, the findings of the comparison will provide the regulators in the UK and China with insights into the correct directions and steps to proceed the reforms of bankers' remuneration.

The empirical study in this thesis is very important as it provides empirical evidence to strengthen the views and arguments. It will be applied to describe and analyse the practices of bankers' remuneration before and after the regulatory reforms in the UK and China. The empirical evidence will reveal the real problems and the post-reform changes in the practices of bankers' remuneration, and the implementation and practical effects of the two regulatory frameworks.

Specifically, both quantitative and qualitative methods will be adopted. Quantitative research will be undertaken to collect, calculate and analyse the information and data about the levels, structures, and incentive mechanisms of bankers' remuneration disclosed in banks' annual reports. Qualitative research particularly serves the discussions on the political incentives in Chinese banks and will be applied to collect and analyse the information about Chinese bankers' career trajectories. The information of bankers' career trajectories will be collected from their biographies published in banks' annual reports and the Index of China's Leaders and Cadres, as well as their profiles at Wikipedia and Baidu Baike.

1.4 Originality

First of all, the research is original and innovative in its thoughts.

After the GFC, the issue of bankers' remuneration and its regulation in industrialised countries has become a debatable topic and attracted extensive attention from academics. Nevertheless, the majority of discussions have just slightly touched the surface of the issue by simply repeating the populist opinion that bankers' remuneration was too high. Thus, it must be controlled by national governments. This kind of descriptive statements cannot

¹¹ Ibid, 458

address the questions: how bankers' remuneration contributed to the Crisis? What are the proper and correct solutions? In order to clarify these questions, the thesis will examine the practice of bankers' remuneration and banks' risk-taking activities with the support of empirical evidence.

In contrast to the extensive debates on bankers' remuneration in developed financial markets, the existing academic studies have completely ignored the issue outside this sphere, such as in emerging markets. To fill in the gap, the thesis will extend the research scope by probing into the practice and regulation of bankers' remuneration in China. It will also establish a comparative framework which provides an overall and thorough interpretation of bankers' remuneration in different types of financial markets.

Moreover, the thesis provides a perspective of institutionalism to shed light on the questions: why have the specific problems of bankers' remuneration emerged in China and the UK? Why have the particular regulatory approaches been adopted? Why have the regulations been implemented in different ways? It will put the comparison in the context of different legal, economic and political institutions to reveal the institutional origins of the divergences. In this sense, the insightfulness and deepness of the thesis will strongly push forward the research of bankers' remuneration.

The research is also original and innovative in its methodology. It will apply the methods of empirical study and comparative legal and institutional analysis, which have not been adopted by previous studies on bankers' remuneration. The application of the two methods and their potential contributions to the thesis have been explained in Section 1.3.

1.5 Thesis Structure

The thesis contains ten chapters. Apart from the Introduction and the Conclusion, the eight chapters in the middle are divided into four parts. The thesis structure and the gist of each chapter are briefly summarised as follows.

Part I, comprised of Chapter 2, is the theoretical framework of the thesis. It interprets and synthesises the relevant theories about bankers' remuneration to lay the theoretical foundations for subsequent chapters.

Part II includes Chapter 3, 4 and 5, which discusses the regulation of bankers' remuneration in the UK. Chapter 3 probes into the problem in bankers' remuneration practice before the GFC, with an emphasis on its impact on bank failures. Chapter 4 systematically analyses the major measures that have been taken by the UK regulators to solve the problem. Chapter 5 examines the changes in bankers' remuneration practice and evaluates the effects of the post-crisis regulation.

Part III includes Chapter 6, 7 and 8, which discusses the regulation of bankers' remuneration in China. Chapter 6 probes into the problem in bankers' remuneration practice in the context

of China's transitional financial reform. Chapter 7 provides a comprehensive exposition of the major measures that have been introduced by the Chinese banking regulators to modernise and marketise bankers' remuneration. Chapter 8 investigates the remuneration practices of major Chinese banks by tracking the evolution of banks' remuneration policies and bankers' career trajectories. It also evaluates the effects of the regulatory framework.

Part IV, made up of Chapter 9, carries out the comparative legal and institutional study on bankers' remuneration between the UK and China. This chapter synthesises the divergences between the two jurisdictions and discusses the institutional origins of the divergences.

Chapter 10 concludes the major findings of this thesis, based on which it makes recommendations to the ongoing regulatory reforms in the UK and China. It also highlights the academic impact and contributions of this thesis.

Part I
Theoretical Foundations

Chapter 2

The Theoretical Foundations of Bankers' Remuneration and Its Regulation

2.1 Introduction

In Western developed financial markets, bankers' remuneration became an issue in banking regulation only after the problem was exposed through banks' failures during the GFC. In some emerging markets, national regulators have started to pay attention to bankers' remuneration only after it has been controversially debated in developed markets.

Among previous academic discussions, banking scholars only focused on the regulation of capital adequacy, industrial licensing and market conduct, while ignoring the regulation of bankers' remuneration. Previously, bankers' remuneration was practised in the same way as executive remuneration in non-financial industries, which was deemed as an internal governance affair subject to companies' discretion. Accordingly, bankers' remuneration and its regulation were not studied independently on a theoretical basis.

After the GFC, how to regulate bankers' remuneration has become an independent topic. Nevertheless, it is brand-new, without a well-developed theoretical framework. Regulating bankers' remuneration is an interdisciplinary topic between banking regulation and corporate governance. In these two areas, there have been consolidated and well-developed theories which provide the theoretical foundations and rationales for banking regulatory activities and corporate governance models. Since the GFC, the relevant theories have been further developed with new thoughts and discussions. This chapter will review and synthesise these theories and apply them to interpret the practice and regulation of bankers' remuneration. It will form the integrated theoretical foundations of this thesis.

The chapter is structured as below. Section 2.2 defines and interprets the core concepts and terms that will be used throughout the thesis. Section 2.3 summarises the theories about banking and banks. Section 2.4 summarises the theories about executive remuneration in the context of general corporate governance. Section 2.5 discusses the theoretical rationales of banking regulation. Section 2.6 discusses the theories about banking and financial reforms in developing economies. Section 2.7 is the conclusion.

2.2 Core Concepts

2.2.1 Bank

Generally, textbooks define a bank as a financial institution which is licensed in a jurisdiction to take deposits and use the funds in the course of business, including making loans and investments.¹

This definition clarifies the core businesses of a bank: taking deposits and making loans. These are the essential functions of commercial banking. In both English Law and Chinese Law, the statutory definitions emphasise these traditional characteristics to distinguish banks from other financial institutions.²

However, nowadays, financial institutions which take deposits and make loans are also involved in a variety of investment activities. In particular, traditional commercial banks have developed into universal banking groups with broader engagement in investment banking and other financial activities. For this reason, the textbook definition above also stresses investment banking as an important function of banks.

In fact, the statutory definitions can be interpreted to be compatible with the changes in banks' businesses today. That is, the statutory meaning of a bank refers to any financial institution that has a function of commercial banking, no matter it has other functions or not. Banking groups in the UK and China which have transferred from traditional commercial banks are exactly described by this definition. In this thesis, without special declaration, a bank particularly means a commercial bank or a universal bank with the function of commercial banking, while investment banks are excluded.

2.2.2 Banker

Strictly speaking, the word 'banker' is not a formal academic term. After the GFC, it has been widely used by media and academics. However, the meaning has been rarely clarified.

In a company, executive directors and senior managers are at the core of the decision-making process and comprehensively in charge of the company's business and management. Their remuneration packages and incentives are one of the major topics in the studies of general corporate governance. 'Executive remuneration', 'directors' remuneration' and 'managers' remuneration' are the commonly used terms.

¹ Anu Arora, *Banking Law* (Pearson Education Limited 2014) 6; Ross Cranstan, *Principles of Banking Law* (2nd edn, OUP 2002) 6

² The definition in Article 2 of the UK's Banking Act 2009 is: 'bank' means a UK institution which has permission under Part 4 of the Financial Services and Markets Act 2000 (FSMA 2000) to carry on the regulated activity of accepting deposits. The definition in Article 2 of the Commercial Banking Law of the People's Republic of China (PRC) (中华人民共和国商业银行法) 2015 is: 'commercial banks' are those enterprises which are established in accordance with this legislation and the Company Law of the PRC (中华人民共和国公司法) to absorb public deposits, make loans, arrange settlement of accounts and engage in other businesses.

According to the Compensation Principles and Standards Assessment Methodology issued by the BCBS, the regulation should be applied to bank staff whose professional activities have a material impact on the bank's risk profile.³ This 'material impact' criterion has been adopted by the financial regulators in the UK - the Prudential Regulation Authority (PRA) and the Financial Conduct Authority (FCA). However, Neither the BCBS nor the UK regulators have specified how to assess the 'material impact'.

In fact, the 'material impact' criterion can be understood as a non-exhaustive list, which includes any employee who plays a role in the bank's risk-taking activities. In this sense, executive directors and senior managers are included.

The definition of banker in this thesis is based on the 'material impact' criterion. However, it is in a narrower sense. A banker refers to an executive director or senior manager in a bank. Other employees who could also have an impact on risk-taking but not as essential as executive directors and senior managers, such as the managers of subsidiaries, independent directors and members of supervisory board (particularly in Chinese banks), are excluded.

2.2.3 Remuneration

'Remuneration', 'compensation' and 'payment' can be interchangeably used. In academic research and regulatory documents, the meaning of remuneration is unequivocal: all types of monetary or economic benefits received by an employee in relation to the employment. Therefore, remuneration includes basic salary, bonuses, equity-based awards, pensions, severance payments, golden parachutes,⁴ and so on. Among these types of benefits, pensions and severance payments are akin to workmen welfares, whereas they are less related to the specific role or responsibilities of an employee in the company. Thus, they are excluded. A golden parachute is an anti-takeover tactic particularly used in American companies, while less common in the UK and China. Therefore, it is also excluded.

In this thesis, remuneration particularly includes fixed remuneration and variable remuneration. Fixed remuneration refers to basic salary. Variable remuneration, which is interchangeably used with the term 'performance-based remuneration', refers to cash bonuses and equity-based remuneration. The detailed definitions of the two components will be given in Chapter 3.

2.2.4 Banking Regulation

Banking regulation refers to the state intervention in the banking sector through the promulgation of an authoritative set of rules, accompanied by some other mechanisms, such

³ BCBS, *Compensation Principles and Standards Assessment Methodology*, Article 11

⁴ Golden parachutes usually refer to a set of economic benefits given to top executives when their tenures are terminated due to merger or takeover.

as a governmental agency, for monitoring and promoting banking activities.⁵ From a static perspective, banking regulation refers to a series of rules.⁶ From a dynamic perspective, banking regulation is a process that a government enacts rules, and directs and adjusts banks' activities with these rules.⁷

The process of directing and adjusting banks' activities is the enforcement of rules. This is often known as banking supervision.⁸ Regulation specifically refers to the process of enacting rules. Namely, banking regulation and supervision are often distinguished. Nevertheless, this thesis gives a broader definition to 'regulation' and incorporates the signification of 'supervision' into it. Thus, the term 'regulation of bankers' remuneration' refers to both the enactment and the enforcement of the rules of bankers' remuneration.

2.3 Theories About Banking

2.3.1 The Significance of Banking: Financial Intermediary

Banks are the financial intermediaries between massive borrowers and lenders. They collect dispersive household savings and transform them into the funding for investments or other forms of wealth.⁹ The role of financial intermediaries is indispensable in a country's social and economic life. Between borrowers and lenders, there are serious information asymmetries, which increase transaction costs.¹⁰ First of all, borrowers possess the true characteristics of their own, which are of crucial importance for lenders to decide whether to lend money to borrowers and how to protect themselves against defaults. However, borrowers prefer to exaggerate the positive side but conceal the negative side. As a result, it will be more costly for lenders to verify borrowers' true characteristics.¹¹ If lenders have no access to the true characteristics, to avoid any potential losses, they will increase the

⁵ Robert Baldwin *et al* (eds), *A Reader on Regulation* (OUP 1998) 3; Bronwen Morgan and Karen Yeung, *An Introduction to Law and Regulation: Text and Materials* (CUP 2007) 16

⁶ Dalvinder Singh, *Banking Regulation of UK and US Financial Markets* (Ashgate Publishing 2007) 7

⁷ Weiping He, *Banking Regulation in China: The Role of Public and Private Sectors* (Palgrave Macmillan 2014) 28

⁸ House of Lords (HL) Selected Committee on Economic Affairs, *Banking Supervision and Regulation* (2nd Report of Session 2008-09, HL Paper 101-I) 10

⁹ Eugene F. Fama, 'Banking in the Theory of Finance' (1980) 6 (1) *Journal of Monetary Economics* 39, 40; Franklin Allen and Anthony M. Santomero, 'The Theory of Financial Intermediation' (1997) 21 (11-12) *Journal of Banking and Finance* 1461, 1463; Hans Degryse *et al*, *Microeconomics of Banking: Methods, Applications and Results* (OUP 2009) 9-10

¹⁰ Hayne E. Leland and David H. Pyle, 'Informational Asymmetries, Financial Structure, and Financial Intermediation' (1977) 32 (2) *The Journal of Finance* 371, 372; Sudipto Bhattacharya and Anjan V. Thakor, 'Contemporary Banking Theory' (1993) 3 (1) *Journal of Financial Intermediation* 2, 8; Franklin Allen and Anthony M. Santomero, 'What Do Financial Intermediaries Do?' (2001) 25 *Journal of Banking and Finance* 271, 272

¹¹ Hayne E. Leland and David H. Pyle, 'Informational Asymmetries, Financial Structure, and Financial Intermediation' (*ibid*) 372

interest rates or require collaterals or guarantees. However, this will lead to higher costs for borrowers to use cash flows, and therefore reduce the efficiency of funding allocation.¹²

In comparison, financial intermediaries are advantageous over individuals in information collection and monitoring. Usually, a bank contracts with numerous depositors and borrowers following a systemic and uniform set of proceedings, which is less costly than the duplicated proceedings taken by individual enterprises.¹³ Moreover, there are a variety of borrowing, lending or payment activities between a bank and an enterprise, which enables the bank to possess comprehensive information about the enterprise. Therefore, before making any loans, banks can collect the proprietary information about the targeted businesses of borrowers, and evaluate the qualities and potential returns at much lower costs than individual lenders.¹⁴ After the loans have been made, banks can also closely oversee the changing situations of borrowers, which would substantially influence their debt-paying abilities.

Moreover, by lending to numerous entrepreneurs and companies, a bank's business is diversified, which can reduce the risks of the bank. The losses of one loan will not lead to serious financial failures if other loans can be fully repaid. Moreover, a bank has dispersive depositors, and the losses of loans can be widely shared. For each individual depositor, the damages are much less than those suffered by an individual lender who has directly lent to individual borrowers through bilateral contracts, whereas could not get repaid. Furthermore, by bridging between borrowers and lenders, banks create liquidity for the market. They finance relatively illiquid assets while providing depositors with flexible chances for redemptions.¹⁵

Along with the development of modern finance, banks have expanded their businesses to a variety of new financial activities and services, such as mutual funds, trusts, investment banking and insurance. Through these activities, banks have made more contributions to financial growth and innovation.

In conclusion, banks always play a significant role in reducing transaction costs and risks and promoting financial growth. Economic and social development, and the interests of depositors, consumers and enterprises, are all closely bound up to a country's banking system. In order to maintain the sustainability of the banking sector, as well as to develop

¹² Douglas W. Diamond, 'Financial Intermediation and Delegated Monitoring' (1984) 51 (3) *The Review of Economic Studies* 393, 394

¹³ *Ibid*, 404

¹⁴ Franklin Allen, 'The Market for Information and the Origin of Financial Intermediation' (1990) 1 *Journal of Financial Intermediation* 3, 5; Sudipto Bhattacharya and Anjan V. Thakor, 'Contemporary Banking Theory' (n10) 9; Hayne E. Leland and David H. Pyle, 'Informational Asymmetries, Financial Structure, and Financial Intermediation' (n10) 372

¹⁵ Allen N. Berger and Christa H. S. Bouwman, 'Bank Liquidity Creation' (2009) 22 (9) *The Review of Financial Studies* 3779, 3380

the economy and enhance social welfare, it is necessary for a national government to regulate banks' activities.

2.3.2 The Particularities of Banking

The business operation and capital structure of banks differ from those of companies in non-financial industries. The particular risks of banking are endogenously embedded in banks' business operation and capital structure. Therefore, risk management and control is a very important objective of banking regulation.

2.3.2.1 'Borrow Short, Lend Long' and Bank Run

As the financial intermediaries, banks are able to create financial liquidity on illiquid assets. By providing long-term loans, banks fulfil the market's demand for illiquid assets. By offering demand-deposit contracts, banks promise depositors the flexible options to withdraw their deposits.¹⁶ Therefore, the business of commercial banking is characterised as 'borrow short, lend long'.

The model of 'borrow short, lend long' is inherently accompanied by a considerable drawback: the mismatch of maturity between banks' assets and liabilities. It makes banks vulnerably exposed to the possibility of a bank run.¹⁷ A bank run will occur when a majority of depositors and other debtholders require the bank to convert their debt claims into cash at the same time. In these circumstances, the bank usually cannot provide sufficient amounts of cash flows, and therefore becomes trapped in a liquidity crisis.¹⁸

A bank run is very destructive. It will result in the collapse of a previously healthy bank.¹⁹ Moreover, subject to systemic risk, the panic would quickly spread to the depositors of other banks and then jeopardise the soundness and safety of the banking sector as a whole. Finally, it could destroy public confidence in the financial market and the government, bringing immeasurable damages to economic development and social stability.

2.3.2.2 High Leverage Ratio

Banks' capital structure is highly leveraged. Equity capital and debt capital are the two resources of financing. Usually, the ratio between debt capital and equity capital is known

¹⁶ Douglas W. Diamond and Philip H. Dybvig, 'Bank Runs, Deposit Insurance and Liquidity' (1983) 91 (3) *Journal of Political Economy* 401, 403; Anil K. Kashyap, 'Banks as Liquidity Providers: An Explanation for the Coexistence of Lending and Deposit-taking' (2002) 57 (1) *The Journal of Finance* 33, 35; Franklin Allen and Douglas Gale, 'Optimal Financial Crises' (1998) 53 (4) *The Journal of Finance* 1245, 1245; Itay Goldstein and Ady Pauzner, 'Demand-deposit Contracts and the Probability of Bank Runs' (2005) 60 (3) *The Journal of Finance* 1293, 1293

¹⁷ Itay Goldstein and Ady Pauzner, 'Demand-deposit Contracts and the Probability of Bank Runs' (ibid) 1293; Douglas W. Diamond and Philip H. Dybvig, 'Bank Runs, Deposit Insurance and Liquidity' (ibid) 403

¹⁸ Charles W. Calomiris and Gary Gorton, 'The Origins of Banking Panics: Models, Facts and Bank Regulation' in R. Glenn Hubbard (eds), *Financial Markets and Financial Crises* (University of Chicago Press 1991) 109, 112

¹⁹ Douglas W. Diamond and Raghuram G. Rajan, 'Liquidity Shortages and Banking Crises' (2005) 60 (2) *The Journal of Finance* 615, 639

as the leverage ratio. If a firm takes much more debt capital than equity capital, its leverage ratio will be very high. In comparison to non-financial firms, the leverage ratio of banks is much higher.²⁰ It is because as the financial intermediaries, banks' own equity assets are far from sufficient to meet the massive funding demands in the market. Thus, they must rely on the debt assets acquired from depositors.

However, the high leverage ratio is inherently associated with the high risk of insolvency.²¹ Banks promise their depositors the full certainty to get the deposits back. As a consequence, redemptions of deposits must be fully realised regardless of the performance of the illiquid, long-term loans, which is always uncertain.²² If the returns of these assets are poor, only with equity capital, banks will not be able to fulfil the large amounts of liabilities.²³ As a consequence, banks will be in danger of insolvency.

The high risk of insolvency and liquidity risk are endogenous in banks' business operation and capital structure, and cannot be completely eliminated. Nevertheless, banking regulation is helpful for controlling and reducing these risks.

2.3.2.3 Systemic Risk

The banking industry is typically subject to systemic risk. The Bank for International Settlements defines systemic risk as 'the risk that the failure of a participant to meet its contractual obligations may in turn cause other participants to default with a chain reaction leading to broader financial difficulties.'²⁴

In the banking sector, every institution is intertwined with each other in the financial market through interbank businesses and the cooperation in financial services. Moreover, banks doing business across national borders are connected with the global financial industry.²⁵ Usually, systemic risk can build up suddenly and unexpectedly, and spread fast.²⁶ The failure of one bank propagates as a contagion and simultaneously ignites the failures of

²⁰ Mark Flannery, 'Debt Maturity and the Deadweight Cost of Leverage: Optimally Financing Banking Firms' (1994) 84 (1) *The American Economic Review* 320, 320

²¹ Adrian Blundell-Wignall and Caroline Roulet, 'Business Models of Banks, Leverage and the Distance-to-default' (2012) 2 *The Organisation for Economic Co-operation and Development (OECD) Journal: Financial Market Trends* 7, 21

²² Charles Goodhart *et al*, *Financial Regulation: Why, How and Where Now?* (Routledge 1998) 11-2

²³ George J. Benston and George G. Kaufman, 'The Appropriate Role of Bank Regulation' (1996) 106 (436) *The Economic Journal* 688, 691

²⁴ Bank for International Settlements, *64th Annual Report* (June 1994) http://www.bis.org/publ/arpdf/archive/ar1994_en.pdf accessed by 18 October 2015, 177

²⁵ George G. Kaufman and Kenneth E. Scott, 'What Is Systemic Risk, and Do Bank Regulators Retard or Contribute to It?' (2003) 7 (3) *The Independent Review* 371, 375

²⁶ Douglas W. Arner, 'The Global Credit Crisis of 2008: Causes and Consequences' (2009) *Asian Institute of International Financial Law Working Paper No. 3* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1330744 accessed by 19 October 2015

many other banks or even the meltdown of the entire banking system.²⁷ Large and major banks are more deeply and widely interconnected and more influential. The failure of one will ignite a strong chain reaction in the financial system and induce system-wide economic disaster. These banks are known as the ‘too-big-to-fail’ institutions. In the face of their failures, governments have to take emergent rescue measures to prevent the economy from melting down.²⁸

The GFC is just the best evidence of the destruction of systemic risk. After the GFC, controlling systemic risk has become the primary objective to strengthen the global financial safety net, and enhancing prudential risk-taking in bank corporate governance is an important aspect.

To conclude, banks are at the core of a country’s economic and social life. However, banking is inherently associated with high risks. Liquidity risk, the risk of insolvency, and systemic risk are endogenously embedded in banks’ business operation and capital structure. Therefore, controlling risks to maintain banking stability is a crucial task of banking regulation.

2.4 Theories About Executive Remuneration

2.4.1 Agency Theory and Shareholder Primacy

Before the GFC, in Anglo-American countries, executive remuneration in the banking sector was practised in the same way as that in non-financial industries. The design and practice of bankers’ remuneration were not intervened by regulators, while only subject to banks’ internal governance.

The Anglo-American model of corporate governance is theoretically and ideologically founded on agency theory and shareholder primacy.²⁹ The ownership and control in modern corporations are separated. Shareholders own a company’s shares, while the power to operate day-to-day business is delegated to professional executives.³⁰ As the owners, shareholders assume the uncertainties in the company’s operation, namely they are the residual risk bearers.³¹ Therefore, shareholders should be entitled to all of the returns on

²⁷ Viral V. Acharya, ‘A Theory of Systemic Risk and Design of Prudential Bank Regulation’ (2009) 5 (3) *Journal of Financial Stability* 224, 224

²⁸ Frederic S. Mishkin, ‘How Big a Problem Is Too Big to Fail?’ (2006) 44 (4) *Journal of Economic Literature* 988, 990

²⁹ Andrew Keay, ‘Shareholder Primacy in Corporate Law: Can It Survive? Should It Survive?’ (2010) 7 (3) *European Company and Financial Law Review* 369, 370

³⁰ Adolf A. Berle and Gardiner Means, *The Modern Corporation and Private Property* (2nd edn, Transaction Publishers 1991) 125

³¹ Michael C. Jensen and William H. Meckling, ‘Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure’ (1976) 3 (4) *Journal of Financial Economics* 305, 308; Eugene F. Fama, ‘Agency Problems and the Theory of the Firm’ (1980) 88 (2) *The Journal of Political Economy* 288, 290; Eugene F.

shares after the company's contractual obligations are satisfied.³² In this sense, shareholders are the residual claimants, and a company is operating for shareholders' interests. Therefore, executives are regarded as the agents of shareholders and the primary objective of their governance is to take optimal strategies to maximise shareholders' interests.³³

However, if executives are self-interested, they cannot be expected to act in the best interests of shareholders all the time. Executives may exert the power of control to pursue personal interests, which will impair the welfare of shareholders. As a result, the costs of the agency-principal structure will increase. Jensen and Meckling define these costs as 'residual losses'.³⁴ One of the solutions to reduce residual losses is aligning executives' interests with shareholders' interests through remuneration incentives.

Before the GFC, remuneration systems in Anglo-American corporations were based on agency theory and shareholder primacy. Equity-based incentives were used to attach executives' benefits to shareholder return and share price. However, in banks, these arrangements distortedly incentivised bankers to take excessive risks. In Chapter 3, the problem will be analysed in detail.

2.4.2 Stakeholder Theory

In terms of the objectives and principles of corporate governance, stakeholder theory is a major alternative of agency theory and shareholder primacy.³⁵

The concept of stakeholders refers to any identifiable individual or group who could affect or be affected by the activities of a firm.³⁶ In academic discussions, the concept of stakeholders is used in a narrower sense, which means the constituencies that are closely connected with a firm, especially those a firm depends on for its survival and development, such as employees, customers, government agencies, local communities, and so on.³⁷

Fama and Michael C. Jensen, 'Separation of Ownership and Control' (1983) 26 (2) *Journal of Law and Economics* 301, 302-3

³² Michael C. Jensen, *A Theory of the Firm: Governance, Residual Claims, and Organisational Forms* (Harvard University Press 2003) 141-2

³³ Michael C. Jensen and William H. Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (n31) 309; Andrew Keay, 'Shareholder Primacy in Corporate Law: Can It Survive? Should It Survive?' (n29) 375

³⁴ Michael C. Jensen and William H. Meckling, 'Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure' (n31) 309

³⁵ Thomas Donaldson and Lee E. Preston, 'The Stakeholder Theory of the Corporation: Concepts, Evidence and Implications' (1995) 20 (1) *The Academy of Management Review* 65, 70

³⁶ R. Edward Freeman and David L. Reed, 'Stockholders and Stakeholders: A New Perspective on Corporate Governance' (1983) 25 (3) *California Management Review* 88, 91

³⁷ R. Edward Freeman, 'A Stakeholder Theory of the Modern Corporation' (2001) 3 *Perspectives in Business Ethics* (Sie) 144, 144

Opposite to agency theory, stakeholder theory argues that the operation of a company is for not only shareholders' interests but also the multiple purposes of different stakeholders.³⁸ Therefore, corporate governance should not be organised to maximise shareholders' interests at the expense of other constituencies' interests. Instead, it must try to keep the balance and harmonisation among the diverse interests of different stakeholders. Advocates of stakeholder theory criticise agency theory and shareholder primacy because the imbalanced and overwhelming focus on one group's stakes will finally jeopardise the health and soundness of the company as a whole.³⁹ If the company fails, all stakes in its equity, bonds, products and services will be damaged.

Stakeholder theory emphasises the significance of corporate governance in social welfare enhancing. A company establishes contractual relationships with all kinds of stakeholders. Therefore, on behalf of the company, executives have contractual duties to manage for the interests of both shareholders and stakeholders.⁴⁰ It is also directors' fiduciary duty to take into account the interests of different stakeholders.⁴¹ As a corollary, different stakeholders should be allowed to participate in corporate governance affairs, including the design and management of executive remuneration.⁴²

In practice, the corporate governance models in some jurisdictions outside the Anglo-American world, such as German law and Japanese law, are based on stakeholder theory.⁴³ Even in major Anglo-American jurisdictions, such as the UK and the US, the post-crisis era has observed a great shift from agency theory to stakeholder theory in both academic debates and regulatory practices. Particularly in the banking sector, the bank failures which were significantly affected by the corporate governance arrangements in accordance with agency theory and shareholder primary, have caused tremendous economic losses to not only shareholders but also massive customers, depositors, taxpayers and national

³⁸ Thomas Donaldson and Lee E. Preston, 'The Stakeholder Theory of the Corporation: Concepts, Evidences and Implications' (n35) 68

³⁹ R.Edward Freeman and David L. Reed, 'Stockholders and Stakeholders: A New Perspective on Corporate Governance' (n36) 96

⁴⁰ R.Edward Freeman, 'The Stakeholder Approach Revisited' (2004) 5 (3) *Zeitschrift für Wirtschafts-und Unternehmensethik* 228, 235

⁴¹ *Ibid*

⁴² Thomas Donaldson and Lee E. Preston, 'The Stakeholder Theory of the Corporation: Concepts, Evidences and Implications' (n35) 88

⁴³ Corporate governance in German Law emphasises the co-determination (*Mitbestimmung*) of employees and the function of the supervisory board (*Aufsichtsrat*). The Japanese model presumes that corporations exist within a tightly connected and interconnected set of stakeholders. See *ibid*, 76.

governments.⁴⁴ Therefore, it has been widely argued that bank corporate governance should aim at protecting stakeholders' interests and balancing with shareholders' interests.⁴⁵

This theoretical and ideological shift has had an impact on the discussions of bankers' remuneration. According to stakeholder theory, if bankers' remuneration is completely oriented by the interests of a single constituency, it will be detrimental to the bank's integral development, and the objectives of economic growth and social welfare enhancing.⁴⁶ Thus, the pre-crisis policies and practices of bankers' remuneration on the basis of agency theory and shareholder primacy should be reformed. After the GFC, many national governments have launched regulatory reforms of bankers' remuneration with the purposes of maintaining financial stability and protecting the public interest, which are compatible with the proposition of stakeholder theory.

2.5 Theories About Regulation

Regulation is the intervention in private activities by public power, usually a government or its agency.⁴⁷ Regulation universally exists in economic and social life. The banking industry is always subject to extensive governmental regulation. In academic discussions, there are different theories explaining the motivations and approaches of governmental regulation. This section will summarise the basic arguments of the two main theories - public interest theory and private interest theory, to shed light on the motivations and approaches of the post-crisis regulations of bankers' remuneration.

2.5.1 Public Interest Theory

Public interest theory deems that legislators and regulators regulate economic and social life for the collective goal to satisfy and promote the public interest.⁴⁸ Public interest can be explained as the common welfare and benefits, and the shared opinions and values among the public in society.⁴⁹ Sometimes, there are irreconcilable opinions and contradictory interests among different groups. Thus, the pursuit of the public interest is also a compromise and balance among these irreconcilable opinions and contradictory interests.⁵⁰

⁴⁴ Terence Tse, 'Shareholder and Stakeholder Theory: After the Financial Crisis' (2011) 3 (1) *Qualitative Research in Financial Markets* 51, 54; Blanche Segrestin and Armand Hatchuel, 'Beyond Agency Theory: A Post-crisis View of Corporate Law' (2011) 22 (3) *British Journal of Management* 484, 491

⁴⁵ Marco Becht *et al*, 'Why Bank Governance Is Different' (2011) 27 (3) *Oxford Review of Economic Policy* 437, 445

⁴⁶ Thomas Donaldson and Lee E. Preston, 'The Stakeholder Theory of the Corporation: Concepts, Evidences and Implications' (n35) 87

⁴⁷ Oliver James, 'Regulation Inside Government: Public Interest Justifications and Regulatory Failures' (2000) 78 (2) *Public Administration* 327, 327

⁴⁸ Bronwen Morgan and Karen Yeung, *An Introduction to Law and Regulation: Text and Materials* (n5) 17-8

⁴⁹ Weiping He, *Banking Regulation in China: The Role of Public and Private Sectors* (n7) 29

⁵⁰ *Ibid*

According to public interest theory, the ‘invisible hand’ - market mechanism cannot always be functional or efficient to achieve the goals of the public. In economic and business development, a liberal market could operate to fulfil the interests of a minority group, regardless of the damages to other groups, in which circumstances the aggregate economic and social costs for all social members would exceed the aggregate benefits. Therefore, for the sake of the public, regulation is needed to correct market deficiencies and imperfections.⁵¹

The market failures to achieve the public interest include monopoly, externalities, information asymmetries and the inefficient supply of public goods.⁵² These problems also exist in the banking sector, especially when regulation is absent or inadequate. Therefore, governments need to take a variety of regulatory measures to deal with these problems. For instance, governments control banks’ risk-taking activities to reduce the externality of risk shifting from banks to depositors and taxpayers, who are always in a disadvantageous situation due to information asymmetries.⁵³

The stability of the banking system is of crucial importance to social-economic sustainability and every individual’s welfare. Therefore, some academics argue that the banking sector is a kind of ‘quasi-public good’.⁵⁴ Although mostly owned by private, banking contains some public good characters. Specifically, without regulation, private banking cannot maximise the public interest.

This view has been more widely acknowledged after the GFC, which justifies the tightening and expansion of banking regulation. In particular, national governments in major economies have announced that the regulatory intervention in bankers’ remuneration to control banks’ risk-taking activities is necessary for maintaining financial stability and protecting the public interest.

2.5.2 Private Interest Theory

Although public interest theory provides the orthodoxy rationale for a government to intervene in private activities, it has substantial weaknesses. It assumes that regulation is *bona fide* for the best interests of the public. However, it fails to account for a good deal of evidence that in practice, many governmental policies were unable to achieve their original

⁵¹ Richard Posner, ‘Theories of Economic Regulation’ (1974) 5 (2) *The Bell Journal of Economics and Management Science* 335, 335

⁵² Bronwen Morgan and Karen Yeung, *An Introduction to Law and Regulation: Text and Materials* (n5) 18

⁵³ David Llewellyn, ‘The Economic Rational for Financial Regulation’ (1999) FSA Occasional Paper Series 1 <http://www.fsa.gov.uk/pubs/occpapers/op01.pdf> accessed 8 November 2017, 21

⁵⁴ Weiping He, *Banking Regulation in China: The Role of Public and Private Sectors* (n7) 29; Hassan Bougrine and Mario Seccareccia, ‘Rethinking Banking Institutions in Contemporary Economies: Are There Alternatives to the Status Quo?’ in Louis-Philippe Rochon and Mario Seccareccia (eds), *Monetary Economies of Production: Banking and Financial Circuits and the Role of the State* (Edward Elgar 2013) 134, 135

purposes for economic efficiency, social welfare and social justice. On the contrary, some policies even resulted in undesirable outcomes.⁵⁵

The proponents of public interest theory try to reformulate the theory by arguing that the failure of regulation is due to the mismanagement in the process of designing and implementing policies. Nevertheless, regulators' fidelity to the purpose of promoting the public interest should not be denied.⁵⁶ However, this interpretation still fails to explain how mismanagement could happen and why the practical evidence has been divergent with the theory.

An alternative perspective, private interest theory, deems that regulation is driven by individuals or groups with the purpose to maximise their own interests.⁵⁷ These individuals and groups can be politicians, officials, government departments and the interest groups in regulated industries.⁵⁸ Politicians, officials and government departments can utilise their power to enact legislation and regulatory policies to expropriate benefits from private industries.⁵⁹ Interest groups, for their own demands, will try to lobby the legislature and regulatory bodies and impose some sort of pressure on them to enact, amend or abolish policies.⁶⁰

Public interest theory and private interest theory are divergent from each other. Nevertheless, they are not completely opposite. In fact, both theories assert that governmental regulation should protect the public interest. The divergence is that public interest theory is a normative and prescriptive perspective which focuses on what regulation should achieve, whereas private interest theory is positive and explanatory which tries to depict and interpret the regulatory process in reality.⁶¹

For any national government, in order to consolidate its power, it is important to maintain public confidence and votes. To this end, a government must make efforts to fulfil the public interest. In this sense, the government's own interests are convergent with the public interest. However, regulatory mechanisms may be manipulated by government members and departments and industrial interest groups for their own interests, in which circumstances the pursuit of private interests will be contrary to the public interest. In reality, a government's regulatory activities are complex, which incorporate the pursuits of both the public interest and private interests. When a government enacts and implements its regulation to enhance the public interest, the processes of policy-making and

⁵⁵ Richard Posner, 'Theories of Economic Regulation' (n51) 337

⁵⁶ Ibid

⁵⁷ Bronwen Morgen and Karen Yeung, *An Introduction to Law and Regulation: Text and Materials* (n5) 43

⁵⁸ Richard Posner, 'Theories of Economic Regulation' (n51) 341; Weiping He, *Banking Regulation in China: The Role of Public and Private Sectors* (n7) 32

⁵⁹ Weiping He, *Banking Regulation in China: The Role of Public and Private Sectors* (n7) 32

⁶⁰ Bronwen Morgen and Karen Yeung, *An Introduction to Law and Regulation: Text and Materials* (n5) 44

⁶¹ Ibid, 17

implementation may be influenced by private interest pursuit. As a result, the government needs to make some compromises.

In terms of bankers' remuneration in the UK and China, the regulatory policies and practices have combined the considerations of both the public interest and private interests. This view, on the basis of a combination of public interest theory and private interest theory, will be discussed in depth in Chapter 9.

2.6 Theories About Institutional Change

The evolution of bankers' remuneration before the GFC, the emergence and enhancement of the regulation of bankers' remuneration, and the reforms in practice after the GFC, all come down to institutional changes. Economists and social scientists have developed a variety of thoughts and analyses in exploring the causes, processes and consequences of the observed institutional changes in economy, politics, legal system and social and cultural norms.

The theory of institutional change, developed by Douglass North, is one of the cornerstones of institutionalism studies. According to North, institutions are the structure that humans impose on themselves to interact with each other. Institutions determine the incentives, objectives and choices of individuals and organisations, which will shape the performance of the economy and society over time.⁶²

Institutions include both formal rules, such as constitutions, laws and property rights and informal standards and norms, such as conventions, customs, traditions, taboos, codes of conduct, and so on.⁶³ All institutions interact with each other and form the framework of constraints on individual behaviours. The framework determines the incentives for different kinds of individuals and organisations, which will direct them towards specific objectives. That is to say, the understanding of individuals and organisations about their best interests, as well as the resources and knowledge they can utilise and the actions they can take to maximise their interests, are all confined by the framework of existing institutions.⁶⁴ Therefore, the institutional framework is stable.

Nevertheless, North further pointed out that institutions are also overwhelmingly subject to incremental evolution.⁶⁵ In the process of gaining the resources and knowledge, individuals and organisations constantly interact with each other. The ongoing interaction would add marginal adjustments to the allocation of resources and the access to knowledge. Therefore,

⁶² Douglass C. North, 'Institutions' (1991) 5 (1) *The Journal of Economic Perspectives* 97, 97; Douglass C. North, *Institutions, Institutional Change and Economic Performance* (CUP 1990) 3

⁶³ Douglass C. North, *Institutions, Institutional Change and Economic Performance* (ibid) 3

⁶⁴ Douglass C. North, 'Institutions' (n62) 97

⁶⁵ Douglass C. North, *Institutions, Institutional Change and Economic Performance* (n62) 83

the prices and the bargaining strengths for different individuals and organisations to obtain a certain type of resources or knowledge will change. Moreover, the subjective perception of individuals and organisations about their best interests will be changing gradually. As a consequence, if some individuals and organisations are still able to realise welfare-maximisation within the existing institutional framework, they will continue to invest in the previous resources and knowledge. Nevertheless, it is possible that along with the accumulation of incremental changes, some individuals and organisations believe that the predicted payoffs by changing the institutional constraints will exceed the payoffs that they can secure by sticking to the existing framework.⁶⁶ Therefore, as North summarised, institutional change occurs in the course of the welfare-maximising activities of individuals and organisations on the basis of the existing institutions.⁶⁷

North's theory has been widely applied to interpret the changes in economic, political, legal and social institutions in different countries. It has two implications. First, the existing institutions play a significant role in directing the development of the institutions in the future. Second, apart from special circumstances such as war or revolution, normally institutional change is on an incremental and gradual basis. These statements form the view of path dependence, which is an important contribution of institutionalism studies.⁶⁸

The evolutions and reforms of bankers' remuneration in both the UK and China can also be analysed through the perspective of institutional change. The pre-crisis institutions of banking and corporate governance formed the existing institutional framework of bankers' remuneration. It shaped the interests and choices of different players in the practice of bankers' remuneration, including banks, bankers, investors, customers and governments. In the course of welfare-maximising, the allocation of resources through bankers' remuneration and the bargaining strengths to influence the decision-making of bankers' remuneration had been changing gradually and finally accumulated the problem that was exposed in the GFC. Therefore, some market players have urged the governments to seek institutional reforms on bankers' remuneration. Nevertheless, the impact of the existing institutions on the current reforms of bankers' remuneration is still profound and deep, showing the character of path dependence. As a consequence, the current reforms have been promoting on a gradual and incremental basis. Moreover, the existing institutions in different financial markets are different from each other, which result in the different directions and patterns of their current approaches.

All of the theories discussed above are based on the economic and business practices in industrialised countries. For transitional countries like China, these theories are also helpful

⁶⁶ Ibid, 79

⁶⁷ Ibid, 78-9 & 86

⁶⁸ David W. Galenson, 'Institutions, Institutional Change and Economic Performance by Douglass C. North' (1993) 41 (2) *Economic Development and Cultural Change* 419, 420

for understanding the direction and principles of the transitional reform. Nevertheless, they cannot comprehensively or realistically interpret the characteristics of the transitional economy and financial system.

Ronald McKinnon, based on the experience of the economic and financial liberalisation and modernisation processes in different transitional countries, including China, Russia, Eastern European countries, South Korea, Chile and others, has pointed out that the institutional transformation from a central planned economy to a liberal market economy must follow a gradual order. The national government in a transitional economy should not undertake all of the measures of liberalisation and modernisation simultaneously.⁶⁹ In particular, he has emphasised that the government must secure the control over the financial system at the very beginning of the reform and move moderately and cautiously to establish independent and modern commercial banks.⁷⁰ He has also compared the radical privatisation reforms in Russia and Eastern European countries and the gradualist approach in China and has spoken highly of the latter.

Indeed, China's reforms in all aspects of economy and business have been pushed forward in a gradual way. McKinnon's work theoretically highlights the essential characteristics of China's reforms. His angle will also be applied to analyse the modernisation and marketisation reform of bankers' remuneration in China.

2.7 Conclusion

This chapter has discussed the theories relevant to bankers' remuneration and its regulation. It has laid the theoretical foundation for the thesis.

First of all, the chapter has defined the core concepts in this thesis. A bank means a commercial bank or a universal bank with the function of commercial banking. However, the definition does not include an investment bank. The term 'banker' refers to executive directors and senior managers who have a material impact on banks' risk-taking activities. Remuneration refers to any sort of fixed and variable remuneration, while pensions, severance payments and golden parachutes are excluded. Regulation is defined in the broader context which includes both regulatory rules and the supervision of rule enforcement.

From a theoretical perspective, the chapter has emphasised the significant role of banks as the financial intermediaries in economic and social life. It has also discussed the essential characteristics of banks, including maturity mismatch, high leverage ratio and systemic intertwinement, which originate from the nature of banks' business. Due to these essential

⁶⁹ Ronald I. McKinnon, *The Order of Economic Liberalisation: Financial Control in the Transition to a Market Economy* (2nd edn, Johns Hopkins University Press 1993) 4

⁷⁰ *Ibid.*, 7

characteristics, banks are subject to liquidity risk, the risk of insolvency and systemic risk. Therefore, banking is inherently a high-risk industry. As banks are of crucial importance to economic development and social stability, in order to control these endogenous risks, it is necessary for governments to regulate banks' business and internal governance.

In the Anglo-American context, bankers' remuneration was practised in the same way as executive remuneration in non-financial companies, on the basis of agency theory and shareholder primacy. Bankers' remuneration was a corporate governance device to motivate bankers to act in the best interests of shareholders. However, after the GFC, this approach was criticised because it failed to take financial stability and the public interest into consideration. As a consequence, the alternative stakeholder theory which considers corporate governance as an approach to achieving the balance between different stakeholders' interests has become more convincing. The post-crisis decade has observed the theoretical shift from agency theory and shareholder primacy to stakeholder theory.

Stakeholder theory focuses on the interests of broad and diverse stakeholders that are associated with a company. This view is compatible with public interest theory which emphasises that the purpose of regulation is for the general welfare of the public. An alternative perspective is private interest theory which argues that any regulation is the consequence of individuals and groups pursuing their private interests. In fact, the focuses of the two theories are different. Public interest theory is a normative and prescriptive perspective which focuses on what regulation should achieve, whereas private interest theory is positive and explanatory which tries to depict and interpret the regulatory process in reality. Usually, the real regulatory activities are complex, which incorporate the pursuits of both the public interest and private interests.

The nature of legal and regulatory reform is institutional change. According to North, institutional change is subject to path dependence. It implies that existing institutions play a significant role in the direction of future institutional change and the change is on a gradual and incremental basis. McKinnon has applied the theory of institutional change to explain the economic and financial reforms in transitional countries. He has pointed out that transitional reforms must follow a gradualist approach rather than a radical one. The banking and financial reform in China is exactly consistent with the gradualist approach. Based on North's and McKinnon's theories, the thesis will provide an institutionalism perspective to analyse the regulatory reforms of bankers' remuneration in the UK and China.

In short, the theories that have introduced in this chapter form the theoretical framework of bankers' remuneration and its regulation. This framework will support the discussions in subsequent chapters.

Part II
The Regulation of Bankers' Remuneration in the UK

Chapter 3

UK Bankers' Remuneration in the Context of the Global Financial Crisis

3.1 Introduction

The meltdown of the US subprime mortgage market rapidly spread to the global financial markets and caused serious financial crises in many major economies. As a highly internationalised financial market and the home to one of the world's top financial centres, the UK also suffered from a very severe banking crisis. From 2007 to 2009, many major and important financial institutions in the UK failed or got trapped in financial difficulties. In 2007, the unprecedented bank run in British history since 1866 occurred in Northern Rock, leading to the collapse and the nationalisation of this bank.¹ This period also witnessed the failures of Royal Bank of Scotland (RBS), HBOS Group (HBOS), Lloyds Banking Group plc (Lloyds) and a number of building societies.² In order to rescue these failed banks, the UK government spent tremendous funds to bail out them.³ The banking crisis has led to substantial social-economic costs and years of recession of the UK's financial industry and national economy.

In the aftermath of the Crisis, the UK authorities launched a series of investigations into the causes of the bank failures. According to the government's official reports, the causes are multiple, including inefficient banking regulation, poor corporate governance, reckless and risky decision-making, and so on. These factors interacted with each other and finally contributed to the vulnerability of the UK banking sector.⁴ In particular, it has been found that bankers' remuneration was one of the main reasons for the reckless and excessive risk-taking activities in UK banks.⁵

This chapter will examine the problem of bankers' remuneration in the UK prior to the GFC, with the purpose to provide robust evidence and arguments to elucidate the causal relationship between bankers' remuneration and the Banking Crisis. It is organised as below. Section 3.2 reviews the UK Banking Crisis during 2007 to 2009. Section 3.3 probes into the details of bankers' remuneration practice and banks' risk-taking activities, in order

¹ 'Britain's Bank Run: The Bank That Failed' *The Economist* (London, 20 September 2007) <http://www.economist.com/node/9832838> accessed 9 February 2016

² A building society is a financial institution which is owned by its members as a mutual organisation. In the UK, a building society is established with the purpose of raising, primarily by subscriptions from members, a fund for making to them advances secured on land for the residential use. See Building Society Act 1986, Article 5(1)

³ HM Treasury, *A New Approach to Financial Regulation: Judgement, Focus and Stability* (CM7874, 2010) 3

⁴ HC Treasury Committee, *Banking Crisis: Dealing with the Failure of the UK Banks* (Seventh Report of Session 2008-09, HC416) 3; HM Treasury, *A New Approach to Financial Regulation: Building a Stronger System* (CM8012, 2007) 3

⁵ HC Treasury Committee, *Banking Crisis: Reforming Corporate Governance and Pay in the City* (Ninth Report of Session 2008-09, HC519) 3

to analyse the causal mechanism between bankers' remuneration and bank failures. Section 3.4 summarises the findings in this chapter.

3.2 The UK Banking Crisis During 2007 to 2009

3.2.1 'The Run on the Rock'

The bank run of Northern Rock was the most serious bank failure in the UK since the collapse of Barings Bank in 1995.⁶ It caused great consternation among depositors and enormous losses to the UK financial sector and national economy.

Northern Rock converted from a building society to a listed bank in October 1997.⁷ During the ten-year period since its demutualisation, the bank developed rapidly. Its total assets surged from GBP 17.4 billion to GBP 113.5 billion, at the average rate of 15% - 20% per year. Before the GFC, it became the fifth largest residential mortgages provider in the UK.⁸

However, at that time no one would foresee that behind Northern Rock's remarkable prosperity there were serious risks.

To expand, Northern Rock had developed a very special business model which relied heavily on residential mortgages and the wholesale markets of inter-bank lending and securitisation. By the end of 2006, 89.2% of its assets were from residential mortgages.⁹ This kind of loan structure made the bank seriously exposed to the risk of default and liquidity risk because loans provided for residential properties are usually in huge amounts and long terms. To create liquidity and profits, Northern Rock largely used the vehicle of mortgage securitisation. Therefore, pools of mortgages were packaged up as bonds and sold to the investors in wholesale markets.¹⁰ If used properly, the vehicle of securitisation will not generate high risks, while bringing substantial benefits.¹¹ However, it was almost Northern Rock's only source of funding to finance its lending. Before the bank run, 60% of Northern Rock's funding was gathered through mortgage securitisation, and 25% was from traditional wholesale borrowings, such as inter-bank lending.¹² Northern Rock relied heavily on wholesale markets. In contrast, very limited funding was obtained from retail

⁶ Andrew Campbell, 'Northern Rock, the Financial Crisis and the Special Resolution Regime' in Joanna Gray and Orkun Akseli (eds), *Financial Regulation in Crisis? The Role of Law and the Failure of Northern Rock* (Edward Elgar 2011) 39, 39

⁷ National Audit Office (NAO), *The Nationalisation of Northern Rock* (Session 2008-09, HC 298) 13

⁸ Matej Marinč and Razvan Vlahu, *The Economics of Bank Bankruptcy Law* (Springer 2012)139; HC Treasury Committee, *The Run on the Rock* (Fifth Report of Session 2007-08, HC 56-I) 11

⁹ HC Treasury Committee, *The Run on the Rock* (ibid) 12

¹⁰ 'Why Northern Rock Was Doomed to Fail' *The Telegraph* (London, 16 September 2007) <http://www.telegraph.co.uk/finance/markets/2815859/Why-Northern-Rock-was-doomed-to-fail.html> accessed 24 April 2017

¹¹ Ibid

¹² HC Treasury Committee, *The Run on the Rock* (n8) 13

deposits. Compared to wholesale funding, retail deposits are more costly, while also steadier and safer.¹³

Therefore, Northern Rock's business structure was highly risky. It was exposed to the risks in the global securitisation markets. In August 2007, the credit crisis in the US subprime mortgage market spread to the asset-backed securities in other financial markets and resulted in serious illiquidity. As a consequence, many banks ceased their lending to each other to isolate risks.¹⁴ When Northern Rock was struggling to find liquidity to pay for its mature borrowings, almost all of the wholesale markets simultaneously closed. In the face of a liquidity crisis, Northern Rock resorted to the Bank of England (BoE) for emergent support. On 14 September 2007, Northern Rock received the liquidity facility from the BoE. However, the BoE announced this information to the public, which led to serious panic among Northern Rock's depositors, who were in anxiety to withdraw their deposits.¹⁵ Up to 17 September 2007, retail depositors withdrew around 20% of Northern Rock's retail deposits (GBP 4.6 billion). The bank run made Northern Rock's situation even worse. Its share price sharply fell by 56% and completely destroyed market confidence.¹⁶

Finally, the HM Treasury had to take measures to stabilise the bank and the financial market. It first offered GBP 120 billion guarantees and then sought for private buyers for Northern Rock.¹⁷ After all the endeavours to sell Northern Rock to the private sector failed, the Treasury had to nationalise it to mitigate the uncertainties and influence of its failure.¹⁸

Northern Rock's collapse also contributed to the disasters of other financial institutions. Bradford & Bingley and Alliance & Leicester, the two closest comparators with Northern Rock, also experienced financial difficulties and their share prices significantly declined.¹⁹ In the end, these two financial institutions were also nationalised or purchased by other banks.

According to the UK Parliament, the bank's risky business model was the primary cause of its failure. Furthermore, the reckless and risky strategies were due to the decisions made by the bank's directors. As a result, the poor corporate governance system and the incentive

¹³ Paul Goldsmith-Pinkham and Tanju Yorulmazer, 'Liquidity, Bank Runs, and Bailouts: Spillover Effects During the Northern Rock Episode' (2010) 37 (2-3) *Journal of Financial Services Research* 83, 86; Kevin Keasey and Gianluca Veronesi, 'Lessons from the Northern Rock Affair' (2008) 16 (1) *Journal of Financial Regulation and Compliance* 8, 10; 'Lessons of the Fall' *The Economist* (London, 18 October 2007) <http://www.economist.com/node/9988865> accessed 24 April 2017

¹⁴ NAO, *The Nationalisation of Northern Rock* (n7) 4

¹⁵ HC Treasury Committee, *The Run on the Rock* (n8) 72; 'Britain's Bank Run: The Bank That Failed' (n1)

¹⁶ NAO, *The Nationalisation of Northern Rock* (n7) 15

¹⁷ The three rounds of guarantees included: the Initial Treasury Guarantees (from 17 September to 8 October 2007), the Expansion of Treasury Guarantees (from 9 October to 17 December 2007) and the Further Expansion of Treasury Guarantees (from 18 December 2007 to 22 February 2008). See HC Treasury Committee, *The Run on the Rock* (n8) 124-62

¹⁸ NAO, *The Nationalisation of Northern Rock* (n7) 29

¹⁹ *Ibid*, 17

mechanism for bankers should be criticised and carefully examined.²⁰ The failure of Northern Rock alarmed the UK authorities to scrutinise the problems in bank corporate governance and find out the essential factors that generated excessive risk-taking.

3.2.2 The Bailout of RBS

RBS is a large, major British bank with a long history since 1727. It has various businesses all over the world. The pre-crisis period observed the bank's dramatic growth. In 2007 and 2008, RBS ranked as the largest bank by assets and the fifth largest bank by market capitalisation in the world.²¹

The rise of RBS was based on its aggressive expansion through global merger and acquisition. Since 2000, RBS acquired many financial institutions, including large banking groups, such as NatWest, and a variety of small businesses in investment banking and insurance.²² The merger and acquisition strategy increased the quantity of the bank's total assets and expanded its businesses. However, in fact, it did more harm than good to the bank. It deteriorated the bank's assets quality, reduced its capital adequacy ratio and made the bank more exposed to the systemic risk in the global financial markets.

For instance, RBS took over a US lender called Greenwich Capital. This financial institution was exposed to subprime losses. Thus, the takeover significantly contributed to the failure of RBS.²³ Moreover, to support acquisitions, RBS primarily raised funding through debt financing, especially short-term wholesale borrowings. In comparison to other financing methods, such as equity capital or deposits, short-term wholesale borrowings are quick and cheap. However, they are riskier. Similar to Northern Rock, when the credit crisis occurred, too much reliance on wholesale markets exponentially increased the liquidity risk in RBS. Moreover, taking too many debts led to the deterioration of the bank's capital adequacy. In 2007, to complete the acquisition of a large Dutch bank ABN AMRO, RBS resorted to short-term wholesale markets.²⁴ As a result, its common equity tier 1 (CET 1)

²⁰ HC Treasury Committee, *The Run on the Rock* (n8) 18-9

²¹ 'The World's Largest Banks 2008' (*Global Finance*, 04 August 2009) <https://www.gfmag.com/awards-rankings/best-banks-and-financial-rankings/the-worlds-biggest-banks-2008-> accessed 20 February 2016; 'The World's Largest Banks 2009' (*Global Finance*, 19 October 2009) <https://www.gfmag.com/awards-rankings/best-banks-and-financial-rankings/worlds-biggest-banks-2009> accessed 20 February 2016; HC Treasury Committee, *The FSA's Report into the Failure of RBS* (Fifth Report of Session 2012-13, HC 640) 3

²² HC Treasury Committee, *Banking Crisis: Dealing with the Failure of the UK Banks* (n4) 18; Gordon Rayner, 'Banking Bailout: The Rise and Fall of RBS' *The Telegraph* (London, 20 January 2009) <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/4291807/Banking-bailout-The-rise-and-fall-of-RBS.html> accessed 20 February 2016

²³ HC Treasury Committee, *Banking Crisis: Dealing with the Failure of the UK Banks* (n4) 18

²⁴ FSA, *The Failure of the Royal Bank of Scotland* (December 2011) 23

ratio was only about 2% at the end of 2007,²⁵ which was far lower than the 4.5% minimum standard stipulated by the BCBS after the GFC.²⁶

Due to the heavy dependence on short-term wholesale markets and the low capital adequacy ratio, RBS was trapped in illiquidity in October 2008.²⁷ It had to resort to the Emergency Liquidity Assistance offered by the BoE to liquid itself temporarily. To prevent the then largest British bank from melting down, the UK government finally decided to bail out RBS by recapitalising it with GBP 45.5 billion new equity. After the capital injection, the UK government became the majority shareholder of RBS with 57.9% of its shares.²⁸ The nationalisation saved RBS from turning into a catastrophe to the UK financial system. Nevertheless, it still caused tremendous losses. From 2008 to 2017, the market value of the injected capital has declined to only GBP 17 billion.²⁹

The failure of RBS also resulted from its aggressive and greedy strategies and the deficient risk management.³⁰ In particular, the FSA attributed the failure to the excessive risks taken by reckless and over-confident executives. It criticised the poor management system and incentive mechanism in RBS and recommended to impose legal sanctions on bankers for the breach of due diligence and regulate the remuneration incentives for bankers.³¹

3.2.3 The Acquisition of HBOS and the Bailout of Lloyds

Lloyds is one of the ‘Big Four’ banking groups in the UK.³² Unlike Northern Rock and RBS, Lloyds did not rely heavily on global securitisation or wholesale funding. Instead, retail banking was its best-developed arm. Therefore, originally Lloyds had a relatively robust business structure which helped it maintain a strong liquidity position and the resilience to the US subprime crisis.³³ However, the decision to take over HBOS, another banking group in the UK which was seriously hit by the GFC, directly induced the failure of Lloyds.

Similar to the business models of Northern Rock and RBS, HBOS also adopted an ambitious approach of growing before the GFC. In 2001, HBOS was established following the merger of Halifax plc and the Bank of Scotland. Since then, HBOS launched expansionary strategies for rapid growth. On the one hand, it set up a series of aggressive financial targets, such as taking 15%-20% market shares in all the key markets and

²⁵ Ibid, 22

²⁶ BCBS, *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* (Revised Version, June 2011) 13

²⁷ FSA, *The Failure of the Royal Bank of Scotland* (n24) 13

²⁸ Ibid, 57

²⁹ The figure is calculated by the author according to the share price and market capital of RBS in April 2017.

³⁰ FSA, *The Failure of the Royal Bank of Scotland* (n24) 23

³¹ Ibid, 251

³² The UK ‘Big Four’ banks usually refer to Barclays Bank plc (Barclays), HSBC Bank plc (HSBC), RBS and Lloyds.

³³ HC Treasury Committee, *Banking Crisis: Dealing with the Failure of the UK Banks* (n4) 26

achieving 20% Return on Equity (ROE).³⁴ To realise these targets, HBOS continuously increased its corporate lending scale, regardless of borrowers' debt-paying abilities. On the other hand, to control costs, it relied predominantly on debt-financing through short-term wholesale borrowings.³⁵ From 2003 to 2007, its total assets increased by 63% and its total debts doubled, which embedded huge risks.

When the international inter-banking liquidity level dramatically declined due to the bankruptcy of Lehman Brothers, many short-term borrowings of HBOS became mature. As a result, the bank was confronted with the same trouble experienced by Northern Rock. Since late September 2008, HBOS suffered from serious illiquidity and substantial outflows of deposits.³⁶ Without any solution for funding, HBOS had to announce that it failed to meet its liabilities. At the same time, it started to discuss with Lloyds TSB Group (Lloyds TSB) in respect to the acquisition.³⁷

Lloyds TSB wanted to get 'a strong insurance arm and a Scottish presence' through this acquisition.³⁸ In terms of the poor financial situation of HBOS, the top managers in Lloyds confidently believed that the pain brought by the acquisition was temporary and it would be 'a good purchase' for the shareholders in a couple of years.³⁹ However, what the acquisition brought to Lloyds TSB was neither a strong insurance arm nor a Scottish presence. Instead, it was the danger of collapse. In 2008, HBOS recorded a loss of GBP 10,825 million, whereas the profits earned by Lloyds was only GBP 807 million. Therefore, Lloyds was also trapped in financial difficulties following its acquisition of HBOS. The situation damaged market confidence. Thus, Lloyds failed to raise any more capital from private investors and had to accept the GBP 17 billion rescue package provided by the UK government.⁴⁰

When examining the corporate governance models, in particular, the decision-making processes of HBOS and Lloyds, the similar problems in Northern Rock and RBS were found. For instance, HBOS had developed a corporate governance culture which prioritised

³⁴ ROE is the ratio between net income and shareholders' equity. The formula is: $ROE = \frac{Net\ Income}{Shareholders' Equity}$. 'Definition of ROE' (*Financial Times Lexicon*) <http://lexicon.ft.com/Term?term=return-on-equity--roe> accessed 9 May 2017.

³⁵ HC Treasury Committee, *Banking Crisis: Dealing with the Failure of the UK Banks* (n4) 24; FCA and PRA, *The Failure of HBOS plc* (November 2015) 18-28

³⁶ FCA and PRA, *The Failure of HBOS plc* (ibid) 22

³⁷ After the acquisition of HBOS, Lloyds TBS Group changed into Lloyds Banking Group, see ibid, 22.

³⁸ HBOS had a significant share in the Scottish banking market and an extensive insurance customer base. See FCA and PRA, *The Failure of HBOS plc* (n35) 16; HC Treasury Committee, *Banking Crisis: Dealing with the Failure of the UK Banks* (n4) 52

³⁹ Ibid

⁴⁰ Angela Monaghan, 'Lloyds Banking Group Timeline: From Bailout to Government Sale' *The Guardian* (London, 17 September 2013) <http://www.theguardian.com/business/2013/sep/17/lloyds-banking-group-from-bailout-to-selloff> accessed 21 February 2016

business expansion over risk management.⁴¹ Executives focused on the growth of assets scale, short-term profits and shareholder returns because these financial indicators were decisive to the assessments of their performance and their remuneration packages. As a result, risk management was given insufficient time, attention and priority by the board.⁴² In respect to the acquisition of HBOS, the then CEO of Lloyds admitted that the responsibility lay primarily with the bank's board as they failed to perform with sufficient due diligence. On the contrary, they were unduly optimistic about the prospects after the acquisition. Therefore, the cases of HBOS and Lloyds also demonstrated that the bank failures were largely attributed to the corporate governance systems and the remuneration incentives for bankers.

3.2.4 The Impact of the UK Banking Crisis

The impact of the UK Banking Crisis is deep and severe. It resulted in extensive turmoil in the banking sector, heavily hit the UK's financial industry and economy, and generated grievous damages to the public.

First, before the Crisis, 48% of the funding of UK banks was wholesale-based.⁴³ Due to the contagion effect, the Banking Crisis paralysed the entire banking system and depressed the UK financial industry.⁴⁴ Apart from the aforementioned bank failures, there were also many smaller banks and building societies in the UK collapsed. They were either bailed out by the government or acquired by the private sector. These failed financial institutions are listed in Table 3.1.

Table 3.1 The UK Smaller Banks and Building Societies Failed During the GFC⁴⁵

Institution	Result	Date
Catholic Building Society	Private acquisition	June 2008
Alliance & Leicester	Private acquisition	July 2008
Derbyshire Building Society	Private acquisition	September 2008
Cheshire Building Society	Private acquisition	September 2008
Bradford & Bingley	Government bailout and private acquisition	September 2008
Barnsley Building Society	Private acquisition	October 2008
Scarborough Building Society	Private acquisition	November 2008
Dunfermline Building Society	Private acquisition	March 2009
Chesham Building Society	Private acquisition	February 2010

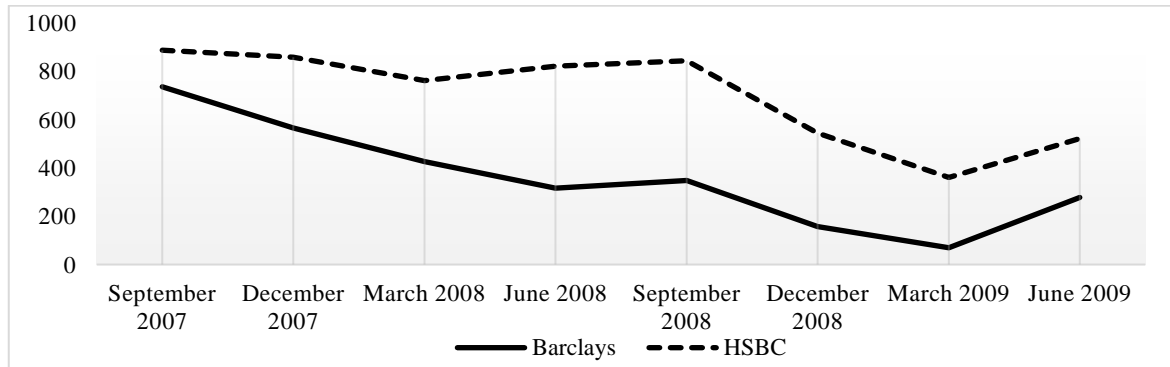
⁴¹ FCA and PRA, *The Failure of HBOS plc* (n35) 31

⁴² Ibid, 29

⁴³ Mimoza Shabani *et al*, 'The Financial System in the UK' (2015) FESSUD Studies in Financial Systems No.4 <http://fessud.eu/studies-in-financial-systems/> accessed 14 April 2017, 59

⁴⁴ Paul Goldsmith-Pinkham and Tanju Yorulmazer, 'Liquidity, Bank Runs, and Bailouts: Spillover Effects During the Northern Rock Episode' (n13) 84

⁴⁵ The table is made by the author in line with the 'List of Banks Acquired or Bankrupted During the Great Recession' in Wikipedia, see https://en.wikipedia.org/wiki/List_of_banks_acquired_or_bankrupted_during_the_Great_Recession accessed 28 April 2017

Figure 3.1 The Share Prices of Barclays and HSBC from 2007 to 2009 (Unit: Pence)⁴⁶

Many major, important UK banks, such as Barclays and HSBC, also experienced long and serious downturns, though they survived the Crisis without resorting to governmental rescue. Figure 3.1 shows the dramatic decline in the share prices of Barclays and HSBC, which started following the bank run of Northern Rock. For instance, the share price of Barclays was nearly 800 pence at the beginning of the Crisis but plummeted down to only 51 pence in early 2009. The profitability of the two banks was also substantially diminished. In 2008, the pre-tax profit of HSBC reduced by 62%, its Earnings per Share (EPS)⁴⁷ shrank by 72%, and its ROE dropped from 15.9% to only 4.7%.⁴⁸

From September to October 2008, the LIBOR rates, which are the interbank interest rates of certain UK banks showing their willingness to lend to each other, suddenly surged to the highest record in history.⁴⁹ It demonstrated that the confidence of banks in each other was destroyed and the UK wholesale banking market was paralysed.

Moreover, the Banking Crisis has led to years of recession of the UK's economy. After the GFC, the UK's economy suffered from six consecutive quarters' negative growth, which was the longest post-crisis recession among the G7 economies and the most serious downturn in the UK since the World War II.⁵⁰ As shown in Figure 3.2, the sharpest fall in GDP growth occurred in the first half of 2009 by - 4.0%, which was the lowest growth rate

⁴⁶ This is designed by the author according to the historical data of the share prices of Barclays and HSBC. The data of Barclays' share price is available at: 'Barclays Share Price Chart' (*Barclays website*) <https://www.home.barclays/barclays-investor-relations/share-price-and-dividends.html> accessed 28 April 2017. The data of HSBC's share price is available at: 'Equities: HSBC Holdings PLC' (*Financial Times*) <https://markets.ft.com/data/equities/tearsheet/charts?s=HSBA:LSE> accessed 3 January 2018

⁴⁷ Earnings per Share (EPS) is the portion of a company's profits allocated to each outstanding share of common stock. The formula is: $EPS = \frac{Net\ Income - Dividend\ on\ Preferred\ Stock}{Average\ Outstanding\ Shares}$

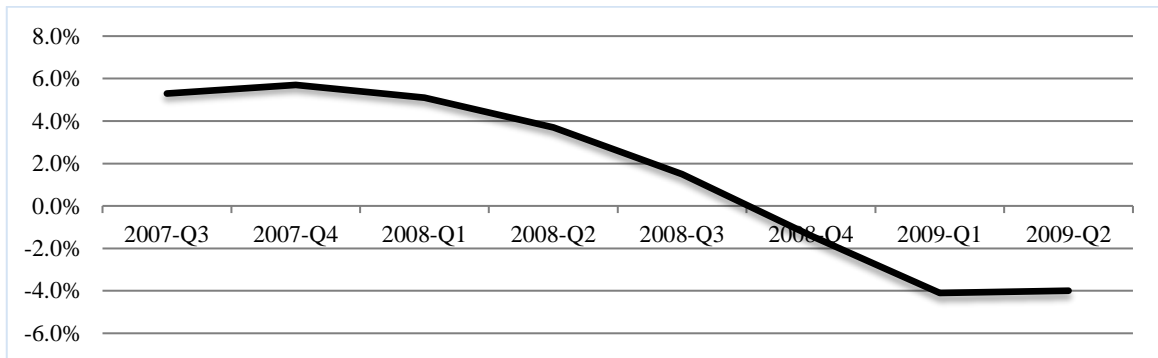
⁴⁸ See HSBC Annual Report 2008, 2

⁴⁹ Angela Monaghan, 'Financial Crisis: Libor Hits Record Level as Confidence Evaporates' *The Telegraph* (London, 30 September 2008) <http://www.telegraph.co.uk/finance/financialcrisis/3112354/Financial-crisis-Libor-hits-record-level-as-confidence-evaporates.html> accessed 28 April 2017

⁵⁰ From 2008 to 2009, the UK's GDP kept negative growth for 18 months. Grahame Allen, 'Recession and Recovery: Key Issues for the 2010 Parliament' (2010) HC Library Research <http://www.parliament.uk/business/publications/research/key-issues-for-the-new-parliament/economic-recovery/recovery-from-recession/> accessed 9 February 2016

since the official records began in 1949.⁵¹ After the sharp decline, the UK economy started to experience the long-term stagnation. The post-crisis decade has been described as the slowest recovery in modern British economic history, which was even slower than the recovery after the Great Depression.⁵²

Figure 3.2 The UK GDP Growth Rate by Quarter from 2007 to 2009⁵³



The slowdown affected all sectors of the economy.⁵⁴ For instance, in the property market, according to the FTSE EPRA/NAREIT UK Index, the total return dropped to - 35.1% and - 42.9% in 2007 and 2008 respectively.⁵⁵

The Banking Crisis also generated tremendous costs to the public. In order to prevent the UK banking sector from melting down, the government launched several rounds of capital injections to bail out the failed banks. In 2008 and 2009, the UK government issued two rounds of Bank Rescue Packages. Besides, there was temporary funding paid from the BoE's Emergency Liquidity Assistance and other rescue programmes. It has been estimated that by the end of 2009, the UK government spent at least GBP 850 billion to save the banking sector.⁵⁶ Undoubtedly, the tremendous costs were finally borne by taxpayers.

The banking collapse also resulted in the increase of unemployment. In the labour market, the number of unemployed people increased by 290,000 at the end of 2008, and the total

⁵¹ Ibid

⁵² Jon Cunliffe, 'The UK Economy post Crisis: A Series of Unfortunate Events?' The Speech at the Centre for International Business Studies, London South Bank University (London, 24 February 2016) <https://www.bankofengland.co.uk/speech/2016/the-uk-economy-post-crisis-a-series-of-unfortunate-events> accessed 28 April 2017

⁵³ The figure is designed by the author in accordance with the data of the UK's GDP provided by the Office for National Statistics. See 'The UK's GDP' (GOV.UK) <https://www.ons.gov.uk/economy/grossdomesticproductgdp/timeseries/ihyo/qna> accessed 28 April 2017

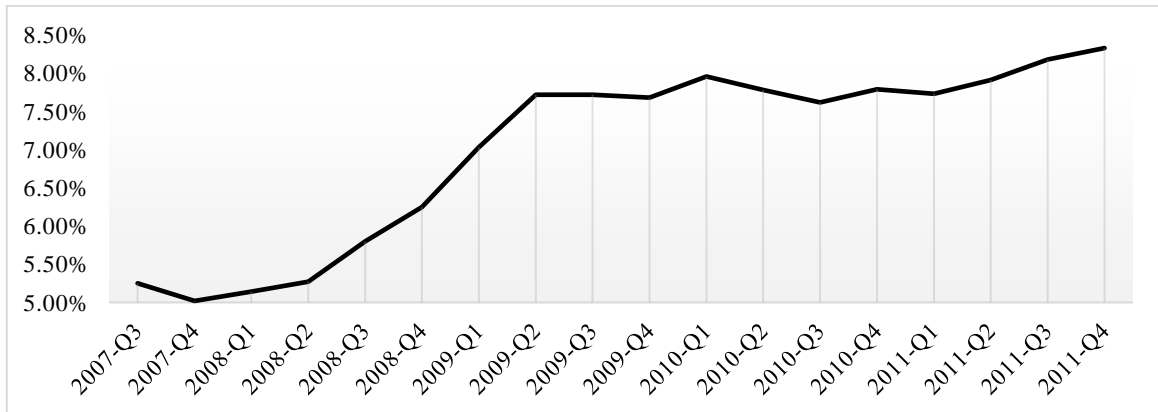
⁵⁴ Ibid

⁵⁵ The FTSE EPRA/NAREIT UK Index belongs to the Global Real Estate Index Series, which represents the general trends in eligible real estate equities worldwide. The data is collected from 'The FTSE Factsheet of the FTSE EPRA/NAREIT UK Index' (FTSE Russell) <http://www.ftse.com/Analytics/FactSheets/Home/> accessed 29 April 2017

⁵⁶ Andrew Grice, '£850 Billion: Official Cost of the Bank Bailout' *Independent* (London, 4 December 2009) <http://www.independent.co.uk/news/uk/politics/163850bn-official-cost-of-the-bank-bailout-1833830.html> accessed 28 April 2017

unemployed population reached 1.92 million, which was the highest figure since 1997.⁵⁷ More seriously, from mid-2007 until the end of 2011, the unemployment rate kept growing from 5.02% to 8.33%.

Figure 3.3 The UK Unemployment Rate from 2007 to 2011⁵⁸



In short, the consequences of the UK Banking Crisis were injurious, and the lessons of the bank failures are still painful. In order to prevent similar disasters in the future, the UK government has launched the overhaul of banking regulation.

3.3 Bankers' Remuneration as a Cause of the Banking Crisis

Before the GFC, the failed UK banks adopted aggressive and expansionary strategies which focused on rapid assets growth and tight costs control, while at the expense of banks' stability. These strategies were due to the reckless and risky decisions made by bankers. According to the UK government's investigations, banks' corporate governance cultures, especially the remuneration systems incentivised bankers to take excessive risks.

After the GFC, it has been widely acknowledged that bankers' remuneration contributed to bank failures. Nevertheless, the causal mechanism of how the pre-crisis bankers' remuneration arrangements affected banks' risk-taking and stability still remains unclear. Among previous academic discussions, there have been some studies trying to provide theoretical interpretations. However, there is no robust empirical evidence. Based on the empirical evidence of the remuneration practices of major UK banks and previous theoretical studies, this section will reveal the causal mechanism between bankers' remuneration and bank failures.

⁵⁷ Alastair Adair *et al*, 'The Global Financial Crisis: Impact on Property Markets in the UK and Ireland' (2009) University of Ulster Real Estate Initiative Research Team Report https://www.researchgate.net/publication/253951034_The_Global_Financial_Crisis_Impact_on_Property_Markets_in_the_UK_and_Ireland accessed 22 February 2016, 11

⁵⁸ The figure is designed by the author in accordance with the data of the UK's unemployment rate provided by the OECD. See 'The UK's Unemployment' (OECD website) <https://data.oecd.org/unemp/unemployment-rate.htm> accessed 28 April 2017

3.3.1 The Level of Bankers' Remuneration Before the GFC

The Banking Crisis evoked strong public condemnation on the level of bankers' remuneration.⁵⁹ Before the GFC, the problem of income inequality had been a long-term social concern in the UK. The fast development of the financial industry had induced the surge of top incomes in this industry and significantly enlarged the income gap between financial companies' CEOs and ordinary workmen.⁶⁰ Since the GFC, public concern on income inequality has increased.

What was the level of bankers' total remuneration in the UK prior to the GFC?

It is by no means easy to calculate the exact amounts earned by bankers because a substantial part of their remuneration is not paid in cash or in kind, instead, it is in ordinary shares, share options or other equity-based awards, the actual value of which usually fluctuates with the bank's share price. Moreover, after share options have been realised, bankers have the freedom to choose to either keep them as share options for several years longer or immediately exercise them, namely, convert them into ordinary shares.⁶¹ Thus, before they exercise the share options, it is impossible to calculate the exact value. Moreover, there are deferred arrangements in banks' equity-based remuneration schemes. The deferred quantity of shares or the deferred amount of awards is usually pending. How much bankers will be paid at the end depends on whether and to what extent they can fulfil the conditions and targets attached to the deferred remuneration.

Therefore, the author estimates the total amounts of bankers' remuneration on a conservative basis. In a specific financial year, only the parts that have been turned into cash or shares and materially disposable by bankers will be calculated into their annual earnings. The method ensures that the outcome represents the minimum possible earnings made by bankers. That is to say, the actual amounts must be higher than the estimated. Therefore, if the estimated level of bankers' remuneration is significantly higher than the level of average salary in the UK, it means that the real income gap must be worse.

Figure 3.4 shows the average annual total remuneration of the executive directors in the UK 'Big Four' banks, i.e. HSBC, Barclays, RBS and Lloyds. These four banks are the largest

⁵⁹ Tim Edmonds and Phil Abraham, 'Banking Executives' Remuneration in the UK' (2017) HC Briefing Paper No.06204 <http://researchbriefings.parliament.uk/ResearchBriefing/Summary/SN06204> accessed 2 January 2017, 3

⁶⁰ Carlo Panico and Antonio Pinto, 'Income Distribution and the Size of the Financial Sector' (2015) Centro Sraffa Working Papers <http://www.centrosraffa.org/public/578e8e62-7b03-4810-8021-4b33a74db71b.pdf> accessed 18 May 2016, 18; Basak Kus, 'Financialisation and Income Inequality in OECD Countries: 1995 - 2007' (2012) 43 (4) *The Economic and Social Review* 477, 477; Martin Williams, 'Finance Industry Wages Rise Faster Than Any Other Sector' *The Guardian* (London, 26 February 2013) <http://www.theguardian.com/careers/finance-industry-wages-earnings> accessed 18 May 2016

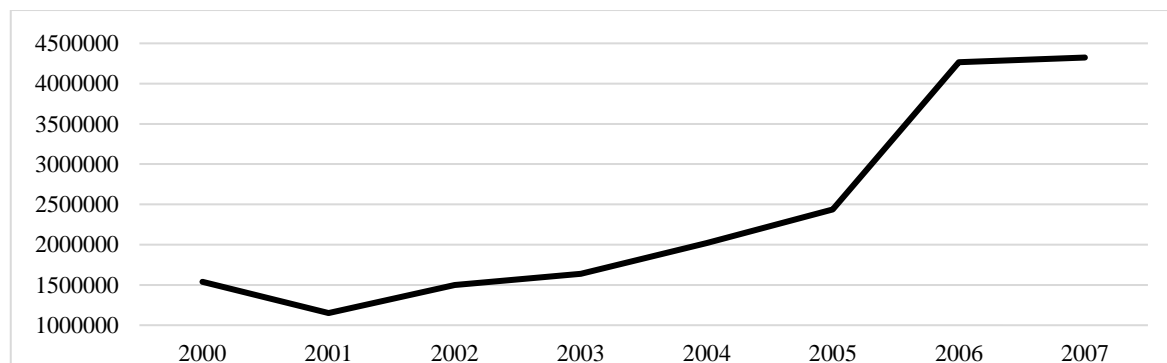
⁶¹ The operational mechanisms of these equity-based remuneration schemes will be explained in Subsection 3.3.2.

and most important banks in the UK. Thus, their models and cultures of remuneration incentives are representative.

During the eight years before the GFC, the total amounts of bankers' remuneration had been growing rapidly. From 2000 to 2004, the average level increased from GBP 1.5 million to GBP 2 million. From 2005 to 2007, it surged to more than GBP 4 million. The reason for the surge was that during this period the banks largely increased cash bonuses for bankers and many of their shares allocated in previous equity-based remuneration schemes were realised.

As just mentioned, the real earnings were higher than the estimated figures. For instance, Fred Goodwin, one of the executive directors in RBS, gained GBP 4.19 million in cash as his fixed pay and bonuses in 2007. Besides, he exercised a portion of share options amounting to GBP 1.06 million. In addition, he still held a great number of exercisable share options, and awards in the form of ordinary shares. If we use the share price of RBS on 31 December 2007 (GBP 4.44) as the benchmark to evaluate these benefits, the amount would be GBP 2.45 million.⁶² However, since these options and awards had not been exercised by the end of 2007, the value was not included.

Figure 3.4 The Average Level of Bankers' Remuneration in the UK 'Big Four' Banks from 2000 to 2007 (Unit: Great Britain Pound (GBP))⁶³



What was the gap between the level of bankers' remuneration and the level of average salary?

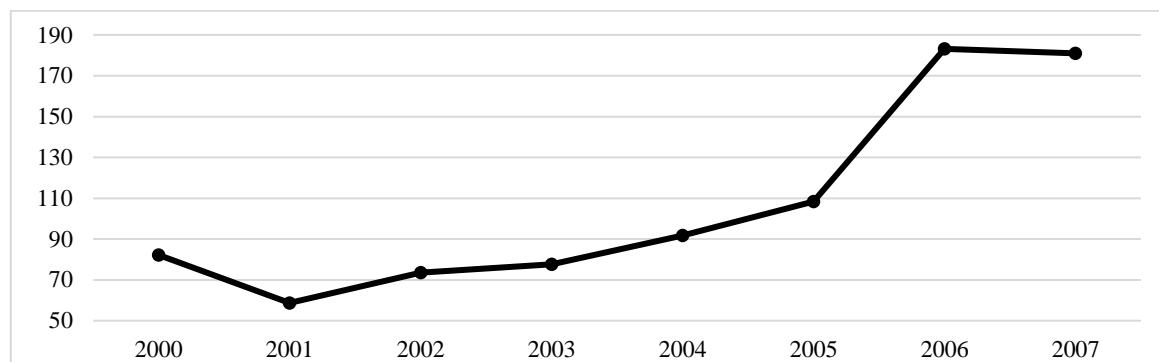
During the pre-crisis period, the average annual salary of ordinary workers in the UK also kept growing, while far slower than bankers' remuneration. Therefore, the gap between bankers' remuneration and the average salary was enormous. More seriously, the surge of bankers' remuneration since 2005 significantly amplified the gap. Before 2005, the remuneration of top bankers was 60 to 100 times of the average salary. In 2006 and 2007, the gap increased to 180 times. From the perspective of social justice, the income gap

⁶² RBS Annual Report 2007, 111-2

⁶³ The original data, the process and criteria of data collection and the calculation methods are available in Appendix A.

between financial elites and ordinary workers had been more and more enlarged. Thus, people tended to attribute the problem of income inequality to the ‘sky high’ level of bankers’ remuneration.⁶⁴

Figure 3.5 The Gap Between Bankers’ Remuneration and the Average Annual Salary in the UK from 2000 to 2007 (Unit: Multiple)⁶⁵



Moreover, the public irritation at the high level of bankers’ remuneration was also due to the tremendous losses and rescue funding caused by bankers’ poor decisions. Bankers should be directly responsible for their reckless and risky decisions which led to the banks’ failures. However, the fact was that they still enjoyed enormous remuneration during and after the Crisis, whereas massive innocent taxpayers paid for the failures.⁶⁶ As a consequence, there have been serious ‘unfair and discomfort’ emotions among the public.⁶⁷ In their eyes, bankers were ‘rewarded for failures’.

⁶⁴ Oliver Denk, ‘Financial Sector Pay and Labour Income Inequality: Evidence from Europe’ (2015) OECD Economics Department Working Papers No. 1225 http://www.oecd-ilibrary.org/economics/financial-sector-pay-and-labour-income-inequality_5js04v5wjw9p-en accessed 1 May 2017, 8; Brian Bell and John Van Reenen, ‘Bankers’ Pay and Extreme Wage Inequality in the UK’ LSE Centre for Economic Performance Special Papers CEPSP2 <http://eprints.lse.ac.uk/28780/> accessed 1 May 2017, 3; Basak Kus, ‘Financialisation and Income Inequality in OECD Countries: 1995 - 2007’ (n60) 485; Natalie Sabadish and Lawrence Mishel, ‘CEO Pay and the Top 1%: How Executive Compensation and Financial-sector Pay Have Fuelled Income Inequality’ (*Economic Policy Institute*, 2 May 2012) <http://www.epi.org/publication/ib331-ceo-pay-top-1-percent/> accessed 1 May 2017

⁶⁵ The data of average salary levels from 2000 to 2007 is calculated by the author in accordance with the formula: $Annual\ Average\ Salary = \frac{Median\ Full-time\ Gross\ Weekly\ Earnings}{7} \times 365$. The data of the median full-time gross weekly earnings is collected from: David Bovill, ‘Patterns of Pay: Estimates from the Annual Survey of Hours and Earnings, UK, 1997 to 2013’ (2014) The Office for National Statistics Publication http://webarchive.nationalarchives.gov.uk/20160105160709/http://www.ons.gov.uk/ons/dcp171766_353368.pdf accessed 1 May 2017. Please refer to the excel document attached to page 4 of this publication.

⁶⁶ The public irritation at the high level of bankers’ remuneration can be reflected by the massive news articles published by financial media. Julia Werdigier, ‘Public Anger Has British Bankers Fretting About Bonuses’ *The New York Times* (London, 26 November 2010) <http://query.nytimes.com/gst/fullpage.html?res=9907E4DA123CF935A15752C1A9669D8B63> accessed 13 December 2017; ‘Brown ‘Very Angry’ About Bonuses’ *BBC News* (London, 09 February 2009) http://news.bbc.co.uk/1/hi/uk_politics/7878418.stm accessed 7 July 2015; ‘Former Banking Bosses Say ‘Sorry’’ *BBC News* (London, 10 February 2009) <http://news.bbc.co.uk/1/hi/business/7880292.stm> accessed 7 July 2015; ‘Britain’s Bank Run: The Bank That failed’ (n1)

⁶⁷ HC Treasury Committee, *Banking Crisis: Reforming Corporate Governance and Pay in the City* (n5) 36; Charlotte Villiers, ‘Controlling Executive Pay: Institutional Investors or Distributive Justice’ (2010) 10 (2) *Journal of Corporate Law Studies* 309, 310

The public irritation is understandable. Nevertheless, it does not mean that their understanding is a reasonable explanation of the causal relationship between bankers' remuneration and the Banking Crisis, or a sufficient justification for regulatory intervention in bankers' remuneration. According to the public, the problem of bankers' remuneration lies in the 'sky high' level: the huge amounts of remuneration made bankers negligent, lazy, selfish and irresponsible and caused the problems in banks' operations.⁶⁸ However, this statement remains vague. To find out how bankers were incentivised by their remuneration packages to take reckless and risky strategies, the examination of remuneration level is not enough. More work on the components and structure, and the incentive mechanism of bankers' remuneration is needed. Nevertheless, the public condemnation on bankers' remuneration level has imposed massive pressure on the UK government and attracted extensive attention from academics. Namely, the public has pushed forward the investigations into the problem of bankers' remuneration.

3.3.2 The Components and Structure of Bankers' Remuneration Before the GFC

Unlike the public, regulators and academics have focused more on the components and structure of bankers' remuneration to find out how bankers were incentivised by these arrangements.⁶⁹ This subsection will introduce the main components of bankers' remuneration, namely, the different forms of benefits paid to bankers before the GFC.⁷⁰ In particular, the remuneration practices of the 'Big Four' banks will be illustrated to provide empirical evidence of the application of different remuneration components. The structure of these components, i.e. how they were combined into bankers' remuneration packages, will also be discussed.

3.3.2.1 The Components of Bankers' Remuneration

According to whether the amount of a component varies with employees' performance or not, remuneration can be divided into two categories - fixed remuneration and variable (performance-based) remuneration.

The most important component of fixed remuneration is basic salary.⁷¹ Basic salary is relevant to an employee's role and position in the firm. It is also influenced by the rates in employment market and the levels offered by peer firms.⁷² However, basic salary will not

⁶⁸ Jack Peters, 'Are Greedy Bankers' Really to Blame for Our Financial Problems?' (*The Huffington Post*, 06 May 2013) http://www.huffingtonpost.co.uk/jack-peters/bankers-really-blame-for-financial-problems_b_2821421.html accessed 1 May 2017

⁶⁹ HM Treasury, *The Walker Review: A Review of Corporate Governance in UK Banks and Other Financial Industries Entities - Financial Recommendations* (November 2009, hereafter the 'Walker Review') para 7.2

⁷⁰ In the thesis, the phrases 'remuneration components' and 'remuneration forms' are interchangeably used.

⁷¹ Kym Maree Sheehan, *The Regulation of Executive Compensation: Greed, Accountability and Say on Pay* (Edward Elgar 2012) 81

⁷² Barclays Annual Report 2007, 146. In order to attract excellent executives, firms try to set the basic salaries above the market median level, see *ibid*, 81.

change with an employee's performance or the firm's business achievements. Nevertheless, a generous basic pay level will help firms retain their staff.⁷³ In addition to basic salary, top executives can enjoy some kinds of benefits to facilitate their work, such as travel assistance, insurance, and so on.⁷⁴ In the UK banking sector, fixed remuneration only makes a minor portion of bankers' total remuneration.⁷⁵

In contrast, variable remuneration is the main source of bankers' benefits. It is the most important corporate governance device to incentivise bankers.

The fundamental rationale to use variable remuneration is agency theory. As discussed in Chapter 2, agency problems will emerge when executives' interests and shareholders' interests are conflicting, and executives pursue their private interests, whereas ignore shareholders' interests. Therefore, the function of variable remuneration is to align the benefits of executives with the firm's performance, usually measured by share price or shareholder return.⁷⁶

Variable remuneration, especially equity-based remuneration started to prevail in the US in the late 1970s.⁷⁷ The decade of the 1980s saw the fast development of equity-based remuneration, especially share options.⁷⁸ This Anglo-American 'pay for performance' approach quickly and profoundly affected the remuneration culture in the UK.⁷⁹ Since the 1980s, cash bonuses and equity-based remuneration had been adopted by more and more UK companies. In the 1990s, variable remuneration was already the predominant component of executive remuneration.⁸⁰

Usually, the variable components of executive remuneration include cash bonuses, share options and restricted (conditional) shares.⁸¹

Cash Bonus is an award paid in cash to executives based on the satisfaction of a set of conditions of performance. Since the 1980s, the 'pay for performance' trend boosted the

⁷³ Barclays Annual Report 2007, 146

⁷⁴ HSBC Annual Report 2007, 324

⁷⁵ Tim Edmonds and Phil Abraham, 'Banking Executives' Remuneration in the UK' (n59) 19

⁷⁶ Bert Spector and Francis C. Spital, 'The Ideology of Executive Bonuses: An Historical Perspective' (2011) 17 (3) *Journal of Management History* 315, 325; Michael Jensen and Kevin Murphy, 'Performance Pay and Top Management Incentives' (1990) 98 (2) *Journal of Political Economy* 225, 226

⁷⁷ Kevin J. Murphy, 'Executive Compensation' in Orley Ashenfelter and David Card (eds), *Handbook of Labour Economics*, vol 3 (Elsevier 1999) 2485, 2486-7; Jay Cullen, *Executive Compensation in Imperfect Financial Markets* (Edward Elgar 2014) 19-20

⁷⁸ Martin Conyon *et al*, 'The Executive Compensation Controversy: A Transatlantic Analysis' (2011) Cornell University ILR School, Institute for Compensation Studies Working Paper <http://digitalcommons.ilr.cornell.edu/ics/5/> accessed 20 May 2016, 15

⁷⁹ *Ibid*, 33; Charlotte Villiers, 'Controlling Executive Pay: Institutional Investors or Distributive Justice' (n67) 316

⁸⁰ HC Trade and Industry Committee, *Rewards for Failure* (Sixteenth Report of Session 2002-03, HC 914) 4

⁸¹ For more details of the variable remuneration schemes used by the 'Big Four' banks before the GFC, please refer to Appendix B.

extensive use of cash bonus. In 1979, only 8% of large UK corporations offered bonuses to their top executives, whereas by 1993 it spread to the majority of UK corporations.⁸² During the three decades, cash bonus was the fastest growing remuneration component and developed into a sophisticated method of incentive.⁸³

In the ‘Big Four’, cash bonus was also a significant part of bankers’ remuneration. Before the Crisis, cash bonuses usually offered on an annual basis. If bankers could achieve all of or a majority of the performance targets in a financial year, at the end of the year, they would be rewarded the cash bonuses commensurate with their performance, without any deferral. Therefore, cash bonuses were usually characterised as short-term incentives.⁸⁴ In practice, every year banks would design a system of performance measurement in advance, in which they would set up the performance targets for bankers. Before the Crisis, most of the targets were based on banks’ annual financial indicators.⁸⁵ Besides, banks would set up the maximum level of annual bonuses, which normally varied from 150% up to 250% of the basic salary. Bankers would gain the maximum level if they fulfilled all of the targets. Sometimes, for outstanding performance, bankers could receive extra bonuses.⁸⁶

In the last couple of years before the GFC, UK banks started to incorporate share bonuses into their annual incentive schemes. Accordingly, banks became more dependent on equity-based remuneration.⁸⁷

Executive Share Option, also known as executive stock option, is a type of variable remuneration used by listed companies to grant executives the rights to purchase companies’ shares at a pre-specified exercise price during a pre-specified period.⁸⁸ In a share option scheme, a company would designate the quantity of options granted to each executive, the vesting period, the exercise period and the exercise price.

The vesting period is also known as lockup period, which means the waiting period before an executive can exercise the options. It starts from the date when the options are granted and usually lasts for a couple of years. During the vesting period, executives have only been

⁸² Martin Conyon *et al*, ‘Taking Care of Business: Executive Compensation in the United Kingdom’ (1995) 105 (430) *The Economic Journal* 704, 706

⁸³ High Pay Centre (HPC), ‘Executive Remuneration in the FTSE 350 - A Focus on Performance-related Pay’ (2014) http://highpaycentre.org/files/IDS_report_for_HPC_2014_final_211014.pdf accessed 3 May 2017, 7

⁸⁴ Kym Maree Sheehan, *The Regulation of Executive Compensation: Greed, Accountability and Say on Pay* (n71) 81

⁸⁵ The financial metrics that were widely used by banks to evaluate bankers’ performance will be elaborated in Subsection 3.3.3.

⁸⁶ HSBC Annual Report 2006, 281; RBS Annual Report 115; Barclays Annual Report 2006, 128; Lloyds Annual Report 2006, 54

⁸⁷ For instance, The Annual Bonus scheme in Barclays was made up of 75% cash and 25% shares, see Barclays Annual Report 2006, 128.

⁸⁸ Udo C. Braendle and John E. Katsos, ‘Directors’ Remuneration and Motivation’ in Alexander Kostyuk *et al* (eds), *The Theory and Practice of Directors’ Remuneration: New Challenges and Opportunities* (Emerald 2016) 21, 27; Jay Cullen, *Executive Compensation in Imperfect Financial Markets* (n77) 21

offered the options, whereas they cannot possess or deal with the shares allocated in the options.

Once the vesting period lapses, the options become vested (exercisable) and the exercise period starts to count immediately. During the exercise period, which usually lasts for five to ten years, executives are free to convert the options into real shares at any date they want. This action is called the exercise of options. After the exercise period lapses, any unexercised options will become void.

The exercise price is the price at which executives buy the shares allocated in their options. The exercise price is pre-specified. Usually, the market share price at the date when the options are granted is used as the exercise price.⁸⁹ When executives exercise the options, they buy the corresponding quantity of shares at the exercise price, rather than the share price at the exercise date. Since share price always fluctuates, usually there will be a gap between the price at the granted date and the price at the exercise date.⁹⁰ If the latter is higher than the former, it means that executives spend less than the common investors in stock exchange market to obtain the same value of shares. The gains from the share options are equal to the price gap multiplying the exercised quantity of shares. If throughout the entire exercise period, the share price has never been higher than the exercise price, exercising the options will generate losses. Thus, executives can choose not to exercise them and let the options lapse.⁹¹

The rationale to use share options to incentivise executives is that, only when the share price keeps increasing during the vesting period, can executives achieve benefits. The higher the share price has increased, the more executives can earn. In this sense, executive remuneration is materially aligned with shareholders' interests.

Usually, share option schemes have a function of deferral. The length of deferral depends on how long the vesting period is. Before the GFC, the vesting periods of the share option schemes in the 'Big Four' were within three years.⁹² Distinguished from annual bonuses, share options were deemed as long or medium-term incentives. Moreover, share option schemes for top executives are usually performance-based, namely, the exercise of options is subject to certain conditions. Only when the specific performance targets have been achieved during the vesting period, can the options become exercisable. Before the GFC, most of the schemes in the four banks were conditional. Namely, bankers could only exercise their options when the targets on certain financial indicators were met.

⁸⁹ Jay Cullen, *Executive Compensation in Imperfect Financial Markets* (n77) 21

⁹⁰ *Ibid*, 22

⁹¹ For more details about the operation of share options, please refer to 'Employee Stock Options' (*CNN*, 24 March 2017) <http://money.cnn.com/pf/money-essentials-employee-stock-options/> accessed 3 May 2017

⁹² See Appendix B.3.

Share options were ever widespread among large UK companies in the late 1980s. However, the 1990s saw the decline due to the policy recommendation of restricting the use of share options.⁹³ Since then, Long-term Incentive Plans (LTIPs), which are mainly in the form of restricted shares, have gradually replaced share options and become the dominant approach of long-term incentives.

Restricted share, also known as conditional share, refers to a type of variable remuneration which is an award in the form of a company's ordinary share. Different from share options, once restricted shares are allocated to executives, they can immediately 'own' the equivalent quantity of shares for free, without paying any exercise price. However, the 'ownership' rights are restricted temporarily. There is also a vesting or lockup period during which executives are not allowed to sell the shares nor entitled to any shareholder rights. If the performance targets have been fulfilled by the end of the vesting period, the shares will become unlocked so that executives are free to deal with the shares. However, if executives have failed to achieve the targets, the restricted shares will be forfeited.⁹⁴

There is another kind of variable remuneration: restricted share unit. Its operation is very similar to restricted share. Usually, it refers to a promise or a contractual-binding right offered by a company to its executives to receive free shares at the end of a certain period to the extent the performance targets have been met. The basic rationale of restricted share and restricted share unit is the same: executives will be awarded the company's ordinary shares on the fulfilment of performance targets. Nevertheless, they are slightly different. Executives can immediately own the restricted shares allocated to them, while they cannot deal with the shares. On the contrary, shares in a restricted share unit will not be owned by executives until the conditions have been fulfilled. Thus, there is no any lockup arrangement in a restricted share unit.⁹⁵

In the 'Big Four' banks, both forms were used for LTIPs. For instance, the Barclays Performance Share Plan, the HSBC Share Plan and the RBS Medium-term Performance Plan were all in the form of restricted shares,⁹⁶ and the LTIP of Lloyds since 2006 was based on restricted share unit.⁹⁷ Both restricted share and restricted share unit are equipped

⁹³ In 1995, the Greenbury Report recommended that share options should be subject to performance targets. See Brian G. M. Main, 'The Rise and Fall of Executive Share Options in Britain' in Jennifer Carpenter and David Yermack (eds), *Executive Compensation and Shareholder Value Theory and Evidence* (Springer 1998) 83, 110

⁹⁴ Bird & Bird, 'Long Term Incentive Plans and Deferred Bonus Plans' (2015) <https://www.twobirds.com/~media/pdfs/expertise/employment/employment-incentive/long-term-incentive-plans-and-deferred-bonus-plans.pdf> accessed 4 May 2017

⁹⁵ Ibid

⁹⁶ Although the scheme was called 'Medium-term Performance Plan', it was in fact indifferent from a LTIP in other banks because its deferral period was also three years.

⁹⁷ See Appendix B.1 and B.3.

with deferral arrangements. Before the GFC, generally the length of deferral in LTIPs was three years.

In fact, LTIP is a generic term which refers to all remuneration schemes focusing on long-term incentives. A LTIP can be organised in any form of variable remuneration. Some banks also used share options for LTIPs.⁹⁸ Nevertheless, usually, banks would arrange their LTIPs with restricted shares and offer separate share option schemes to bankers.

3.3.2.2 The Structure of Bankers' Remuneration

Fixed remuneration, annual cash bonuses and LTIPs in the forms of share options, restricted shares or restricted share unit were the three major components of bankers' remuneration in the UK 'Big Four' banks. With regard to incentives, these three components have different functions. Fixed remuneration is the threshold guarantee for bankers. Annual bonuses and LTIPs provide short-term and long-term incentives respectively.

Bankers' remuneration structure is described by the proportional relations among these remuneration components. In order to reveal the proportion of each component, the author collects empirical evidence from the remuneration packages of the group chief executives in the 'Big Four' banks.

Usually, the amounts of fixed remuneration and annual bonuses were directly published in banks' annual reports. On the contrary, the quantification of the value of share options and restricted shares is difficult because the value of awards granted in a specific financial year is still pending. As a result, how much of the awards will become exercisable or vested remains uncertain.

When working out the total level of bankers' remuneration, the author estimated the minimum value. Only the value of exercised options and vested share awards was included. The reason was that the minimum value of bankers' total remuneration needed to be compared with the average salary level of ordinary workers.

Differently, the purpose to calculate bankers' remuneration structure is to reveal the remuneration and incentive culture in banks, thus, it is necessary to describe the banks' arrangements of allocating different kinds of remuneration components. In order to know the value and proportions of different remuneration components allocated to bankers in a financial year, the calculation should be based on a maximum estimation. Share options and restricted shares in LTIPs are aligned with bankers' performance. If the performance targets are fully achieved, bankers will make the maximum gains allocated under these schemes. In this sense, the maximum estimation depicts the expectations a bank has on its bankers and all the incentives a bank plans to provide in a specific financial year.

⁹⁸ For instance, the Incentive Share Option Plan of Barclays from 2000 to 2004 operated as a LITP, see Appendix B.1 and B.3.

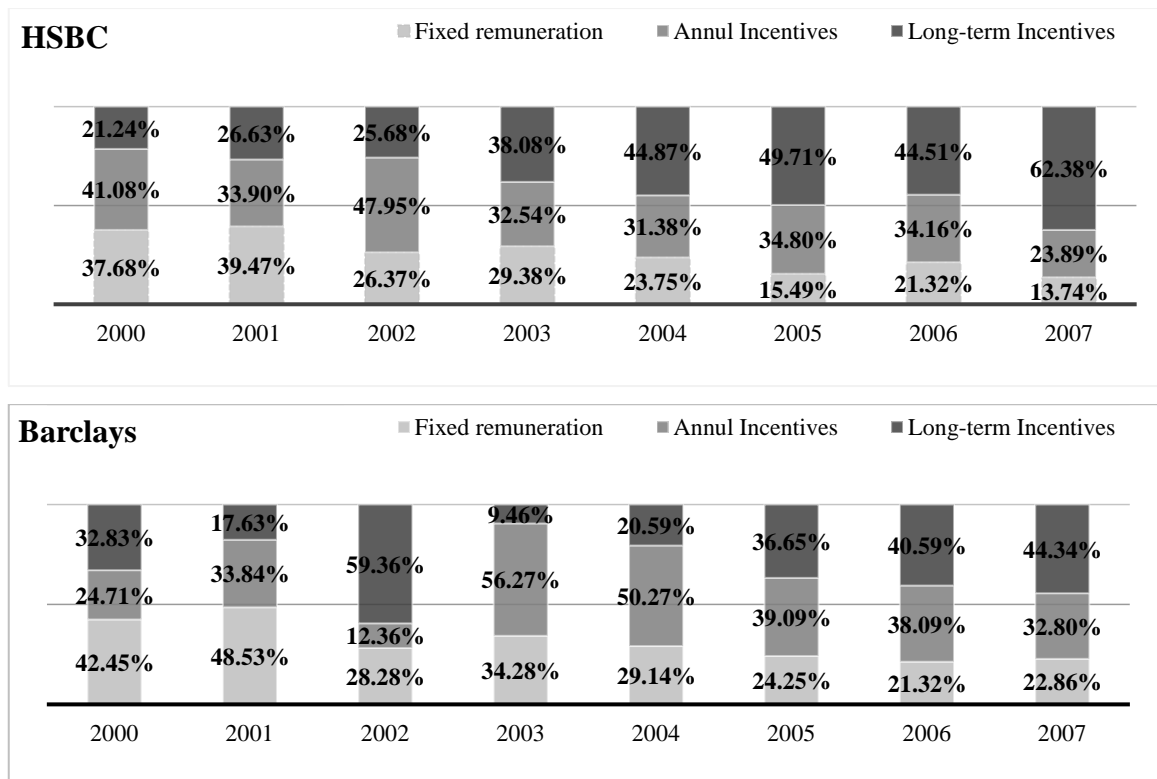
Figure 3.6 shows the structures of the remuneration of group chief executives. It manifests that variable remuneration was dominant while fixed remuneration was minor. Moreover, during 2000 to 2007, the proportion of variable remuneration kept increasing.

Before 2003, in these banks, fixed remuneration still made a relatively important part. For instance, in Lloyds it made more than half of the total remuneration. In contrast, since 2004, the proportion of fixed remuneration declined to about 20%. That is to say, right before the GFC, nearly 80% of bankers' remuneration was performance-based.

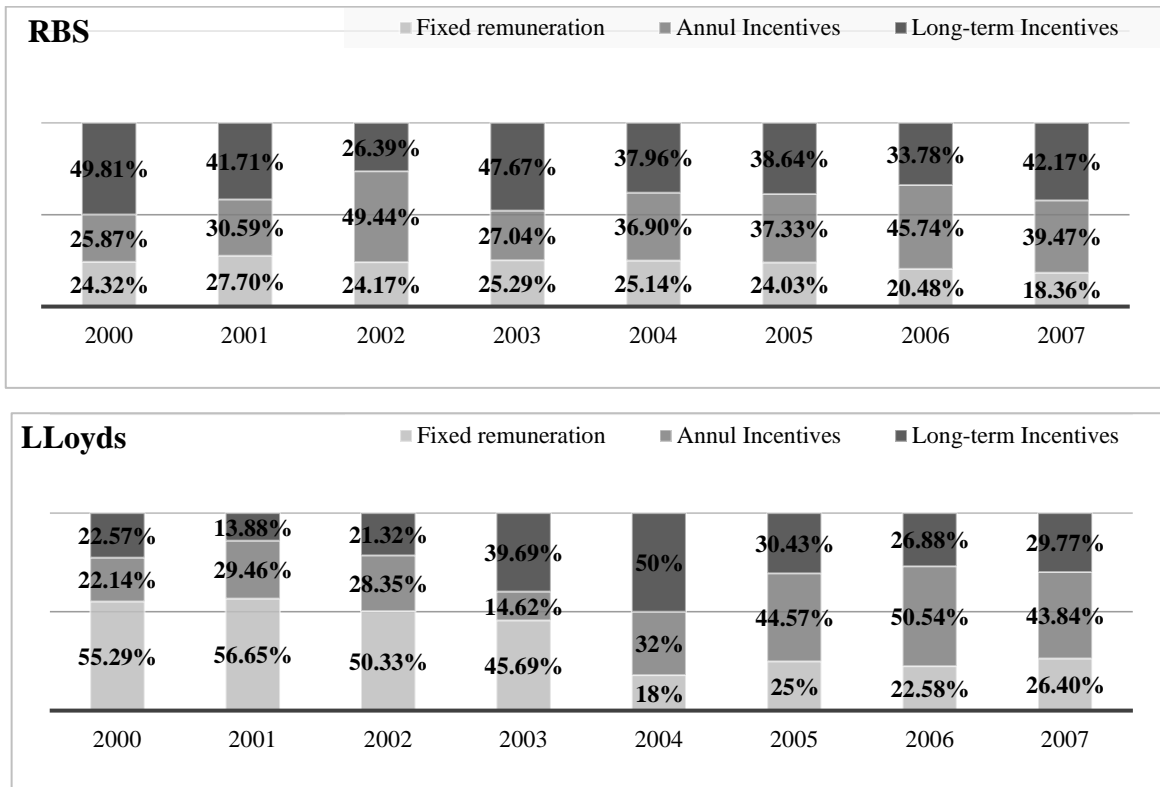
Among the performance-based components, the proportional relations between annual bonuses and LTIPs differed from bank to bank. In most circumstances, the percentages of annual bonuses and LTIPs were close to each other. Neither of them was constantly and overwhelmingly larger than the other.

The structures of bankers' remuneration show that the four banks relied heavily on performance-based remuneration to incentivise their bankers. Bankers' interests were therefore substantially attached to their performance and the banks' businesses. Besides, the volumes of annual bonuses and LTIPs were very similar, which demonstrates that the four banks wanted to pursue both short-term and long-term benefits at the same time.

Figure 3.6 The Structures of Bankers' Remuneration in the UK 'Big Four' Banks from 2000 to 2007⁹⁹



⁹⁹ The original data, the process and criteria of data collection and the calculation method are available in Appendix C.



3.3.3 The Incentive Mechanism of Bankers' Remuneration Before the GFC

The examination of the components and structure of bankers' remuneration demonstrates that the major UK banks relied heavily on variable remuneration. Nevertheless, the findings are still not sufficient to explain why bankers' remuneration resulted in bank failures. To clarify this question, it is necessary to find out what kinds of incentives were embedded in bankers' remuneration, especially variable remuneration.

The incentive mechanism of variable remuneration contains two parts: performance metrics and assessment (measurement) method. Performance metrics are the financial or non-financial indicators used as performance targets. The metrics can be based on either the performance of the whole bank or the performance of each individual banker. Assessment method is about how to assess bankers' performance and reward them for their achievements. Before the GFC, banks had the full discretion to design performance metrics and assessment method.¹⁰⁰

Banks' profitability and shareholders' utilities were the crucial elements of bankers' performance. Total Shareholder Return (TSR), EPS and Economic Profit (EP) were the three performance metrics used in banks' LTIPs. The *modus operandi* was having TSR as the single metric or having a combination of TSR and one of the other two.

¹⁰⁰ The author has examined the incentive mechanisms of all of the annual bonus schemes, share options and LTIPs in the 'Big Four' banks before the GFC. The discussions in Subsection 3.3.3 are based on the empirical data and information provided in Appendix B.

The most important metric was TSR, which is the total amount returned to shareholders in a specified measurement period. Specifically, it includes the yield on dividends and the gains on capital. Dividends are distributed to shareholders when a company has made profits and covered its previous losses. Capital gains are generated from the cash flow return on investment, and measured by share price premium and the capital maintained for expansion, which is the leftover portion after dividend distribution.¹⁰¹ Clearly, TSR is principally determined by share price and economic profit.

In practice, instead of using TSR *per se* as the metric, the ‘Big Four’ banks used the ranking of three-year TSR among a group of comparators to assess bankers’ performance.¹⁰² The banks would choose their competitive peers, usually other top international financial institutions, as the comparators. For instance, HSBC’s comparator group was comprised of 28 large banks in the world, such as Barclays in the UK, BNP Paribas in continental Europe and Citi Group in the US.¹⁰³

The banks would design a hierarchy of TSR rankings and divide the hierarchy into the top level, the middle level and the bottom level. If the ranking was within the top level, the target awards for bankers would be fully vested or exercisable. If the ranking was in the middle level, the corresponding proportion of the awards would be paid. If it fell in the bottom level, meaning that bankers failed to achieve the goal, the awards would be completely forfeited. For example, if HSBC’s TSR ranked from the 1st to the 7th among the 28 banks, 100% of the allocated awards would be vested. If the bank ranked from the 8th to the 14th, correspondingly 90% to 30% of the awards would be vested. If the bank ranked lower than the 14th, bankers could earn nothing.¹⁰⁴

Compared to measuring bankers’ performance by TSR *per se*, measuring by its ranking would make bankers more aggressive. If the growth of TSR *per se* had been used as the metric, bankers could make a foreseeable plan to achieve it. However, when the assessment was based on the TSR ranking among very competitive peers, since bankers had no knowledge about their competitors’ situations, what they could do was to maximise the TSR of their own bank. In addition, the requirements about the rankings to realise the awards were very strict. Generally, if the bank ranked below the median, bankers would not be awarded.

¹⁰¹ $TSR = \frac{(Initial\ Share\ Price - Final\ Share\ Price) + Dividends}{Initial\ Share\ Price}$. For more details about the calculation of TSR, see Bas Deelder *et al*, ‘A Better Way to Understand TRS’ (McKinsey & Company, July 2008) <http://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/a-better-way-to-understand-trs> accessed 8 May 2017

¹⁰² As mentioned, the deferral of a LTIP was usually three years. Therefore, banks set up the measurement period of TSR compatible with the deferral period.

¹⁰³ HSBC Annual Report 2006, 282

¹⁰⁴ See Appendix B.3.

EP and EPS were the other two performance metrics used in LTIPs. EP is the excess of total revenues over the explicit costs of obtaining the revenues.¹⁰⁵ EPS refers to a company's post-tax economic profit divided by its quantity of outstanding common shares.¹⁰⁶ These two indicators can reflect a company's productivity and profitability and have an impact on the company's share price.¹⁰⁷ The growth rates of EP and EPS were used to measure bankers' performance. For instance, banks would require that the EPS growth rate must reach an absolute level or it must exceed the Retail Price Index (RPI) plus a certain percentage, which was usually 9% for three years or 3% per annum.¹⁰⁸ Banks would specify the baseline rate for bankers to get the full awards and the cap rate of nil award. Then a slide scale would be applied to measure the proportions of exercisable awards when the rate fell in between the two points. For example, in the HSBC Share Plan, bankers' would be fully rewarded if the EPS grew by 52% or more in the past three years. If it was lower than 24%, the award was zero. If the rate was exactly 24%, bankers could get 30% of the awards. For any rate in between 24% and 52%, the slide scale would be applied.¹⁰⁹

Before the GFC, TSR, EPS and EP were the only three performance metrics used for LTIPs. Therefore, in the 'Big Four' banks, the so-called long-term incentives only focused on profits and share price.

In comparison, there were more types of performance metrics used for annual short-term incentives, including both financial and non-financial metrics. Financial metrics in annual bonus schemes included EP, EPS, the growth of revenues, net income, Profit before Tax (PBT), ROE, and so on. Revenue is the total amount of gains made from business. Net income usually means 'net profit'. PBT refers to a company's profits before paying corporate income tax. ROE is a financial metric to measure the return generated on shareholders' equity. It is the ratio between net income and shareholders' equity.¹¹⁰ Similar to EP and EPS, all these metrics are relevant to profits and shareholder return and used as the signals of a company's productivity and profitability. In particular, ROE is described as

¹⁰⁵ See the definition given by OECD, 'Glossary of Statistical Terms' (*OECD website*, 17 March 2002) <https://stats.oecd.org/glossary/detail.asp?ID=3288> accessed 8 May 2017

¹⁰⁶ See the definition given by London Stock Exchange, 'EPS' (*London Stock Exchange website*) <http://www.londonstockexchange.com/traders-and-brokers/private-investors/private-investors/selecting-analysing-shares/basic-analytics/eps/eps.htm> accessed 8 May 2017. The calculation formula of EPS is in footnote 47 of this chapter.

¹⁰⁷ Md. Rashidul Islam *et al*, 'How Earning per Share (EPS) Affects on Share Price and Firm Value' (2014) 6 (17) *European Journal of Business and Management* 97, 97-9

¹⁰⁸ For instance, the HSBC Share Plan and the RBS Executive Share Option Plan required the absolute level of EPS growth, while the Lloyds Executive Share Option Scheme and the Lloyds LTIP used the RPI plus a certain percentage as the threshold condition, see Appendix B.3. The RPI is a measurement of the price of goods and services in the UK. See the definition given by Financial Times, 'Definition of Retail Price Index' (*Financial Times Lexicon*) <http://lexicon.ft.com/Term?term=retail-price-index> accessed 2 January 2018

¹⁰⁹ See Appendix B.3.

¹¹⁰ See the definition and formula of ROE in footnote 34 of this chapter.

the ‘mother of all ratios’ in the financial statement.¹¹¹ Many empirical studies in economics have demonstrated that there is a positive correlation between ROE and share price.¹¹²

Apart from these financial metrics, non-financial metrics such as customer satisfaction and employee engagement were also adopted in banks’ annual bonus schemes. Nevertheless, they had a minor influence on the assessment of bankers’ short-term performance.

There were also some other share option schemes offered to bankers, which were usually unconditional to exercise. These schemes, such as the ‘Sharesave’ plans offered by Barclays and Lloyds, were for all employees and they were not performance-based. After the vesting period, options would automatically become exercisable, regardless of bankers’ performance. Nevertheless, these share option schemes still aligned bankers’ interests with share price.¹¹³ The higher the share price was after the vesting period, the more bankers would benefit from exercising the options. In this sense, bankers were still incentivised by these unconditional share options to drive up the bank’s share price.

To conclude, financial indicators in relation to banks’ profitability and shareholders’ utilities were significantly adopted to set up the performance targets in all kinds of variable remuneration schemes. As a result, bankers were incentivised to pursue the fast growth of profits and the high level of share price. Clearly, these banks wanted to incentivise bankers to maximise shareholders’ interests.¹¹⁴

However, none of these banks took into account the metrics of risk management and sustainability, such as risk profile, Capital Adequacy Ratio (CAR) and Liquidity Ratio. Before the GFC, the corporate governance culture in the UK banking sector was entirely based on agency theory and shareholder primacy. Therefore, remuneration incentives were driven by the objectives of fast growth and expansion, while not adjusted by the risks in banks’ operations.¹¹⁵ These arrangements provided bankers with the ambitions to pursue

¹¹¹ Ibid

¹¹² Majed Abdel Majid Kabajeh *et al*, ‘The Relationship Between the ROA, ROE and ROI Ratios with Jordanian Insurance Public Companies Market Share Prices’ (2012) 11 (2) *International Journal of Humanities and Social Science* 115; Sitti Murniati, ‘Effect of Capital Structure, Company Size and Profitability on the Stock Price of Food and Beverage Companies Listed on the Indonesia Stock Exchange’ (2016) 1 (8) *Information Management and Business Review* 23

¹¹³ Iren Levina, ‘Remuneration in Banking: Two Lessons from History and Current Policy’ (2014) University of Massachusetts Amherst Political Economy Research Institute Working Paper Series No. 359 <https://www.peri.umass.edu/media/k2/attachments/WP359.pdf> accessed 10 July 2016, 7-8; Rüdiger Fahlenbrach and René M. Stulz, ‘Bank CEO Incentives and the Credit Crisis’ (2009) NBER Working Paper No. 15212 <http://www.nber.org/papers/w15212> accessed 9 May 2017, 2

¹¹⁴ HSBC Annual Report 2007, 322; Barclays Annual Report 2007, 145; RBS Annual Report 2007, 106; Lloyds Annual Report 2007, 74

¹¹⁵ Ing-haw Cheng *et al*, ‘Yesterday’s Heroes: Compensation and Risk at Financial Firms’ (2015) 70 (2) *The Journal of Finance* 839, 840; Jay Cullen and Gudrun Johnsen, ‘Promoting Bank Stability Through Compensation Reform: Lessons from Iceland’ (2015) 11 (2) *Icelandic Review of Politics and Administration* 333, 335

highly risky strategies, while making them ignorant about the sustainability of individual banks and the long-term stability of the financial system.¹¹⁶

3.3.4 Bankers' Remuneration and Banking Crisis

The incentive mechanism of bankers' remuneration before the GFC has been examined in last section. It had three characteristics. First, it was practised in line with agency theory and shareholder primacy. Therefore, the incentives were aimed at aligning bankers' interests with shareholders' interests. Second, financial indicators based on share price and profits were predominant performance metrics. Third, the incentives were categorised into short-term annual incentives and long-term incentives in a three-year period. However, in fact, both of the two kinds of incentives focused on the achievements in the short run.

These characteristics demonstrated that the incentive mechanism of bankers' remuneration was very similar to that of executive remuneration in non-financial companies.¹¹⁷ In both financial and non-financial industries, these arrangements for variable remuneration would generate managerial short-termism.¹¹⁸ More seriously, due to the particularities of the capital structure and business model of banking, short-termism would exacerbate the problem of excessive risk-taking in banks.

3.3.4.1 Shareholder Short-termism and Managerial Short-termism

Generally, the ownership structures of public companies in the UK are dispersive, without a controlling shareholder.¹¹⁹ Before the governmental bailouts, major UK banks were also dispersedly owned. Usually, shareholders with major shareholdings may tend to have long-term focuses,¹²⁰ whereas individual and institutional shareholders in a dispersedly owned company are more prone to short-termism.¹²¹

¹¹⁶ FSA, *Reforming Remuneration Practice in Financial Services* (Consultation Paper 09/10, March 2009) 9-10

¹¹⁷ For instance, the pre-crisis incentive mechanisms in non-financial FTSE 100 companies, such as Marks and Spenser (a department store) and Pearson (a publishing and education company), were very similar to those in the 'Big Four' banks. See Marks and Spenser Annual Report 2007, 44-50, and Pearson Annual Report 2007, 35-49.

¹¹⁸ In corporate governance, short-termism refers to the prioritisation of short-term interests, which can damage a company's long-term effectiveness and value. In this thesis, 'short-termism', 'short-termist' and 'myopia' are interchangeably used. David Marginson *et al*, 'Performance Measures and Short-termism: An Exploratory Study' (2010) 40 (4) *Accounting and Business Research* 353, 354; Patrick Bolton *et al*, 'Executive Compensation and Short-termist Behaviour in Speculative Markets' (2006) 73 *Review of Economic Studies* 577, 598

¹¹⁹ Department for Business, Innovation & Skills (BIS), *The Kay Review of UK Equity Markets and Long-term Decision Making* (July 2012) 32

¹²⁰ Jeffrey L. Callen and Xiaohua Fang, 'Institutional Investor Stability and Crash Risk: Monitoring Versus Short-termism' (2013) 37 (8) *Journal of Banking and Finance* 3047, 3047; Li Kai *et al*, 'Monitoring: Which Institutions Matter?' (2007) 86 (2) *Journal of Financial Economics* 279, 280 & 304

¹²¹ Marc T. Moore and Edward Walker-Arnott, 'A Fresh Look at Stock Market Short-termism' (2014) 41 (3) *Journal of Law and Society* 416, 416

Short-termism is the tendency to overemphasise the present, and ignore or undervalue the future.¹²² For dispersive shareholders, their interests in a company are dividends and the capital gains through the increase of share price.¹²³ In UK banks, dividends could be distributed on an annual, semi-annual or quarterly basis.¹²⁴ Dividends are distributed out of profits. Therefore, shareholders will have expectations on their company's profitability in the corresponding periods. To maximise the yield on dividends, shareholders will impose pressure on executives to boost short-term profits.¹²⁵

Furthermore, the avail obtained through the increase of share price would also lead to shareholders' myopia behaviours. A great number of shareholders in securities market pursue immediate benefits through the speculation on share price.¹²⁶ These pure speculators, such as high-frequency traders and transient institutional shareholders, usually have high portfolio turnovers and only engage in momentum trading. They will not care about the company's sustainability. They only take chances.¹²⁷

Other shareholders, although they would maintain the shareholdings for a relatively long time and pay attention to the indicators of profitability, such as EPS, EP and TSR, are also subject to short-termism. What they care about is the impact of the periodical financial statements of these indicators on their company's share price.¹²⁸ If the financial targets have not been realised, the market will immediately respond with a fast decline of share price. To avoid capital losses, shareholders prefer the strategies that can keep the financial indicators at high levels so as to provide constant positive signals to the market and drive up the share price. Therefore, the true share value would be overpriced in securities market, and more overoptimistic investors will emerge, which enables the existing shareholders to make significant wealth by selling their shares at a much higher price.¹²⁹ The average holding period of institutional shareholders is about only one year.¹³⁰ Such a short horizon is associated with the overweighting of near-term expected earnings and the underweighting

¹²² Lynne L. Dallas, 'Short-termism, the Financial Crisis and Corporate Governance' (2012) 37 *The Journal of Corporation Law* 265, 312

¹²³ Patrick Bolton *et al*, 'Executive Compensation and Short-termist Behaviour in Speculative Markets' (n118) 578

¹²⁴ Before the Crisis, Barclays, RBS and Lloyds paid their shareholders dividends annually or semi-annually while HSBC paid in every quarter.

¹²⁵ Emerka Duruigbo, 'Tackling Shareholder Short-termism and Managerial Myopia' (2011-2) 100 (1) *Kentucky Law Journal* 531, 532

¹²⁶ Marc T. Moore and Edward Walker-Arnott, 'A Fresh Look at Stock Market Short-termism' (n121) 425

¹²⁷ Lynne L. Dallas, 'Short-termism, the Financial Crisis and Corporate Governance' (n122) 297; Jeffrey L. Callen and Xiaohua Fang, 'Institutional Investor Stability and Crash Risk: Monitoring Versus Short-termism?' (n120) 3049

¹²⁸ Marc T. Moore and Edward Walker-Arnott, 'A Fresh Look at Stock Market Short-termism' (n121) 426

¹²⁹ Lynne L. Dallas, 'Short-termism, the Financial Crisis and Corporate Governance' (n122) 306; Patrick Bolton *et al*, 'Executive Compensation and Short-termist Behaviour in Speculative Markets' (n118) 599

¹³⁰ Kenneth A. Froot *et al*, 'Shareholder Trading Practices and Corporate Investment Horizons' (1992) 5 (2) *Journal of Applied Corporate Finance* 42, 52; Patrick Bolton *et al*, 'Executive Compensation and Short-termist Behaviour in Speculative Markets' (n118) 598

of long-term expected earnings. As a consequence, institutional shareholders will try to affect the board and senior management to enforce aggressive plans.¹³¹

Oriented by agency theory and shareholder primacy, corporate governance would prioritise shareholders' interests. Therefore, shareholder short-termism would be converted into managerial short-termism.¹³² There are different kinds of corporate governance devices which enable shareholders to push executives to take myopia investment strategies, such as their power on the appointment, election and removal of executives.¹³³ Moreover, equity-based remuneration can directly turn executives into shareholders. As a result, executives will have the same pursuit as shareholders to maximise the short-term interests. In addition, empirical evidence shows that executives are willing to sell their shares in the near future.¹³⁴ Even long-serving executives also tend to cash out their equity-based awards as soon as the awards become unlocked.¹³⁵ Therefore, executives are sensitive to the volatility of share price in the short run.

Performance metrics of variable remuneration can also exacerbate managerial short-termism. The performance metrics based on profits and share price are usually indicated in annual, semi-annual and quarterly statements, and the figures are adopted to decide the amounts of equity-based remuneration and cash bonuses. Therefore, these metrics will give rise to the overvaluation of short-term profitability and the undervaluation of long-term development. As a result, executives are encouraged to take myopia investment strategies at the expense of the firm's long-term value and sustainability.¹³⁶ In addition, sometimes executives would manipulate the figures of these indicators to pretend that they have met the targets, which is more detrimental to a company's long-term development.¹³⁷

¹³¹ Brian J. Bushee, 'Do Institutional Investors Prefer Near-term Earnings over Long-run Value?' (2001) 18 (2) *Contemporary Accounting Research* 207, 213; EY, 'Short-termism in Business: Causes, Mechanisms and Consequences' (2014) [http://www.ey.com/Publication/vwLUAssets/EY_Poland_Report/\\$FILE/Short-termism_raport_EY.pdf](http://www.ey.com/Publication/vwLUAssets/EY_Poland_Report/$FILE/Short-termism_raport_EY.pdf) accessed 12 May 2017, 14

¹³² Patrick Bolton *et al*, 'Executive Compensation and Short-termist Behaviour in Speculative Markets' (n118) 427; Robert Rieg, 'Dynamics of Value-based Management: Does Shareholder Value Cause Short-termism' (2015) 26 (2) *Journal of Management Control* 193, 197; EY, 'Short-termism in Business: Causes, Mechanisms and Consequences' (ibid) 17; Angelica Gonzalez and Paul André, 'Board Effectiveness and Short Termism' (2014) 41(1-2) *Journal of Business Finance and Accounting* 185, 189

¹³³ Brian J. Bushee, 'The Influence of Institutional Investors on Myopic R&D Investment Behaviour' (1998) 73 (3) *The Accounting Review* 305, 308

¹³⁴ Qiang Cheng and Terry Warfield, 'Equity Incentives and Earnings Management' (2005) 80 (2) *The Accounting Review* 441, 442

¹³⁵ Lucian A. Bebchuk *et al*, 'The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008' (2010) 27 (2) *Yale Journal on Regulation* 257, 265-9

¹³⁶ Qiang Cheng and Terry Warfield, 'Equity Incentives and Earnings Management' (n134) 470; Angelica Gonzalez and Paul André, 'Board Effectiveness and Short Termism' (n132) 188; Brian J. Bushee, 'The Influence of Institutional Investors on Myopic R&D Investment Behaviour' (n133) 330

¹³⁷ Paul M. Healy, 'The Effect of Bonus Schemes on Accounting Decisions' (1985) 7 *Journal of Accounting and Economics* 85, 106; Robert W. Holthausen *et al*, 'Annual Bonus Schemes and the Manipulation of Earnings' (1995) 19 (1) *Journal of Accounting and Economics* 29, 33; Lynne L. Dallas, 'Short-termism, the Financial Crisis and Corporate Governance' (n 122) 312

The lengths of the vesting periods of share option schemes and LTIPs can also aggravate managerial short-termism.¹³⁸ Before the GFC, the longest deferral period of LTIPs was only three years and many bonuses were annual-based. When the periodical assessment is made every three years, the furthest horizon of executives is up to the end of the third year. When pursuing the financial goals for the current three-year period, executives will not keep an eye on whether the work they are underlying will lead to a perilous consequence after these three years. However, many business projects may have a performing period of more than three years, or may embed potential risks which will expose in a longer period. Therefore, the three-year period is not long enough to encourage long-term focuses.

In short, the pre-crisis arrangements for variable remuneration would contribute to managerial short-termism. First, equity-based remuneration would turn executives into shareholders. Second, variable remuneration was based on the financial metrics relevant to profits and share price to assess executives' performance. Third, the vesting periods were usually very short. Short-termism in corporate governance induces negative consequences to companies, investors and the market as a whole. It results in the overpricing of firm value, overinvestment and market bubbles.¹³⁹

More seriously, due to the particular capital structure and business model of banking, short-termism is more disastrous to banks.

3.3.4.2 Excessive Risk-taking in Banks

Subject to short-termism, executives tend to take risky strategies.¹⁴⁰ These strategies can bring a large volume of earnings. However, they are also highly possible to fail. Besides, some strategies can promptly boost the profit level and share price in the short run. However, at the same time, there could be hidden perils embedded in these strategies, which will destroy the company's value in the long run. In comparison with non-financial companies, banks are more prone to risks. Before the GFC, UK banks took excessive risks through their short-term strategies and finally were caught in the Banking Crisis.

Banks' capital structure is highly leveraged. In combination with shareholders' limited liability, it could exacerbate managerial short-termism in banks.

Lucian Bebchuk and Holger Spamman have designed the simplified models to simulate the capital structure and incentive mechanism in US banking holding companies (BHCs). Based on these models, they have depicted the decision-making process of bank shareholders and bankers when taking risky strategies and provided robust arguments to

¹³⁸ Patrick Bolton *et al*, 'Executive Compensation and Short-termist Behaviour in Speculative Markets' (n118) 581

¹³⁹ *Ibid*, 599

¹⁴⁰ Jeffrey L. Coles *et al*, 'Managerial Incentives and Risk-taking' (2006) 79 (2) *Journal of Financial Economics* 431, 464

support the view that equity-based remuneration can generate excessive risk-taking in highly leveraged banks.¹⁴¹

This thesis applies the models to explain how bankers' remuneration stimulated excessive risk-taking in UK banks. The reference to the view of Bebchuk and Spamman is feasible because the systems of remuneration and incentives, the organisational forms and the capital structures of UK and US banks are very similar.¹⁴²

First of all, the model assumes that there is a commercial bank, which is organised as a corporation. It has 100 units of assets, including 90 units of deposits and 10 units of equity capital.

Scenario I: there is an investment opportunity with 50% chance of success and 50% chance of failure. If the investment succeeds, the value of bank assets increases by X units. The exact amount of X is unknown. If the investment fails, the value decreases by 20 units.

Generally, the strategy's expected value (E) is: $E = 0.5X - 0.5 \times 20 = 0.5X - 10$.

If X is less than 20 units, E is lower than 0. Thus, the strategy has a negative expected value. From the perspective of a risk-neutral manager who has no stakes in the bank's shares and is assumed to consider the interests of the bank as a whole, only when X is equal or more than 20 units, the strategy is worthy of adopting.

However, shareholders will not calculate the expected value in this way. Due to the limited liability, in no circumstances will shareholders be responsible for any losses exceeding their shareholdings. In Scenario I, shareholders' equity makes 10% of the total assets. If the investment fails, shareholders' losses are only 10 units, while the other 10 units are assumed by the bank's depositors. In contrast, if the investment succeeds, the gain X will all be transferred into shareholders' dividends or equity capital. Therefore, from shareholders' perspective, the possible losses are 10 units rather than 20 units. Their expected value is: $E = 0.5X - 0.5 \times 10 = 0.5X - 5$.

Therefore, as long as X exceeds 10, shareholders will choose to invest. However, when X is between 10 and 20, for shareholders the expected value of the investment is positive, while for depositors, it is negative.¹⁴³ Clearly, shareholders tend to take riskier strategies

¹⁴¹ Lucian A. Bebchuk and Holger Spamman, 'Regulating Bankers' Pay' (2010) 98 (2) Georgetown Law Journal 247

¹⁴² Cash bonus and equity-based remuneration were also the main components of US bankers' remuneration. Financial indicators such as EPS, total income and share price were also used as the major performance metrics. Moreover, both UK banking groups and US BHCs are universal banks, with multiple functions including commercial banking, investment banking, securitisation, and so on. Joseph J. Gerakos *et al*, 'Which U.S. Market Interactions Affect CEO Pay? Evidence from UK Companies' (2013) 59 (11) Management Science 2413, 2413; Brian R. Cheffins and Randall S. Thomas, 'Regulation and the Globalisation (Americanisation) of Executive Pay' (2004) 1 (2) Berkeley Business Law Journal 233, 241; Dafna Avraham *et al*, 'A Structural View of US Bank Holding Companies' (2012) 18 (2) Economic Policy Review 65, 65

¹⁴³ Lucian A. Bebchuk and Holger Spamman, 'Regulating Bankers' Pay' (n141) 256

because they only assume a part of the losses when an investment fails, while they can fully enjoy the benefits when it is successful.

Scenario II: there are two strategies for the bank to choose. In strategy A, there is 90% chance of gaining 2 units while 10% chance of losing 10 units. In strategy B, there is 90% chance of gaining 3 units while 10% chance of losing 50 units.

From the perspective of a risk-neutral manager, the expected value of strategy A is: $E = 0.9 \times 2 - 0.1 \times 10 = 0.8$. The expected value of strategy B is: $E = 0.9 \times 3 - 0.1 \times 50 = -2.3$.

Obviously, A produces a positive value whereas B produces a negative value. For the bank's sustainability, the manager will choose A, which is a much safer strategy.

However, shareholders prefer to adventure for the 1 more unit gain offered by strategy B. For them, no matter choosing which one, the losses they need to suffer are 10 units. Therefore, they make decisions on the grounds of gains only. However, with regard to depositors' interests, the two strategies are significantly different. If A is chosen and fails, the 10 units of equity from shareholders are enough to compensate the losses, and their deposits are safe. In contrast, if B fails, apart from the 10 units of equity, 40 units of deposits will be lost. With regard to the bank as a whole, the failure of B will reduce the bank's assets by 50%.¹⁴⁴ This demonstrates that even for a bit more benefits, shareholders would sacrifice the interests of other stakeholders and the bank's sustainability.¹⁴⁵

After all, shareholders usually do not manage specific business strategies. If bankers are properly incentivised to consider the interests of the bank and the depositors, the aforementioned adventurous choice can be avoided. However, performance-based remuneration would incentivise bankers to prioritise shareholders' interests. Therefore, in the two scenarios above, they would behave in the same way as shareholders.

Compared to non-financial companies, equity capital is only a small portion of a bank's assets, while most of the assets are debt capital. In Bebchuk and Spamman's model, the bank's leverage ratio is 9.¹⁴⁶ Usually a non-financial company has much more equity capital, thus, its ratio is much lower.¹⁴⁷ For example, in Scenario II, if the two strategies are for a non-financial company which has 50 units of debts and 50 units of equity, their shareholders will choose strategy A rather than B since no matter which one fails, all losses will be assumed by equity capital. Thus, risky strategies such as B are usually rejected by non-

¹⁴⁴ Ibid, 257

¹⁴⁵ Thomas D. Jeitschko and Shin Dong Jeung, 'Incentives for Risk-taking in Banks - A Unified Approach' (2005) 29 (3) Journal of Banking and Finance 759, 775

¹⁴⁶ $Leverage Ratio = \frac{Total\ debts}{Total\ Equity}$. In reality, the ratio can be ever higher. For instance, the leverage ratio of Lloyds in 2015 is 14 (calculated by the author according to Lloyds Annual Report 2015).

¹⁴⁷ For instance, the leverage ratios of Marks and Spencer and Pearson in 2015 were 1.56 and 0.81 respectively (calculated by the author according to their annual reports in 2015).

financial companies, while favoured by banks. The highly leveraged capital structure of banks amplifies the effect of equity-based remuneration on excessive risk-taking.

Moreover, banks' businesses are inherently riskier.¹⁴⁸ If a non-financial company wants to make more profits, the general method is to increase earnings and meanwhile control costs. For example, a manufacturing business can increase earnings through expanding its sales or developing new product lines. It can also control costs by introducing advanced equipment. In this process, the company faces with business risk, operational risk and market risk. However, when a bank wants to expand its business, it will take more debts, make more loans and provide more financial services. Compared to non-financial companies, a bank is more exposed to credit risk, liquidity risk, the risk of insolvency and systemic risk.¹⁴⁹

Credit risk is the potential that a bank's borrowers fail to meet their obligations. Loans make a substantial part of banks' assets. Non-performing Loans (NPLs) constitute the major source of credit risk.¹⁵⁰ In order to avoid being excessively exposed to credit risk, banks should identify the default factors associated with every loan. However, when a bank aggressively wants to boost its earnings by expanding the scale of loans, it will become more reckless and therefore make more loans in low quality, which will increase the bank's NPL ratio and make the bank less resilient to credit risk.

As explained in Chapter 2, commercial banking is characterised as 'borrow short, lend long'. The mismatch of maturity increases the liquidity risk in a bank.¹⁵¹ Illiquidity can lead the bank into a bank run and increase the risk of insolvency. In addition, since banks' businesses are intertwined with each other, the banking industry is typically subject to systemic risk.

All of these risks are inherently rooted in banks' business operation and capital structure. If banks only focus on profit-making and cost-saving, while disregarding the necessity of risk control, they will become more exposed to risks. For instance, empirical evidence suggests that banks with fewer NPLs and lower exposure to mortgage-backed securities and derivative securities fared much better during the GFC.¹⁵²

Nowadays, the world-leading banking groups are all universal banks. To improve profitability, banks significantly developed their businesses in investment banking.

¹⁴⁸ FSA, *The Turner Review*, 52

¹⁴⁹ William C. Handorf, 'Bank Risk Management, Regulation and CEO Compensation After the Panic of 2008' (2013) 16 (1) *Journal of Banking Regulation* 39, 45-8

¹⁵⁰ BCBS, *Principles for the Management of Credit Risk* (September 2000) 1

¹⁵¹ Kleopatra Nikolaou, 'Liquidity (Risk) Concepts: Definitions and Interactions' (2009) European Central Bank Working Paper Series No. 1008 <https://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1008.pdf?e87aba3a52137adea91048bf54801968> accessed 15 May 2017, 10

¹⁵² Andrew Ellul and Vigay Yerramilli, 'Stronger Risk Controls, Lower Risk: Evidence from U.S. Bank Holding Companies' (2013) 68 (5) *The Journal of Finance* 1757, 1789

Investment banking can bring high profits, whereas it can also generate excessive risks. Once a banking group takes too many risks from the investment banking side, the commercial banking side also becomes risky. Bebchuk and Spamman have further developed their model to simulate the capital structure and incentive mechanism of a banking group. They have proved that excessive risk-taking can be more serious in a banking group.¹⁵³

Scenario III: A banking group has a commercial banking and an investment banking subsidiaries. The commercial bank's assets are made of 90 units of deposits and 10 units of equity and the investment bank has 90 units of non-deposit debts (liabilities) and 10 units of equity. The investment bank has just taken part in a hedge fund business which has equal chances (50%) to gain or lose 12 units.

If the hedge fund is successful, the investment bank will gain 12 units, which will be totally captured by the shareholders of the banking group. If it fails, the investment bank's book value will be wiped out, and there are 2 units of losses that cannot be covered by its own equity. Therefore, the group has to compensate the losses with 2 units of equity of the commercial bank. This scenario demonstrates that the losses caused by the investment banking side can be shifted to the commercial banking side.¹⁵⁴

Scenario IV: The investment bank in Scenario III has just taken an investment strategy C with equal chances to gain or lose 20 units. Meanwhile, there is another business strategy D for the commercial bank, which has 50% chance to gain 8 units and 50% chance to lose 10 units.

If the commercial bank is independent, for shareholders (including bank executives holding the bank's equity), the expected value of D would be: $E = 0.5 \times 8 - 0.5 \times 10 = -0.2$, which is also the expected value of the bank's depositors. Since the outcome is negative, shareholders will not invest. However, in this banking group, given that strategy C has been taken by the investment bank, shareholders of the banking group have already taken the risk of losing 20 units, which amounts to their entire limited liabilities. Namely, the maximum losses they need to assume are 20 units. Therefore, no matter how huge the potential losses of strategy D are, shareholders will not need to assume them. In this situation, if both strategy C and D fail, shareholders assume 20 units of losses, while the other 10 units have to be assumed by creditors. Thus, after taking strategy C, group shareholders are willing to launch strategy D.¹⁵⁵ Therefore, risky strategies that will not be taken by an independent commercial bank will be approved when the commercial bank is an affiliated subsidiary in a banking group. Scenario IV demonstrates that the investment banking side not only takes

¹⁵³ The concrete amounts and percentages in Scenario III and IV are adjusted by the author to make them easier for understanding.

¹⁵⁴ Lucian A. Bebchuk and Holger Spamman, 'Regulating Bankers' Pay' (n141) 259-60

¹⁵⁵ Ibid, 260-1

a lot of risks through its own business, but also stimulates the excessive risk-taking at the group level and makes the depositors of the commercial banking side assume more risks.

The particular capital structure and business model make banks more exposed to risks and substantially amplify the risk appetite of shareholders and bankers. Bank shareholders focus only on the strategies that could immediately boost their returns, regardless of the high potential risks of huge losses and the hidden perils which would destroy bank's long-term value and sustainability. Performance-based remuneration makes bankers shareholder-minded. As a result, they would take excessive risks to realise shareholders' short-term interests.¹⁵⁶

3.3.4.3 The Causal Mechanism Between Bankers' Remuneration and Banking Crisis

The causes of the GFC were multiple. Bankers' remuneration was not the sole reason. Nevertheless, it indispensably contributed to the collapses of banks. Based on the discussions above, the causal mechanism between bankers' remuneration and banking crisis can be clearly revealed.

Prior to the GFC, bankers' remuneration was regarded as a corporate governance device to align bankers' interests with shareholders' interests. To this end, equity-based remuneration was largely adopted. Moreover, financial indicators that were closely related to shareholders' interests, such as TSR, EPS, and so on, became the major metrics of bankers' performance.

Dispersive shareholders are usually subject to short-termism, who emphasise immediate shareholder returns. Equity-based remuneration turned bankers into shareholders. Therefore, shareholders' short-termism substantially encouraged bankers' myopia behaviours. Their myopia behaviours aimed at short-term achievements in profits and share price, regardless of any potential damages to other stakeholders, as well as the bank's sustainability and financial stability. Therefore, myopia strategies usually embedded many high-level risks.

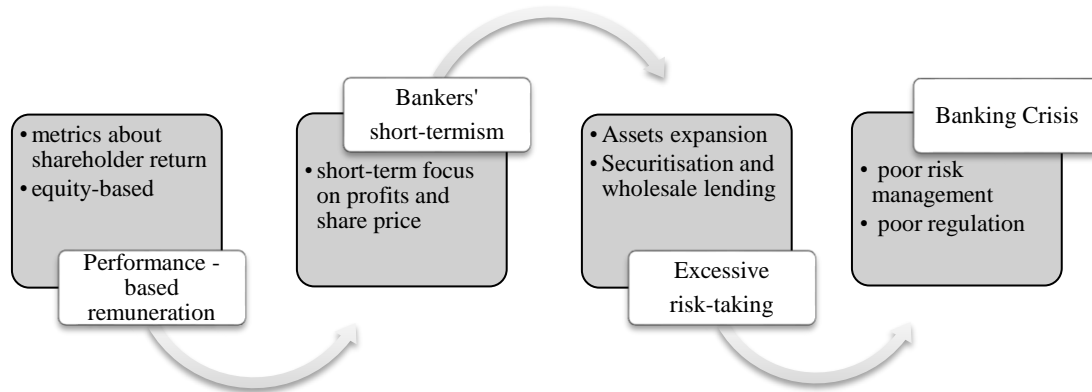
With the protection of limited liability, shareholders were prone to riskier strategies than any other stakeholders in a company. Moreover, the highly leveraged capital structure of banks exacerbated shareholders' risk preference. To fulfil shareholders' desire in profit-making and the increase of share price, bankers relied significantly on assets expansion, securitisation and wholesale banking. These activities made banks far more exposed to excessive risks.

¹⁵⁶ Patrick Bolton *et al*, 'Executive Compensation and Risk Taking' (2015) 19 (6) *Review of Finance* 2139, 2139; IMF, *Global Financial Stability Report: Risk Taking, Liquidity, and Shadow Banking - Curbing Excess While Promoting Growth* (October 2014) 116

Besides, before the GFC, the risk management mechanisms of banks were ineffective to prevent excessive risk-taking.¹⁵⁷ The banking regulation system was incapable of detecting and preventing the risks.¹⁵⁸ In combination with these factors, excessive risk-taking, which resulted from bankers' remuneration, finally contributed to the collapses of many UK banks.

Figure 3.7 diagrammatically explains the causal mechanism between bankers' remuneration and banking crisis. The exposition of this mechanism is important. Only with the knowledge of how bankers' remuneration contributed to bank failures, can the banking regulators figure out the right direction and prescribe the right solution for banking reform.

Figure 3.7 The Causal Mechanism Between Bankers' Remuneration and Banking Crisis



3.4 Conclusion

This chapter has discussed the pre-crisis remuneration practice in the UK banking sector, with an emphasis on the causal relationship between bankers' remuneration and banking crisis. It gives answers to the question: what was the problem of bankers' remuneration in the UK?

As one of the world-leading and highly internationalised financial markets, the UK's banking industry was severely struck by the GFC. Many financial institutions in the City of London collapsed, including several large banks. The Banking Crisis resulted in tremendous economic losses and serious social problems. In order to prevent similar crises in the future, the UK authorities immediately launched investigations into the reasons for bank failures. According to the investigations on the failures of Northern Rock, RBS and Lloyds (including HBOS), all of the banks had adopted very aggressive and expansionary strategies before the Crisis. To support the rapid growth of assets and profits, they relied heavily on loan securitisation, wholesale banking and global acquisition, which made them increasingly exposed to a variety of risks in the global financial markets. In essence, these risky and reckless decisions were caused by these banks' poor corporate governance

¹⁵⁷ Iris H-Y Chiu, *Regulating (From) the Inside: The Legal Framework for Internal Control in Banks and Financial Institutions* (Hart Publishing 2015) 83

¹⁵⁸ *Ibid*, 102-7

cultures, in particular, the incentives of bankers' remuneration. Therefore, the UK government concluded that bankers' remuneration was one of the causes of the Banking Crisis. Therefore, it should be regulated for financial stability and the public interest.

With robust, practical evidence and theoretical discussions, this chapter has revealed the causal mechanism between bankers' remuneration and banking crisis. It has illustrated the pre-crisis remuneration practices of the UK 'Big Four' banks and analysed the level, components and structure, and incentive mechanism of bankers' remuneration.

From the public's perspective, the 'sky high' level of bankers' remuneration was the cause of bank failures. However, this view was insufficient to explain why bankers were incentivised to take excessive risks. In fact, the crux rested with the structure and incentive mechanism of bankers' remuneration.

Before the Crisis, more than 70% of bankers' remuneration in the 'Big Four' was performance-based, usually in the forms of annual cash bonuses, share options and restricted shares. Performance-based remuneration aimed at aligning bankers' benefits with shareholders' interests. Annual cash bonuses provided short-term incentives. Share options and restricted shares were used for LTIPs, which usually rewarded bankers the banks' shares in accordance with their performance in a three-year period. The achievements in profits and shareholder returns, such as EPS, TSR, EP and other financial indicators were the major performance metrics in these remuneration schemes. In general, performance-based remuneration aligned bankers' benefits with shareholders' interests in two dimensions. First, equity-based awards turned bankers into shareholders. Second, the performance metrics made bankers focusing on immediate profits and the increase of share price.

The lessons of the Banking Crisis have demonstrated that the pursuit of shareholders' interests caused the damages to stakeholders' interests, as well as the sustainability of banks and financial stability.

First of all, the majority of individual and institutional shareholders were subject to short-termism. Thus, they preferred to take risky strategies which would boost profits and share price very quickly, while also embedding massive risks. Due to the incentives in bankers' remuneration, bankers became shareholder-minded and tended to take more risks for short-term interests.

Furthermore, the highly leveraged capital structure of banks, in combination with limited shareholder liability, exacerbated the problem of excessive risk-taking. Bank shareholders would choose very risky strategies because they could enjoy all the upsides, whereas creditors assume the majority of the downsides. Due to the particularities of the business model and capital structure of banking, banks are inherently exposed to credit risk, liquidity risk, the risk of insolvency and systemic risk. When banks took aggressive and

expansionary strategies, these risks would be significantly increased. As a consequence, it is more difficult for banks to maintain solvent and liquid.

Besides, the organisational structure of a banking group with both commercial banking and investment banking enabled the risk shifting from the latter to the former. Shareholders and executives in a banking group would take more risks than those of an independent commercial bank, which was very detrimental to the interests of depositors of the commercial banking subsidiary.

Clearly, there is robust evidence to prove the causal mechanism between bankers' remuneration and banking crisis: bankers' remuneration incentivised bankers to take excessive risks for immediate profits and the increase of share price, which trapped the banks into illiquidity and finally contributed to their failures. This finding justifies regulatory intervention in bankers' remuneration. More importantly, it reveals the real problem and sheds light on the right direction of regulation.

Chapter 4

The Regulatory Framework of Bankers' Remuneration in the UK

4.1 Introduction

Prior to the GFC, bankers' remuneration in the UK was unfettered.¹ It was the same as executive remuneration in non-financial industries, which was primarily decided by companies. The regulation of remuneration was limited to the corporate governance codes and relevant guidance, which were for quoted companies in all industries. Moreover, the regulatory approach was on a 'comply and explain' basis.² The former banking regulator FSA did not make any explicit or specific rules in regards to bankers' remuneration.³ Therefore, bankers' remuneration was operated in a laissez-faire market, and the fundamental attitude of banking law and regulation was 'non-interference'.⁴

The Banking Crisis exposed the flaws in bankers' remuneration. As analysed in Chapter 3, it was aimed at linking bankers' benefits with shareholders' interests. However, it resulted in excessive risk-taking and detrimentally affected the interests of massive stakeholders and the stability of the financial system.

The problem rested essentially with the incentive mechanism of performance-based remuneration, which was extensively used by banks. Therefore, the UK government has taken many regulatory measures to reform bankers' remuneration, which constitute an important part of the bold and resolute reform of banking regulation in the UK.

This chapter attempts to provide a comprehensive and systemic understanding of the current regulatory framework of bankers' remuneration in the UK. It is structured as below. Section 4.2 provides an overview of the important reforms in banking regulation and bank corporate

¹ Jay Cullen, *Executive Compensation in Imperfect Financial Markets* (Edward Elgar 2014) 160

² The regulation of corporate governance before the GFC was incorporated into the Combined Code (the predecessor of the current Corporate Governance Code) as well as a series of guidance and consultation papers published by the Financial Reporting Council (FRC) and the Department of Business, Innovation and Skills (BIS). The regulations targeted quoted companies in all industries. A quoted company is a company whose equity capital has been included in the Official List in accordance with Article 74, Part 6 of the FSMA 2000, or is officially listed in an EEA state, or is admitted to dealing on either the New York Stock Exchange or Nasdaq. See the definition in Companies Act 2006, Article 385(2). Therefore, if a financial institution is incorporated in the UK and listed at one of the stock exchanges in the EEA and the US, it should comply with the corporate governance regulations. However, due to the principle of 'comply or explain', companies can choose to provide their explanations for not complying with the regulation. The principle is also applied to the provisions on executive remuneration. Therefore, before the GFC, bankers' remuneration was only regulated on a generic and non-mandatory basis.

³ See the 'Senior Management Arrangements, Systems and Controls (SYSC)' section in the archived FSA Handbook that was implemented before the GFC. <http://webarchive.nationalarchives.gov.uk/20080814090418/http://fsahandbook.info/FSA/html/handbook/SYSC> accessed 18 May 2017

⁴ FSA, *The Turner Review*, 40; Emiliios Avgouleas and Jay Cullen, 'Market Discipline and EU Corporate Governance Reform in the Banking Sector: Merits, Fallacies, and Cognitive Boundaries' (2014) 41 (1) *Journal of Law and Society* 28, 36

governance, in order to sketch out the background of the regulation of bankers' remuneration. Section 4.3 analyses the new rules of the decision-making power of bankers' remuneration, with an emphasis on the roles of remuneration committee and shareholders. Section 4.4 discusses the measures that intervene in bankers' remuneration policy and management, which include the control over remuneration level and structure, the improvement of long-term incentives and the introduction of risk adjustment. Section 4.5 is the conclusion.

4.2 The Government's Response to the Banking Crisis

4.2.1 The Overhaul of Banking Regulation

The Banking Crisis unveiled the inherent riskiness and vulnerability of the UK banking system and the deficiencies in previous banking regulation.⁵ The *ad hoc* governmental rescue could only temporarily prevent the Crisis from further deteriorating. To avoid similar crises in the future, a fundamental and structural reform of banking regulation was urgently needed.⁶ After the GFC, the UK commenced the overhaul of its banking regulatory framework. During the post-crisis decade, dramatic changes have been brought to the institutional and cultural structure of the UK's banking regulation. Many initiatives for prudential regulation and the soundness of bank corporate governance have been taken.⁷ The establishment of a special regulatory framework of bankers' remuneration is integrated into the system-wide overhaul.

Before the GFC, the UK's financial regulation was characterised by the 'Tripartite System', which was comprised of the HM Treasury, the BoE and the FSA. The HM Treasury dealt with general legal policies. The BoE was responsible for financial stability. The FSA focused on prudential regulation and the regulation of conduct of business. Its work particularly targeted individual financial institutions.⁸

After the GFC, these arrangements were strongly criticised. First of all, the collaboration between the FSA and the BoE was problematic. The BoE failed to play an effective role in maintaining financial stability because it had very limited access to the details of each individual bank's situation. As a result, it was impeded from making precise assessments

⁵ Maximilian J.B. Hall, 'The Reform of UK Financial Regulation' (2009) 11 (1) *Journal of Banking Regulation* 31, 31

⁶ FSA, *The Turner Review*, 51

⁷ André Spicer *et al.*, 'Cultural Change in the FCA, PRA and Bank of England: Practising What They Preach?' (*New City Agenda*, 25 October 2016) http://newcityagenda.co.uk/wp-content/uploads/2016/10/NCA-Cultural-change-in-regulators-report_embargoed.pdf accessed 19 May 2017; Eilís Ferran, 'The Break-up of the Financial Services Authority' (2011) 31 (3) *Oxford Journal of Legal Studies* 455, 465-8

⁸ Iain MacNeil, 'The Trajectory of Regulatory Reform in the UK in the Wake of the Financial Crisis' (2010) 11 (4) *European Business Organisation Law Review* 483, 492-3; Conservative Party, *The Tripartite Review: A Review of the UK's Tripartite System of Financial Regulation in Relation to Financial Stability (Preliminary Report)* (March 2009) 13

on the risks in the financial system.⁹ In fact, it was the FSA who had direct dialogues with financial market participants. The FSA's broad power restricted the BoE's engagement in micro-level prudential regulation and blocked the coordination between them.¹⁰ Furthermore, the FSA itself failed to appropriately balance prudential regulation and the regulation of conduct of business. According to the European Central Bank (ECB), 70% staff working time was devoted to the regulation of conduct of business, leaving prudential regulation outside its vision.¹¹

In response, the UK authorities decided to replace the FSA's approach with a 'Twin Peaks' model, which separates the tasks of prudential regulation and the regulation of conduct of business, and allocates them to two independent regulators. Moreover, the model puts the BoE back to an important position in the regulatory system. Following the enactment of the Financial Services Act 2012 - an amendment to the FSMA 2000, a brand-new and independent banking regulator - the FCA was established. The FCA specifically oversees the conduct of business in individual firms. The PRA, a new branch in the BoE, is responsible for the safety and stability of individual firms and the entire financial system.¹² The FCA and the PRA are the 'Twin Peaks'. Large and important financial institutions are simultaneously regulated by the FCA and the PRA, which are known as 'dual-regulated firms'. Banks belong to dual-regulated firms.¹³ Therefore, regulating bankers' remuneration is the responsibility of the 'Twin Peaks'. The post-crisis regulation of bankers' remuneration has been undertaken by the two bodies. The major measures have been enacted in the Remuneration Codes in the FCA Handbook and the PRA Rulebook.¹⁴

In the era of financial liberalisation before the GFC, market-based values such as economic efficiency and transaction facilitation were the primary goals of banking regulation while 'financial stability for public good' was inferior to them. In the FSA's objectives, financial

⁹ Iain MacNeil, 'The Trajectory of Regulatory Reform in the UK in the Wake of the Financial Crisis' (ibid) 493; Conservative Party, Conservative Party, *The Tripartite Review: A Review of the UK's Tripartite System of Financial Regulation in Relation to Financial Stability (Preliminary Report)* (ibid) 5

¹⁰ Michael W. Taylor, 'The Road from Twin Peaks - and the Way Back' (2009) 16 (1) Connecticut Insurance Law Journal 61, 81

¹¹ ECB, *The Role of Central Banks in Prudential Supervision* (2001) https://www.ecb.europa.eu/pub/pdf/other/prudentialsupcbrole_en.pdf accessed 19 May 2017, 4; Michael W. Taylor, 'The Road from Twin Peaks - and the Way Back' (ibid) 80; FSA, *The Turner Review*, 87

¹² Financial Services Act 2012, Article 6 and 9

¹³ For the details of their authorisations, please refer to their websites. FCA, 'Authorisation: What's Involved' (FCA website, 5 September 2017) <https://www.fca.org.uk/firms/authorisation> accessed 4 January 2018; PRA, 'Authorisations' (PRA website, 20 December 2017) <http://www.bankofengland.co.uk/pr/Pages/authorisations/default.aspx> accessed January 2018

¹⁴ Remuneration Codes now refer to the SYSC 19A, B, C, D and E in the FCA Handbook. Each of the five codes applies to one type of financial institutions. The detailed rules among them are slightly different. The SYSC 19D and the 'Remuneration' section in the PRA Rulebook are specifically for the remuneration in banks. Since the contents of these two regulatory documents are the same, the thesis will only cite the SYSC 19D.

stability was omitted.¹⁵ To a large extent, the Banking Crisis was a failure to pay attention to financial stability.¹⁶ Therefore, maintaining financial stability and protecting the public interest have been particularly emphasised as the pivotal guiding principles for the post-crisis banking regulatory reform. The Financial Services Act 2010 added financial stability into the FSA's regulatory objectives.¹⁷ After shifting to the 'Twin Peaks' model, financial stability and the public interest have also been integrated into the objectives of the FCA and the PRA.

However, there have been some arguments that these principles are so generic that they are only meaningful on a symbolic or rhetorical basis, however, they cannot make a substantial difference to the conduct of both the regulators and regulated firms.¹⁸ This statement is overly negative. Although the principles do not elaborate any detailed requirement, they demonstrate that the regulators have been aware of the deficiencies in previous banking regulation. In fact, many of the changes in banking regulation have been in line with the principles of financial stability and the public interest. For instance, the improvements to the Financial Services Compensation Scheme and the ring-fencing policies introduced in 2016 by the PRA are aimed at protecting massive depositors from the risks taken by their banks.¹⁹

The principles of financial stability and the public interest also lay the foundation for the regulation of bankers' remuneration. Before the Crisis, bankers' remuneration was based on agency theory and shareholder primacy, while disregarding other stakeholders' interests, which was contradictory to the public interest view. The incentives of bankers' remuneration had a disastrous impact on banks' risk-taking, which were the major sources of financial instability. Therefore, it is necessary to comply with the principles of maintaining financial stability and protecting the public interest to guide the reform of bankers' remuneration.

The key policy recommendations of the Turner Review and the Walker Review for regulating bankers' remuneration have focused on the consistency with risk management

¹⁵ Mads Tønnesson Andenæs and Iris H-Y Chiu, *The Foundations and Future of Financial Regulation: Governance for Responsibility* (Routledge 2013) 18-9

¹⁶ Sophie Harnay and Laurence Scialom, 'The Influence of the Economic Approaches to Regulation on Banking Regulations: A Short History of Banking Regulations' (2016) 40 (2) *Cambridge Journal of Economics* 401, 416-7; FSA, *The Turner Review*, 83-4; HM Treasury: *A New Approach to Financial Regulation: Judgement, Focus and Stability* (CM7874, 2010) 47-8

¹⁷ Financial Services Act 2010, Article 1

¹⁸ Aldo Mascareño, 'The Ethics of the Financial Crisis' in Poul F Kjaer *et al* (eds), *The Financial Crisis in Constitutional Perspective: The Dark Side of Functional Differentiation* (Hart Publishing 2011) 333, 345; Mads Tønnesson Andenæs and Iris H-Y Chiu, *The Foundations and Future of Financial Regulation: Governance for Responsibility* (n15) 21

¹⁹ The Financial Services Compensation Scheme is the deposit insurance scheme in the UK. For the purpose and function of the Scheme, please refer to <https://www.fscs.org.uk/what-we-cover/about-us/> accessed 21 May 2017. For the details of the ring-fencing scheme, please refer to PRA, *The Implementation of Ring-fencing: The PRA's Approach to Ring-fencing Transfer Schemes* (March 2016)

and long-term incentives.²⁰ Both the FCA Handbook and the PRA Rulebook have pointed out that promoting effective risk management is the most important purpose and requirement of regulating bankers' remuneration.²¹ Furthermore, long-term deferral and the harmonisation with stakeholders' interests have been highlighted as the general principles.²² Clearly, enhancing risk management, promoting long-term incentives and protecting stakeholders' interests are inherently compatible with the principles of maintaining financial stability and protecting the public interest. Therefore, the fundamental principles of the post-crisis banking regulatory reform are also the orientation of the regulation of bankers' remuneration.

4.2.2 The Regulatory Tightening on Bank Corporate Governance

The FSA's regulatory approach on bank corporate governance was characterised as 'meta-regulation'. 'Meta-regulation' means that regulators only provide a broad blueprint of the regulatory framework, which is not elaborate or prescriptive. Regulators only outline the regulatory objectives, while financial institutions are conferred with extensive discretion to decide how to implement these regulatory objectives.²³

The FSA's philosophy of regulation was primarily based on the view that the market mechanism is self-correcting and more efficient than government.²⁴ It believed that the decisions made in banks' boardrooms would be appropriate since directors and managers were competent to capture market information to precisely assess the risks in banks' operations. Therefore, FSA's regulation was on a 'light touch' basis, with limited intervention in banks' business strategies and corporate governance systems.²⁵

After the GFC, the 'meta-regulatory' and 'light touch' approach has been abolished.²⁶ In the Walker Review, the HM Treasury made 39 pieces of recommendations to enhance the regulation of bank corporate governance, which demonstrates that the regulatory approach has become more interventionist and prescriptive.²⁷ The Walker Review has had a significant and profound influence on the post-crisis reforms of bank corporate governance. Many of its policy recommendations have been converted into the provisions in the

²⁰ FSA, *The Turner Review*, 80-1; HM Treasury, *The Walker Review*, 106

²¹ FCA, *Handbook*, SYSC 19.D.1.6 and 2.1

²² FCA, *Handbook*, SYSC 19.D.2.2(4)

²³ Iris H-Y Chiu, *Regulating (From) the Inside: The Legal Framework for Internal Control in Banks and Financial Institutions* (Hart Publishing 2015) 14-5. 'Meta-regulation' can be interchangeably used with the norm of 'principle-based regulation'. For the definition of 'principle-based regulation', see FSA, *Principles-based Regulation: Focusing on the Outcomes That Matter* (April 2007) 4

²⁴ FSA, *The Turner Review*, 87

²⁵ Ibid; Iain MacNeil, 'The Trajectory of Regulatory Reform in the UK in the Wake of the Financial Crisis' (n8) 493

²⁶ Iris H-Y Chiu, *Regulating (From) the Inside: The Legal Framework for Internal Control in Banks and Financial Institutions* (n23) 24

²⁷ HM Treasury, *The Walker Review*, Preface

Corporate Governance Code, which aims at the corporate governance systems of quoted companies, including large UK banks.²⁸ Moreover, many of the rules in the FCA Handbook and the PRA Rulebook are also based on the Walker Review.

In terms of bankers' remuneration, the Walker Review's recommendations focus on the independent role of remuneration committee and non-executive directors (NEDs), the information disclosure about remuneration policy and practice, the risk adjustment in performance assessment, and the arrangements for retention and punishment.²⁹ Most of these contents have been incorporated into the current regulatory framework.

In short, the regulatory framework of bankers' remuneration is an important section of the post-crisis banking regulatory reform in the UK and integrated into the regulatory tightening of bank corporate governance. The fundamental principles of the post-crisis banking regulation: maintaining financial stability and protecting the public interest, have oriented the regulation of bankers' remuneration. The government's policy recommendations to enhance bank corporate governance have also laid the foundation for the important measures that have been taken to reform bankers' remuneration.

4.3 The Regulation on the Decision-making Power of Bankers' Remuneration

The regulation on the decision-making power of bankers' remuneration deals with the issue 'who among banks' constituencies should decide bankers' remuneration policies and dominate the implementation'. It tries to find out the optimal model that can ensure the most efficient decisions for financial stability and the public interest.³⁰

The decision-making mechanism of executive remuneration depends on the corporate governance paradigm in a jurisdiction. Therefore, the company law and affiliated regulations in the jurisdiction crucially determine the power allocation on remuneration affairs. Usually, shareholders, the board of directors (BOD) and managers are the three major constituencies who may have the sole or collective voice on executive remuneration. Nevertheless, the specific models differ from one jurisdiction to another. For instance, under the director primacy model in American corporate governance, bankers' remuneration is primarily decided by the BOD.³¹ Nevertheless, sometimes in remuneration

²⁸ In particular, the Corporate Governance Code applies to all companies with a Premium listing of equity shares in London but regardless of whether they are incorporated in the UK or elsewhere. FRC, *The UK Corporate Governance Code* (April 2016), Governance and the Code, Article 6

²⁹ HM Treasury, *The Walker Review*, Chapter 7

³⁰ John Pound, 'The Promise of the Governed Corporation' (*Harvard Business Review*, March 1995) <https://hbr.org/1995/03/the-promise-of-the-governed-corporation> accessed 23 May 2017, 10

³¹ The director primary model favours that the decision-making and internal control of a company should centre on the board and directors rather than shareholders. This model is not against agency theory and shareholder primary. On the contrary, it conforms to the maximisation of shareholders' interests as the ultimate purpose of corporate governance. See Bernard S. Black and John C. Coffee, 'Hail Britannia?: Institutional Investor Behaviour under Limited Regulation' (1994) 92 (7) *Michigan Law Review* 1997, 2079;

practice, if managers could manipulate the decisions of the BOD for self-benefit remuneration plans, the director primacy model will be dissimilated to the managerialism model,³² in which managers are at the heart of decision-making.

Before the GFC, the decision-making of executive remuneration in UK companies, including banks, was also based on the director primacy model,³³ with preventive arrangements against executive manipulation, such as forbidding executives from deciding their own remuneration and maintaining the independence of remuneration committee.³⁴

After the GFC, the power allocation on executive remuneration has been significantly changed through the regulatory reform of general corporate governance. The two most important changes are the enhancement of the independence and responsibility of remuneration committee, and the empowerment to shareholders on executive remuneration, which is commonly known as shareholder ‘Say on Pay’. These two measures have also deeply affected the reform of bankers’ remuneration.

4.3.1 The Independence and Responsibility of Remuneration Committee

The independence of a company’s remuneration committee can be measured by the engagement and delegation of NEDs. Usually, a remuneration committee should be solely or mainly comprised of NEDs.³⁵ NEDs are the professionals with industrial experience, while without material business, financial or private connections with the company. Thus, the basic function of NEDs is to bring independent and professional judgements to boardrooms. More importantly, NEDs act as a device of checks and balance to supervise the actions of executives.³⁶ The idea of remuneration committee is to ensure the

Stephen M. Bainbridge, ‘Director Primacy and Shareholder Disempowerment’ (2006) 119 (6) *Harvard Law Review* 1735, 1744-8; Stephen M. Bainbridge, ‘Director Primacy’ (2010) UCLA School of Law, Law & Economics Research Paper No. 10-06 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1615838 accessed 23 May 2017, 4; Stephen M. Bainbridge, ‘Director Primacy: The Means and Ends of Corporate Governance’ (2003) 97 (2) *Northwestern University Law Review* 547, 554-9

³² Lucian A. Bebchuk and Jesse Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (Harvard University Press 2006) 72-4

³³ The main view on the corporate governance model in UK companies does not define it as a director primacy paradigm. In comparison with the US, shareholders in UK companies are traditionally more powerful. For more discussions on the differences in shareholder power between the UK and the US, see Jennifer G. Hill, ‘The Trajectory of American Corporate Governance: Shareholder Empowerment and Private Ordering Combat’ (2017) European Corporate Governance Institute Law Working Paper No. 343/2017 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2921692 accessed 25 May 2017, 1-2; John Armour *et al*, ‘Shareholder Primacy and the Trajectory of UK Corporate Governance’ (2003) 41 (3) *British Journal of Industrial Relations* 531, 532. Nevertheless, in terms of the executive pay-setting process, before the GFC shareholders in UK companies did not play a decisive role. The situations in banks were the same. Therefore, the thesis tends to classify it as the director primacy model.

³⁴ FRC, *The Combined Code on Corporate Governance* (June 2008), Article 1B

³⁵ Brian G. M. Main and James Johnston, ‘Remuneration Committees and Corporate Governance’ (1993) 23 (91A) *Accounting and Business Research* 351, 351

³⁶ Charlie Weir *et al*, ‘Internal and External Governance Mechanisms : Their Impact on the Performance of Large UK Public Companies’ (2002) 29 (5-6) *Journal of Business Finance and Accounting* 579, 583

independence of the decision-making process of executive remuneration.³⁷ To constrain executives from manipulating and inflating their own remuneration, they should be excluded from the pay-setting process.³⁸ NEDs, due to their assumed characters: disinterested and neutral, are believed to be more suitable for making reasonable remuneration policy and carrying out efficient remuneration practice.³⁹

In 1992 the Committee on the Financial Aspects of Corporate Governance (the Cadbury Committee) in the FRC first made the recommendation of establishing a remuneration committee in quoted companies. Prior to the GFC, it had been practised in the UK for fifteen years.⁴⁰ However, the failure of bankers' remuneration threw doubt upon the independence and effectiveness of the remuneration committees in financial institutions.⁴¹ The Walker Review has pointed out that the role of remuneration committee was not sufficient and should be enhanced.⁴²

Informed by the Walker Review, in 2010 the FRC published the enhanced requirements on the independence and responsibility of remuneration committee in its up-to-date Corporate Governance Code.⁴³ For listed companies in all industries, there should be at least three NEDs in the remuneration committee.⁴⁴ The general delegated responsibilities of a remuneration committee are: first, setting up the remuneration of all executive directors and the chairman; second, recommending and monitoring the remuneration level and structure of senior management; third, consulting the chief executive or appointing external consultants in respect of executive directors' remuneration. Moreover, the operation of remuneration committee should be independent and transparent. Directors should be forbidden from participating in the decision-making processes of their own remuneration.⁴⁵

³⁷ Martin Conyon and Simon I. Peck, 'Board Control, Remuneration Committees, and Top Management Compensation' (1998) 41 (2) *The Academy of Management Journal* 146, 148

³⁸ Brian G. M. Main and James Johnston, 'Remuneration Committees and Corporate Governance' (n35) 351-3

³⁹ Chii-Shyan Kuo and Shih-Ti Yu, 'Remuneration Committee, Board Independence and Top Executive Compensation' (2014) 7 *Journal of Risk and Financial Management* 28, 29; Ian Gregory-Smith, 'Chief Executive Pay and Remuneration Committee Independence' (2012) 74 (4) *Oxford Bulletin of Economics and Statistics* 510, 511; Alan Dignam, 'Remuneration and Riots: Rethinking Corporate Governance Reform in the Age of Entitlement' (2013) 66 (1) *Current Legal Problems* 401, 409

⁴⁰ The Corporate Governance Committee, *The Cadbury Report* (December 1992), Article 4.42; Steve Thompson, 'Executive Pay and Corporate Governance Reform in the UK: What Has Been Achieved?' in Randall S. Thomas and Jennifer G. Hill (eds), *Research Handbook on Executive Pay* (Edward Elgar 2012) 58, 59

⁴¹ Ian Gregory-Smith, 'Chief Executive Pay and Remuneration Committee Independence' (n39) 511

⁴² HM Treasury, *The Walker Review*, Chapter 7, 112

⁴³ The latest version of the Corporate Governance Code was released in 2016, but the contents about executive remuneration remain the same with previous versions. Thus, the citations will be based on the 2016 version.

⁴⁴ The minimum number of NEDs in a remuneration committee of a smaller company is two. A smaller company is a company that is below the FTSE 350 throughout the year. FRC, *The UK Corporate Governance Code* (April 2016), Article B.1.2. For the requirement of the number of NEDs, see Article D.2.1.

⁴⁵ FRC, *The UK Corporate Governance Code* (April 2016), Article D.2, Main Principle

If directors are consulted for others' remuneration, the committee should take care of their proposals, in order to avoid conflicts of interests.⁴⁶

These requirements in the Corporate Governance Code are on the basis of 'comply and explain', which means that they are not the rigid 'hard law'. On the contrary, the FCA's Remuneration Code has imposed mandatory and stricter requirements on banks in respect of the independence and responsibility of remuneration committee. It requires that a bank which is 'significant in terms of its size, internal organisation and the nature, the scope and the complexity of its activities must establish a remuneration committee',⁴⁷ which must completely consist of NEDs.⁴⁸ The responsibilities of banks' remuneration committees are special and more complex. The general responsibility is to exercise competent and independent judgement on remuneration policy and practice, and the incentives for bankers.⁴⁹ Particularly, when preparing for the decisions of bankers' remuneration, remuneration committees are required to keep an eye on banks' risks, the long-term interests of shareholders and stakeholders, and the public interest.⁵⁰

For UK banks, the regulation of remuneration committee is made up of the basic rules in the Corporate Governance Code and the enhanced rules in the Remuneration Code. Despite that the reformed rules have strengthened the function and power of remuneration committee, the power allocation on bankers' remuneration is not essentially changed. According to the general rules in company law, the remuneration committee is principally responsible for designing, practicing and monitoring remuneration policies, while the remuneration report should be finally approved and signed by the BOD.⁵¹ The FRC also specifies that 'while the board may make use of committees to assist its consideration of audit, risk and remuneration, it retains responsibility for, and makes the final decisions on, all of these areas'.⁵² Clearly, in terms of the decision-making of executive remuneration, the UK company law and the regulation of general corporate governance still prefer to keep the BOD and executive directors at an important position, rather than completely replacing

⁴⁶ FRC, *The UK Corporate Governance Code* (April 2016), Article D.2, Supporting Principle

⁴⁷ FCA, *Handbook* (July 2015), SYSC 19D.3.12(1). There is no specific explanation about what kinds of banks can be regarded as 'significant in terms of its size, internal organisation and the nature, the scope and the complexity of its activities'. Nevertheless, in the PRA's supervisory statement in regards to the application of the proportionality of remuneration standards, it categorises UK banks into three proportionality levels. Level one refers to banks with assets of more than GBP 50 billion. Level two includes banks with assets from GBP 15 to 50 billion. Banks with less than GBP 15 billion assets fall into level three. A remuneration committee is only compulsory for those banks in level one and two. See PRA, *Supervisory Statement SS2/17* (April 2017) 7-11. In fact, the proportionality levels are also used for the application of other regulatory measures, such as bankers' bonus cap. According to the PRA, the thesis defines banks that are 'significant in terms of its size, internal organisation and the nature, the scope and the complexity of its activities' as those in level one and two, namely, with more than GBP 15 billion assets.

⁴⁸ FCA, *Handbook*, SYSC 19D.3.12(2)(b)

⁴⁹ FCA, *Handbook*, SYSC 19D.3.12(1) and 2(a)

⁵⁰ FCA, *Handbook*, SYSC 19D.3.12(2)(c) and (d)

⁵¹ Companies Act 2006, Article 422(1)

⁵² FRC, *Guidance on Board Effectiveness* (March 2011), Article 6.1

them by NEDs. Moreover, in the Remuneration Code, the job of remuneration committee is described as ‘the preparation of decisions’, which implies that remuneration committee is not the final decision maker. It demonstrates that the banking regulators are holding the same opinion as the UK company law and the FRC. That is to say, the final decisions in respect of bankers’ remuneration are made by executive directors and NEDs together, as the collective actions of the BOD.

Nevertheless, the regulation of bankers’ remuneration stipulates that remuneration committee owes responsibilities to the bank and its broader stakeholders, and the public interest. This is the most significant change made to the role and responsibilities of banks’ remuneration committees. It directly and correctly responded to the problem in previous remuneration practice: bankers were incentivised to maximise shareholders’ interests, while finally resulting in huge detriments to the banking system and the public. Therefore, the redefinition of remuneration committee’s responsibilities, together with the enhancement of its independence, will help curb excessive risk-taking and improve the effectiveness of bankers’ remuneration in maintaining financial stability and protecting the public interest.

However, the independence, competence and effectiveness of NEDs and board committees in corporate governance practice are always challenged. The appointments and salaries of NEDs are tied to executive directors. As a result, they tend to comply with, rather than dissenting from executive directors’ intentions.⁵³ Therefore, NEDs would act as ‘window dressing’ and their function to improve corporate governance would be eroded.⁵⁴ The author does not deny the possibility of these problems in corporate governance practice. Nevertheless, since this chapter focuses on the rules in regulatory books, this issue will not be further discussed.

4.3.2 Shareholder ‘Say on Pay’

Because of the BOD’s deficiencies perceived by the market during the GFC, in the aftermath, corporate governance reforms have paid more attention to shareholder empowerment.⁵⁵ New policies in support of shareholder empowerment have been adopted by the legislators and regulators in many Western industrialised countries. For example, corporate governance in the US has been shifting from director primacy to shareholder empowerment.⁵⁶ In the UK, due to the traditionally stronger position of shareholders, the

⁵³ Randall Morck, ‘Behavioural Finance in Corporate Governance - Independent Directors, Non-Executive Chairs, and the Importance of the Devil’s Advocate’ (2004) NBER Working Paper No. 10644 <http://www.nber.org/papers/w10644> accessed 25 May 2017, 15

⁵⁴ Suzanne Le Mire and George Gilligan, ‘Independence and Independent Company Directors’ (2013) 13 (2) *Journal of Corporate Law Studies* 443, 456

⁵⁵ Demetra Arsalidou, *Rethinking Corporate Governance in Financial Institutions* (Routledge 2015) 159; Jonathan Mukwiri and Mathias Siems, ‘The Financial Crisis: A Reason to Improve Shareholder Protection in the EU?’ (2014) 41 (1) *Journal of Law and Society* 51, 57

⁵⁶ Stephen M. Bainbridge, *Corporate Governance After the Financial Crisis* (OUP 2016) 205-6; Stephen M. Bainbridge, ‘Shareholder Activism in the Obama Era’ (2009) UCLA School of Law, Law & Economics

reform seems not as revolutionary as that in the US. Nevertheless, the post-crisis regulation of corporate governance also bolsters the view that more power should be authorised to shareholders.⁵⁷ A significant action is the revision made to the legislation of shareholder ‘Say on Pay’. It has substantially changed the power allocation on bankers’ remuneration. Shareholders have started to share the power with the BOD.

4.3.2.1 A Brief Introduction and the Early History in the UK

As the name suggests, shareholder ‘Say on Pay’ refers to a corporate governance arrangement which empowers shareholders to play an influential or a decisive role in the determination of executive remuneration. It is usually exercised in the form of a shareholder vote on a company’s remuneration report. Across different jurisdictions, the vote can be either binding or non-binding. A binding vote means that the decision made by shareholders is final and cannot be challenged by the BOD or senior management. It is a real power of decision-making. In contrast, the outcome of a non-binding vote is advisory, which means that it is only a right of suggestion and a channel of expression.⁵⁸

In the world, the UK was the forerunner of ‘Say on Pay’ legislation. In 2002, the UK government issued the Directors’ Remuneration Report Regulations as an amendment to the Companies Act 1985, in which shareholders in quoted companies were entitled to a non-binding vote on the approval of directors’ remuneration report at the annual general meeting (AGM).⁵⁹ Afterwards, the relevant provisions have been introduced to the Companies Act 2006.

The rule itself was procedurally mandatory, meaning that companies must organise a shareholder vote. However, the outcome was only advisory. Theoretically, even if shareholders expressed their dissatisfaction with the remuneration report, the BOD could still ignore it.⁶⁰ However, due to the empowerment by the Companies Act to shareholders on other essential corporate governance affairs, such as the appointment and removal of directors, shareholders’ dissent could have a great influence on the board’s decision of

Research Paper No. 09-14 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1437791 accessed 23 May 2017, 2-4

⁵⁷ After the GFC, the FRC has released the Stewardship Code with the attempt to strengthen the engagement of institutional shareholders. It can demonstrate that the fundamental position of the UK corporate governance regulator is in favour of a more powerful role of shareholders. Eva Micheler, ‘Facilitating Investor Engagement and Stewardship’ (2013) 14 *European Business Organisation Law Review* 29, 45

⁵⁸ Philip J. Wells, ‘Executive Remuneration: Regulatory Reforms in UK Company Law’ (2015) 57 (4) *International Journal of Law and Management* 300, 312

⁵⁹ Companies Act 2006, Article 439(1)

⁶⁰ Minor Myers, ‘The Perils of Shareholder Voting on Executive Compensation’ (2011) 36 *Delaware Journal of Corporate Law* 417, 428; BIS, *Shareholder Votes on Directors’ Remuneration* (Impact Assessment 0341, May 2012) <http://www.parliament.uk/documents/impact-assessments/ial2-014f.pdf> accessed 26 May 2017, 11

executive remuneration.⁶¹ According to the empirical evidence, the responses to shareholder dissent varied among companies. Among the 75 firms that received high dissent votes, 23 (31%) changed their remuneration structures, while others not.⁶² Since the law did not stipulate what the BOD should do to respond to shareholders' opposition, directors still had massive flexibilities to choose whether to accept or reject shareholders' opinions.⁶³ Therefore, as a non-binding vote, the nature of 'Say on Pay' was just a 'voice' on executive remuneration.⁶⁴

4.3.2.2 The Post-crisis Reform in the UK

The ineffectiveness of the non-binding 'Say on Pay' was widely criticised. In practice, it often failed to encourage sufficient shareholder engagement. Statistical data shows that from 2003 to 2011, only 20 remuneration reports were defeated by more than 50% shareholders.⁶⁵ It was argued that the low shareholder engagement should be attributed to the advisory character of the vote. Shareholders would be less motivated if they are aware that the BOD will always implement the remuneration policy regardless of the outcome of the vote.⁶⁶ As a consequence, policy makers concerned about the limitation of the non-binding 'Say on Pay' and started to seek a solution to make it effective.⁶⁷

In March 2012, the BIS published a proposal to strengthen the rules of 'Say on Pay' by offering shareholders a binding vote on directors' remuneration policy.⁶⁸ In October 2013, this proposal came into law through the enactment of the Enterprise and Regulatory Reform Act 2013, which is an amendment to the Companies Act 2006. Subsequently, more details have been promulgated in the Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2013.⁶⁹

⁶¹ Minor Myers, 'The Perils of Shareholder Voting on Executive Compensation' (ibid) 421; Lucian A. Bebchuk and Jesse Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (n32) 72-4

⁶² High dissent means that there are more than 20% shareholders voting against the remuneration report. Fabrizio Ferri and David A. Maber, 'Say on Pay Votes and CEO Compensation: Evidence from the UK' (2013) 17 (2) *Review of Finance* 527, 539

⁶³ BIS, *Shareholder Votes on Directors' Remuneration* (n60) 11

⁶⁴ Philip J. Wells, 'Executive Remuneration: Regulatory Reforms in UK Company Law' (n58) 312

⁶⁵ HPC, 'The State of Pay: One Year on From the High Pay Commission' (2012) http://highpaycentre.org/files/state_of_pay.pdf accessed 26 May 2017, 19

⁶⁶ Kiersten Zaza, 'The Impact of Say on Pay' (2012) 31 *Review of Banking and Financial Law* 580, 582

⁶⁷ BIS, *Executive Pay, Shareholder Voting Rights Consultation* (June 2012) https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/207452/12-918-executive-pay-consultation-shareholder-voting-responses.pdf accessed 26 May 2017, 10

⁶⁸ Ibid, 16

⁶⁹ The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2013, Schedule 8, Part 4

Currently, all quoted companies must put their directors' remuneration policies under the shareholder vote at the accounts meeting or other general meetings.⁷⁰ Specifically, if the BOD plans to make any change to the remuneration policy, a shareholder vote must be held. If the remuneration policy has been carrying out for three financial years, in order to continue with it, the BOD needs another approval from shareholders by the end of the third year.⁷¹ More importantly, any resolution made by shareholders will be legally binding. To approve the remuneration policy, an ordinary resolution is required. If more than 50% shareholders are against the remuneration policy, the BOD should still apply its previous policy, revise the rejected proposal, and put it under shareholder vote at next accounts meeting.⁷²

The vote is not binding on the whole remuneration report. Usually, a remuneration report comprises two substantial sections: the remuneration policy which outlines the proposal of directors' remuneration in the coming financial year and the implementation of the remuneration policies made in previous financial years.⁷³ Currently, the binding vote is only applied to the first section, the remuneration policy, whereas shareholders' opinion on the implementation of remuneration remains non-binding.⁷⁴ The contents of the remuneration policy include remuneration level, composition and structure, and the system of performance metrics and assessment. All of these are the essential aspects of executive remuneration. In comparison, the implementation is minor because it is a summary of how the remuneration policy approved by shareholders has been carried out by the BOD. As long as shareholders can decide the contents of the remuneration policy, the BOD and directors have very limited discretion to change them during the process of implementation. The binding 'Say on Pay' has substantially reframed the power allocation on executive remuneration. In terms of directors' remuneration, the final power has been largely transferred from the BOD to shareholders. The role of shareholders has shifted from a 'voice' to a real decision maker.⁷⁵ However, it does not mean that directors have been completely excluded from the pay-setting process. They still maintain the power to draft and implement the remuneration policy. Besides, managers' remuneration is still decided by the BOD. Currently, the decision-making of executive remuneration in UK quoted companies can be described as a process of 'co-determination' between shareholders and the BOD.

⁷⁰ Accounts meeting means a general meeting of the company before which the company's annual accounts for a financial year are to be laid. Companies Act 2006, Article 439A(8)(a)

⁷¹ Companies Act 2006, Article 439(1) and (7)

⁷² Companies Act 2006, Article 439(2)(a); BIS, *Executive Pay, Shareholder Voting Rights Consultation* (n67) 17

⁷³ BIS, *Executive Pay, Shareholder Voting Rights Consultation* (ibid) 16

⁷⁴ Ibid, 17; Companies Act 2006, Article 439(1) and (7)

⁷⁵ Minor Myers, 'The Perils of Shareholder Voting on Executive Compensation' (n60) 429

The reform of shareholder ‘Say on Pay’ demonstrates the enhancing trend of shareholder empowerment in the UK corporate governance system. Besides, ‘Say on Pay’ may be further enhanced. The government led by Prime Minister Theresa May has been considering to extend the binding vote to the implementation of remuneration.⁷⁶

4.3.2.3 The Theoretical Rationales and Academic Criticism

In academic discussions, ‘Say on Pay’ is always a controversial topic. Based on shareholder primacy, proponents argue that ‘Say on Pay’ is a necessary mechanism to deal with the conflicts of interests between shareholders and directors.⁷⁷ It provides shareholders with the opportunity to intervene in the decision-making of remuneration, in order to make sure that directors’ remuneration is well aligned with their performance in the pursuit of shareholders’ interests.⁷⁸ In addition, it can act as a mechanism of checks and balance to prevent the self-benefiting and manipulating actions of directors.

However, ‘Say on Pay’ has also received great criticism. Some opponents analyse from a theoretical perspective that it muddles the boundaries of power and responsibilities between the BOD and shareholders. Thus, it challenges the very fundamental separation between ownership and control in modern corporations.⁷⁹ Other opponents argue that it is practically counterproductive. Shareholders are indifferent to, or ignorant about executive remuneration. They may have a free-rider mentality, or have no professional knowledge to make correct judgements.⁸⁰ More seriously, shareholders are often prone to short-term interests and risk-taking, without a long-term angle.⁸¹ Therefore, they tend to be content with the remuneration policy which will bring immediate shareholder returns to them.⁸²

In fact, ‘Say on Pay’ is not a special regulatory device of bankers’ remuneration. It is uniformly applied to quoted companies in all industries and affects the majority of UK banks. In terms of shareholder ‘Say on Pay’ in non-financial industries, scholars have had

⁷⁶ Kate Burgess *et al*, ‘Shareholders Ready to Show Their Hand over Executive Pay’ *Financial Times* (London, 31 March 2017) <https://www.ft.com/content/5c031f44-13a5-11e7-80f4-13e067d5072c> accessed 26 May 2017

⁷⁷ Konstantinos Stathopoulos and Georgios Voulgaris, ‘The Importance of Shareholder Activism: The Case of Say on Pay’ (2016) 24 (3) *Corporate Governance: An International Review* 359, 361

⁷⁸ Minor Myers, ‘The Perils of Shareholder Voting on Executive Compensation’ (n60) 431

⁷⁹ Stephen M. Bainbridge, ‘Remarks on Say on Pay: An Unjustified Incursion on Director Authority’ (2008) UCLA School of Law, Law & Economics Research Paper No. 08-06 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1101688 accessed 26 May 2017, 8; Jeremy Ryan Delman, ‘Structuring Say-on-Pay: A Comparative Look at Global Variations in Shareholder Voting on Executive Compensation’ (2017) 2 *Columbia Business Law Review* 583, 613

⁸⁰ Stephen M. Bainbridge, ‘Remarks on Say on Pay: An Unjustified Incursion on Director Authority’ (ibid) 10

⁸¹ Philip J. Wells, ‘Executive Remuneration: Regulatory Reforms in UK Company Law’ (n58) 317

⁸² Brian R. Cheffins and Randall S. Thomas, ‘Should Shareholders Have a Greater Say over Executive Pay? Learning from the US Experience’ (2001) 1 (2) *Journal of Corporate Law Studies* 277, 294; Jeremy Ryan Delman, ‘Structuring Say-on-Pay: A Comparative Look at Global Variations in Shareholder Voting on Executive Compensation’ (n79) 602

comprehensive and sophisticated debates on its function and flaws. However, ‘Say on Pay’ in the banking sector has rarely been discussed.

In the banking sector, ‘Say on Pay’ is contradictory with the fundamental principles of the regulation of bankers’ remuneration. The nature of ‘Say on Pay’ is shareholder empowerment, the ideological basis of which is shareholder primacy. However, the post-crisis regulatory reform of bankers’ remuneration is aimed at shifting remuneration practice from maximising shareholders’ interests to promoting financial stability and protecting the public interest. In this sense, applying ‘Say on Pay’ to banks will lead to the conflicts with the fundamental principles and the values of other regulatory measures of bankers’ remuneration. Further discussions on these conflicts will be provided in Chapter 5.

4.4 The Regulation on Remuneration Policy and Management

The company law in the UK traditionally views that the law should provide flexibility and autonomy to companies for business efficiency.⁸³ However, bank corporate governance should be different because it highly pertains to the stability of the financial system and national economy. Therefore, banking regulation must try to balance the values of efficiency and stability.⁸⁴ This acknowledgement has been reinforced after the GFC. The regulation of bankers’ remuneration is more interventionist than the remuneration rules in general corporate governance regulations. Apart from the reforms of the decision-making power, the regulation has focused more on the control over banks’ remuneration policy and management. The new regulatory measures have intervened in remuneration level and structure (bankers’ bonus cap), and the incentive mechanism (deferral, clawback and *malus*, and risk adjustment).

4.4.1 Bankers’ Bonus Cap

Bankers’ bonus cap is a new regulatory measure adopted after the GFC, with which the banking regulators can directly control the level and structure of bankers’ remuneration. In fact, it is not one of the initiatives of the UK government, while a part of the EU banking regulatory framework. As widely known, on 23 June 2016, the UK has decided to withdraw from the EU. Nevertheless, when the EU formally released the rules of bankers’ bonus cap in 2013, the UK was still one of its member states. Therefore, the relevant rules have been implemented by the FCA and the PRA in their regulations and remain valid after Brexit.

Bankers’ bonus cap is a mandatory limit on the ratio between bankers’ variable remuneration and fixed remuneration. ‘Bankers’ bonus cap’ is the commonly used name of

⁸³ Henry T. C. Hu, ‘Efficient Markets and the Law: A Predictable Past and an Uncertain Future’ (2012) 4 Annual Review of Financial Economics 179, 180-2

⁸⁴ Marco Becht *et al.*, ‘Why Bank Governance Is Different’ (2011) 27 (3) Oxford Review of Economic Policy 437, 445; Fredrick Tung, ‘Pay for Bankers’ Performance: Structuring Executive Compensation for Risk Regulation’ (2011) 105 (3) Northwestern University Law Review 1205, 1210

this rule in academic and media articles. In fact, the cap is imposed on all types of variable remuneration, not only annual bonuses.⁸⁵

Among Western liberal market economies, such strict regulatory intervention was not seen before the GFC. Even after the GFC, the EU is the only jurisdiction that has written the cap into legislation. Because of the unprecedentedly rigid and interventionist character of bankers' bonus cap, since it was proposed until today, it has been fiercely and constantly debated. It is also the most contentious part in the UK's regulatory framework of bankers' remuneration.

4.4.1.1 The Proposals at the Early Stage

Many financial institutions in other EU member states also suffered from severe financial difficulties.⁸⁶ Prior to the GFC, large banks in the EU had developed very similar equity-based remuneration components and incentive cultures with those in the US and the UK financial markets.⁸⁷ Therefore, the EU authorities and the governments of many member states also faced with the problem of how to reform bankers' remuneration to control short-termism and excessive risk-taking.⁸⁸ According to the EU policy makers and many of its think-tanks, it was the incentives in variable remuneration that unduly stimulated bankers to take risky strategies. As a consequence, imposing a mandatory ceiling to restrain the level of variable remuneration will help reduce bankers' incentives.⁸⁹

The idea of bonus cap first emerged in France and Germany. The two countries took the lead to impose rigid limitations on bankers' variable remuneration at the domestic level. At the very beginning, the limitations only targeted bankers' remuneration in those troubled financial institutions in France and Germany.⁹⁰ In 2009, both countries applied bankers' bonus cap to all financial firms.⁹¹

⁸⁵ Longjie Lu, 'The End of Bankers' Bonus Cap: How Will the UK Regulate Bankers' Remuneration After Brexit?' (2016) 27 (7) *European Business Law Review* 1091, 1102

⁸⁶ Walter W. Eubanks, 'The European Union's Response to the 2007-2009 Financial Crisis' (2010) Congressional Research Service for the US Congress - R41367 <https://fas.org/sgp/crs/row/R41367.pdf> accessed 28 May 2017, 1

⁸⁷ Emiliios Avgouleas and Jay Cullen, 'Market Discipline and EU Corporate Governance Reform in the Banking Sector: Merits, Fallacies, and Cognitive Boundaries' (n4) 31; Kevin J. Murphy, 'Regulating Banking Bonuses in the European Union: A Case Study in Unintended Consequences' (2013) 19 (4) *European Financial Management* 631, 635

⁸⁸ Edyta M. Dorenbos and Alessio M. Paces, 'Corporate Governance of Banks: Is More Board Independence the Solution?' (2013) 2 *Dovens Schmidt Quarterly* 46, 46-7

⁸⁹ 'A New Row Is Brewing over Bankers' Bonuses' *The Economist* (London, 12 May 2012) 80; John O'Donnell and Alice Baghdjian, 'EU Moves Closer to Imposing Caps on Banker Bonuses' *Reuters* (Brussels and London, 27 February 2013) <http://www.reuters.com/article/us-eu-bonus-idUSBRE91Q07J20130227> accessed 28 May 2017

⁹⁰ Tito Boeri *et al* (eds), *Executive Remuneration and Employee Performance-related Pay: A Transatlantic Perspective: A Transatlantic Perspective* (OUP 2013) 73

⁹¹ *Ibid*, 75; Francesca Fabbri and Dalia Marin, 'What Explains the Rise in Executive Pay in Germany? A Panel Data Analysis for 1977-2009' (2016) 118 (2) *The Scandinavian Journal of Economics* 235, 235; Longjie

Simultaneously, bankers' bonus cap was put forward at the international level. Germany and France jointly made a proposal to the G20 meeting held in September 2009 in London. They suggested that bankers' bonuses should be capped by a certain percentage of the firm's total assets or revenue.⁹² The French-German proposal was championed by many other continental European countries, such as Sweden, the Netherlands, Luxembourg, Spain and Italy.⁹³ However, the G20 failed to reach a consensus at the meeting because the UK and the US jointly rejected it.⁹⁴ 20 days later at the G20 Summit in Pittsburgh, it was turned down again due to the same reason.⁹⁵ Finally, the effort to make the cap as a worldwide regulatory measure for bankers' remuneration was failed.

4.4.1.2 The Legislation at the EU Level and the Implementation in the UK

After the failures at the G20 meetings, the plan was brought to the EU legislators. In March 2010, a proposal that bankers' variable remuneration should be limited to 50% of the total annual remuneration was made to the European Parliament.⁹⁶ In June, the European Parliament's Committee on Economic and Monetary Affairs (ECON) approved this proposal and officially declared the plan of legislation.⁹⁷ This was the rudiment of the EU bankers' bonus cap.

In April 2012, The European Parliament decided to draw up the legislation to limit the ratio between bankers' variable and fixed remuneration to 1:1.⁹⁸ In May, the ECON announced

Lu, 'The End of Bankers' Bonus Cap: How Will the UK Regulate Bankers' Remuneration After Brexit?' (n85) 1102

⁹² Phillip Inman, 'France and Germany Declare War on Bankers' Bonuses' *The Guardian* (London, 1 September 2009) <https://www.theguardian.com/business/2009/sep/01/france-germany-demand-bonus-sanctions> accessed 28 May 2017; Patrick Wintour and Andrew Clark, 'G20 Leaders Split over Bank Bonus Curbs' *The Guardian* (Pittsburgh, 25 September 2009) <https://www.theguardian.com/world/2009/sep/24/g20-leaders-split-over-bankers-bonuses> accessed 28 May 2017

⁹³ Kevin J. Murphy, 'Regulating Banking Bonuses in the European Union: A Case Study in Unintended Consequences' (n87) 643; Tito Boeri *et al* (eds), *Executive Remuneration and Employee Performance-related Pay: A Transatlantic Perspective* (n90) 75

⁹⁴ Brian Brady, 'London G20 Meeting Rejects Plan to Cap Bankers' Bonuses' *Independent* (London, 5 September 2009) <http://www.independent.co.uk/news/world/politics/london-g20-meeting-rejects-plan-to-cap-bankers-bonuses-1782517.html> accessed 28 May 2017; Ashley Seager and Toby Helm, 'Gordon Brown Persuades G20 Summit Not to Cap Bankers' Bonuses' *The Guardian* (London, 6 September 2016) <http://www.theguardian.com/politics/2009/sep/06/bankers-pay-g20-finance-crisis> accessed 28 May 2017

⁹⁵ Patrick Wintour and Andrew Clark, 'G20 Leaders Split over Bank Bonus Curbs' (n92)

⁹⁶ Nikki Tait, 'MEPs Seek Tougher Curbs on Bankers' Bonuses' *Financial Time* (London 8 March 2010) <https://next.ft.com/content/0f560e42-2a94-11df-b7d7-00144feabdc0> accessed 28 May 2017

⁹⁷ 'European Parliament Caps Bankers' Bonuses' (*European Parliament website*, 30 June 2010) <http://www.europarl.europa.eu/sides/getDoc.do?language=en&type=IM-PRESS&reference=20100630IPR77285> accessed 28 May 2017

⁹⁸ Alex Barker and Brooke Masters, 'European Union Seeks Strict Newcurbs to Cap Bankers' Bonuses' *Financial Times* (London, 13 April 2012) 1

to add the 1:1 ratio cap to the CRD IV.⁹⁹ However, as the 1:1 ratio was considered too strict by some member states, the European Commission rejected it.¹⁰⁰

As a consequence, the European Parliament made a compromise to allow the ratio to be greater than 1:1 with the approval by a supermajority of shareholders. Nevertheless, under no circumstances can the ratio be higher than 2:1. Finally, the revised CRD IV, in which the loosened proposal of bankers' bonus cap was included, has been approved by the European Parliament on 16 April 2013.¹⁰¹ Accordingly, the cap came into force since 1 January 2014.

As a member state in the EU, the UK had to implement the rules of bankers' bonus cap in line with the CRD IV, notwithstanding its opposition and worries. As stated, the cap aims at reducing the incentives for bankers by curbing the quantity of variable remuneration. Therefore, it emphasises that the level of fixed components should represent a sufficiently high proportion of the total remuneration. On the contrary, variable components should be controlled and paying no variable remuneration should be allowed.¹⁰²

In line with the CRD IV, the UK Remuneration Code stipulates that the level of variable remuneration shall not exceed 100% of fixed remuneration. A higher ratio can be adopted with the approval of a supermajority of shareholders.¹⁰³ The 'supermajority of shareholders' should fulfil either of the two conditions: at least 66% of the shares or equivalent ownership rights agree if at least 50% of the shares or equivalent ownership rights in the firm are represented; or at least 75% of the shares or equivalent ownership rights agree if less than 50% of the shares or equivalent ownership rights in the firm are represented.¹⁰⁴ Nevertheless, variable components shall never exceed 200% of fixed components.¹⁰⁵

The cap in the CRD IV is only a threshold. Member states can apply lower caps to further restrict the level of variable remuneration.¹⁰⁶ However, the UK version is completely a duplicate of the EU bankers' bonus cap, without any stricter requirement.¹⁰⁷ In fact, the FCA regarded the implementation as an unavoidable legal duty. It announced that the rules

⁹⁹ 'European Parliament Panel Backs Cap on Bank Bonuses' *Reuters* (Brussels, 4 May 2012) <http://uk.reuters.com/article/uk-eu-banks-pay-idUKBRE84DOT220120514> accessed 7 August 2016

¹⁰⁰ Kevin J. Murphy, 'Regulating Banking Bonuses in the European Union: A Case Study in Unintended Consequences' (n87) 643-4

¹⁰¹ 'Parliament Votes Reform Package to Strengthen EU Banks' (*European Parliament website*, 16 April 2013) <http://www.europarl.europa.eu/news/en/news-room/20130416IPR07333/Parliament-votes-reform-package-to-strengthen-EU-banks> accessed 7 August 2016

¹⁰² FCA, *Handbook*, SYSC 19D.3.48(2)

¹⁰³ FCA, *Handbook*, SYSC 19D.3.49(2)

¹⁰⁴ FCA, *Handbook*, SYSC 19D.3.50(5)

¹⁰⁵ FCA, *Handbook*, SYSC 19D.3.49(1)

¹⁰⁶ The CRD IV, Article 94 (1)(g)(i) and (ii)

¹⁰⁷ Longjie Lu, 'The End of Bankers' Bonus Cap: How Will the UK Regulate Bankers' Remuneration After Brexit?' (n85) 1106

would be implemented on a ‘legal minimum’ basis and in a way of ‘intelligent or even strict copy out’.¹⁰⁸ Obviously, the UK government had to, however, it was by no means willing to impose the cap.

4.4.1.3 The Extension of Bankers’ Bonus Cap and the UK’s Rejection

Although it is a legal duty of the EU member states to implement bankers’ bonus cap, the relevant rules should be subject to the proportionality principle. The proportionality principle is one of the fundamental principles of EU law, which means that the EU directives’ competence shall not go beyond the necessity to achieve its goals.¹⁰⁹ In terms of the remuneration rules, ‘the effect of the proportionality principle is that not all institutions have to give substance to the remuneration requirements in the same way and to the same extent.’¹¹⁰ Instead, the implementation of the rules in member states should be allowed with ‘some flexibility to the size, internal organisation and nature, scope and complexity of institutions’ activities.¹¹¹

Therefore, the UK banking regulators have decided to exempt the financial firms which are usually smaller in size and undertake less complex or risky financial activities from complying with bankers’ bonus cap. There are five Remuneration Codes in the FCA Handbook, each one is applied to one type of financial institutions. SYSC 19B and 19C regulate Alternative Investment Fund Managers and BIPRU firms respectively. In these two Codes, bankers’ bonus cap is not applied.¹¹² Besides, IFPRU firms with less than GBP 15 billion assets do not need to stick to the cap, either.¹¹³ According to the BoE, there are at

¹⁰⁸ FCA, *CRD IV for Investment Firms Feedback and Final Rules for CP13/6, CP13/9 (Chapter 16) and CP13/12* (Policy Statement 13/10, December 2013) 7

¹⁰⁹ The Treaty on European Union, Article 5

¹¹⁰ The Committee of European Banking Supervisors, *Guidelines on Remuneration Policies and Practices* (December 2010) 18

¹¹¹ Ibid, 17; Tamsin Rickard, ‘Proportionate Application of Remuneration Requirements: New European Banking Authority’ (*King & Wood Mallets*, 13 January 2016) <http://www.kwm.com/en/uk/knowledge/insights/proportionate-application-of-remuneration-requirements-20160113#> accessed 29 May 2017

¹¹² Alternative Investment Fund Managers are financial institutions that provide portfolio management and risk management services to one or more Alternative Investment Funds, which usually include hedge funds, private equity firms and investment trusts. See The Alternative Investment Fund Managers Directive, Article 4 and the FCA’s introduction of this Directive, FCA, ‘AIFMD’ (*FCA website*, 13 April 2017) <https://www.fca.org.uk/firms/aifmd> accessed 29 May 2017. A BIPRU firm refers to a firm, as defined in Article 4 (1)(2)(c) of the EU Capital Requirements Regulation (CRR) that provides one or more of the following investment services: execution of orders on behalf of clients, portfolio management, reception and transmission of orders in relation to one or more financial instruments, and investment advice. FCA, *Handbook*, Glossary.

¹¹³ An IFPRU firm refers to ‘an investment firm, as defined in Article 4(1)(2) of the EU CRR (including a collective portfolio management investment firm), that satisfies the following conditions: (a) it is a firm; (b) its head office is in the UK and it is not otherwise excluded under IFPRU 1.1.5 R; and (c) it is not a designated investment firm. FCA, *Handbook*, Glossary. Remuneration in IFPRU firms should comply with the SYSC 19A, in which the bonus cap is incorporated and applied to those with more than GBP 15 billion assets.

least one thousand such kind of smaller financial institutions in the City of London.¹¹⁴ Liberalising these smaller firms can save their costs of regulatory compliance and improve the regulators' efficiency. Moreover, as they are not systemically important nor financially complex or risky, the exemption will not substantially affect financial stability.

However, in March 2015, the European Banking Authority (EBA), the EU's financial watchdog, recommended in a consultation paper to exclude bankers' bonus cap from subject to the proportionality principle. Accordingly, bankers' bonus cap would be imposed on all CRD-regulated financial firms, irrespective of size, type and the complexity of activities.¹¹⁵ In light of the CRD IV, the EBA is delegated to publish detailed guidelines in support of the implementation.¹¹⁶ In December, the EBA formally issued the Guidelines on Sound Remuneration Policies, to which it attached the proposal to extend the cap to all financial institutions.¹¹⁷

The EBA's strong insistence on the extension of bankers' bonus cap demonstrates the EU's stance to regulate the level and structure of bankers' remuneration with direct and tough intervention. Nevertheless, different from the CRD IV, the EBA Guidelines are 'soft law', which are not legally binding on the member states. The UK banking regulators therefore have the leeway to choose not to follow the Guidelines. Were the extension of bankers' bonus cap applied in the UK, all of the aforementioned smaller financial institutions would have to change their remuneration policies. Therefore, the extension proposal received fierce opposition from the UK financial sector.¹¹⁸ In the end, the FCA and the PRA explicitly announced that they would not extend bankers' bonus cap to smaller financial institutions in the City of London.¹¹⁹

Throughout the entire process, including the drafting, legislation and implementation, the UK always held an opposite position against the EU bankers' bonus cap. The UK government, including the BoE, the FCA and many top leaders such as the previous Prime Minister David Cameron and the previous Chancellor of the Exchequer George Osborne, and the British Banking Association, all constantly criticised the deficiencies of bankers' bonus cap and concerned about the potential problems it would bring to the UK's own

¹¹⁴ Caroline Binham and Mark Odell, 'UK Declines to Extend EU Bonus Cap Rules' *Financial Times* (London, 29 February 2016) 20

¹¹⁵ EBA, *Draft Guidelines on Sound Remuneration Policies* (March 2015), Article 72

¹¹⁶ The CRD IV, Article 74(3) and 75(2)

¹¹⁷ EBA, *Guidelines on Sound Remuneration Policies* (December 2015), Article 79; EBA, *Opinion of the EBA on the Application of the Principle of Proportionality to the Remuneration Provisions in Directive 2013/36/EU* (December 2015), Article 29

¹¹⁸ Martin Arnold and Harriet Agnew, 'UK Banks Fight Back Against EU Bonus Cap Extension' *Financial Times* (London, 3 June 2015) <https://www.ft.com/content/2b57aef4-0a0c-11e5-82e4-00144feabdc0> accessed 29 May 2017

¹¹⁹ FCA, 'PRA and FCA Statement on Compliance with the EBA Guidelines on Sound Remuneration Policies' (*FCA website*, 29 February 2016) <https://www.fca.org.uk/news/statements/pr-and-fca-statement-compliance-eba-guidelines-sound-remuneration-policies> accessed 29 May 2017

regulatory framework of bankers' remuneration. In fact, the EU bankers' bonus cap is incompatible with the traditional, liberal market-based regulatory ideology in the UK. It also conflicts with the initiative measures introduced by the UK banking regulators and would attenuate the competitiveness of the UK financial industry. For these reasons, the UK tried several times to fight against the EU. The impact of bankers' bonus cap on the UK's regulation of bankers' remuneration and the analysis of the UK's challenge against the cap will be further discussed in next chapter.

4.4.2 Long-term Incentive Mechanisms

Confronted with the problems of short-termism and excessive risk-taking, the EU has chosen to limit the level of bankers' variable remuneration. The rationale is that if bankers do not receive a lot of variable remuneration, they will not be incentivised to take excessive risks. However, the UK banking regulators reckon that the EU bankers' bonus cap is counterproductive, rather than helpful. Their reform has focused on how to redesign the incentive mechanism of variable remuneration to make bankers prudent about risk-taking and attentive to banks' long-term interests. To this end, the FCA and the PRA have mandated the requirements of deferral and introduced some new measures, such as clawback and *malus*. Some of these rules are on the basis of the CRD IV. However, different from bankers' bonus cap, deferral, clawback and *malus* are also the UK regulators' own initiatives. Prior to the CRD IV, relevant policy recommendations of these measures were already made in the Turner Review and the Walker Review. After the implementation of the CRD IV, the FCA and the PRA have made more detailed and stricter requirements in these aspects.

4.4.2.1 Deferral

Before the GFC, deferral was a voluntary arrangement in bankers' variable remuneration. After the GFC, the UK regulators have written it into regulation and made it a mandatory requirement, which is much stricter than banks' previous voluntary deferral arrangements.

The Turner Review has stressed that performance-based remuneration should be deferred in accordance with banks' business circles and risks.¹²⁰ The Walker Review has prescribed detailed requirements: at least half of the variable remuneration should be in the form of LTIPs; for these LTIP awards, half of them should be deferred in a period of no less than three years and the remainder in a period of no less than five years; other variable remuneration schemes should also be subject to a three-year deferral arrangement and no more than one-third shall be paid in the first year.¹²¹ These recommendations have laid the foundation for the rule-making of the formal regulation of bankers' remuneration.

¹²⁰ FSA, *The Turner Review*, 80

¹²¹ HM Treasury, *The Walker Review*, Chapter 7, 117

At the EU level, deferral is required by the CRD IV. It mandates that in any event at least 40% of the variable remuneration shall be deferred over a period which is no less than three to five years. Besides, the deferred portion shall not be vested faster than a pro-rata basis.¹²² That is to say, if the deferral period is three years, by the end of the first year, bankers shall not be paid with more than one-third of the whole deferred portion, and by the end of the second year, the accumulated pay shall be no more than two-thirds. These requirements are very similar to the recommendations of the Walker Review. The CRD IV further requires that for bankers whose variable remuneration is particularly high, at least 60% shall be deferred and the length of deferral shall be in line with the bank's business cycle, the nature of its business, as well as the risks and activities undertaken by individual bankers.¹²³ However, the CRD IV does not define the term 'particularly high variable remuneration'. Thus, it has been left to the discretion of the member states.

In 2014, the rules of deferral in the CRD IV were introduced to the UK Remuneration Code. In terms of the 'particularly high variable remuneration', the Remuneration Code defines it as 'above GBP 500,000' or 'payable to a director (excluding NED) of a firm that is significant in terms of its size, internal organisation and the nature, scope and complexity of its activities'.¹²⁴

Originally, the deferral requirements in the Remuneration Code were kept completely the same as those in the CRD IV. However, in the UK, the three to five-year deferral length has been questioned as a relatively near term since the performance of some financial products and investments will not be certain until a longer period elapses.¹²⁵ The UK Parliamentary Commission on Banking Standards (PCBS) has also mentioned that regulators could further strengthen the deferral policies by extending the length to up to ten years.¹²⁶

In June 2015, the FCA and the PRA jointly published a policy statement, in which they launched a new round of reform on executive remuneration in dual-regulated firms, which include all UK banks.¹²⁷ In the new Remuneration Code SYSC 19D which came into effect since 1 July 2015, the requirements of deferral have been tightened. For Remuneration Code

¹²² The CRD IV, Article 94(m)

¹²³ The CRD IV, Article 94(m)

¹²⁴ FCA, *Handbook (2014)*, SYSC 19A(3), (4) and (6). In 2014, Remuneration Code SYSC 19A was applied to banks, building societies and investment firms. The change to five Remuneration Codes was made in 2015. Since then, the SYSC 19D has become the specific regulatory document for bankers' remuneration. In terms of the definition of 'a firm that is significant in terms of its size, internal organisation and the nature, scope and complexity of its activities', see footnote 47 in this chapter.

¹²⁵ Iris H-Y Chiu, *Regulating (From) the Inside: The Legal Framework for Internal Control in Banks and Financial Institutions* (n23) 224

¹²⁶ PCBS, *Changing Banking for Good* (First Report of Session 2013-14, HL Paper 27-II/HC 175-II) 399

¹²⁷ FCA and PRA, *Strengthening the Alignment of Risk and Reward: New Remuneration Rules* (PRA PS12/15 and FCA PS 15/16, June 2015) 7-9

staff¹²⁸ who perform a PRA-designated senior management function, the length of deferral has been extended to seven years. Moreover, vesting shall not start until three years after the allocation of awards, and no faster than a pro-rata basis.¹²⁹ The PRA-designated senior management functions are listed in the PRA Rulebook. The functions cover chairman, chief executive, chief finance, executive directors, chairmen of remuneration, audit, nominations and risk committees, group entity senior managers, the heads of key business areas and overseas branches, and so on.¹³⁰ Namely, ‘bankers’ defined in this thesis: executive directors and senior managers in banks’ headquarters, are covered by the senior management functions, and therefore subject to the enhanced rules of deferral. For other Remuneration Code staff, deferral period remains three to five years. Vesting shall not take place until one year after the allocation of awards, and no faster than a pro-rata basis.¹³¹

The requirements about the minimum proportions that shall be deferred remain the same as previous stipulations.¹³² Nevertheless, the new Code has given banks the discretion to replace the GBP 500,000 threshold with lesser amounts when necessary, which means that banks can apply the 60% deferral requirement to a wider scope of regulated staff.¹³³

In the post-crisis period, the deferral policies have been made mandatory and more and more rigorous. Its rigorousness is two-fold: first, the length of deferral has been extended from three years in banks’ voluntary arrangements to up to seven years in the new Remuneration Code; second, the requirements on the minimum proportions of deferral have been imposed on banks, and they have to defer at least 40% of bankers’ variable remuneration.

Enhancing the requirements of deferral is one of the most important measures to align bankers’ remuneration with their long-term performance, and thereby constrain their short-termism. In essence, deferral is the extension of the assessment period of bankers’ performance. When a substantial part of performance-based remuneration is distributed into a seven-year period, and the vesting of awards is based on each year’s achievements, and the bank’s overall sustainability throughout the seven-year period, bankers will be encouraged to take into consideration the potential impact of a strategy on the bank’s business in a longer future.

¹²⁸ Remuneration Code staff are those whose professional activities have a material impact on the firms’ risk profile, also known as material risk takers. FCA, *Handbook*, SYSC 19D.3.4(1).

¹²⁹ FCA, *Handbook*, SYSC 19D.3.59(1)

¹³⁰ PRA, *Rulebook*, Senior Management Functions, Article 1.2

¹³¹ FCA, *Handbook*, SYSC 19D.3.59(1)(a)

¹³² FCA, *Handbook*, SYSC 19D.3.59(2)

¹³³ FCA, *Handbook*, SYSC 19D.3.60(2)

4.4.2.2 Clawback and *Malus*

Clawback of remuneration is a punitive arrangement whereby the company is entitled to the retrieval of the cash, stocks or other forms of remuneration paid to its employees under specified circumstances, such as significant strategic failure or serious misconduct. *Malus* is another punitive measure: the deduction of unvested deferred variable remuneration in the above circumstances.¹³⁴ The basic rationale of the two measures is that bankers should be responsible for the long-term losses caused by their decisions.

Specifically, clawback acts on paid bonuses and vested shares. Banks will retrieve from bankers what they have been awarded for their failed strategies or misconduct. *Malus* works on the variable portion which has been allocated to bankers, while remaining unvested or unpaid because of the deferral policies. When applying *malus*, banks will reduce or repeal the quantity of the originally promised awards.

Before the Crisis, clawback and *malus* were neither required by regulators nor voluntarily exercised by banks. Bankers did not need to concern that the money paid to them would be called back or the promised awards would be possibly reduced due to their previous misconduct or malpractice, or the relevant failures, losses and risks.¹³⁵ The lack of a punishment mechanism on bankers' poor performance indulged their recklessness because the costs of taking excessive risks were very low. As a consequence, bankers' risk appetite was expanded. Clawback and *malus* have the functions of promoting bankers' long-term focuses and encouraging their diligent management and prudential risk-taking.¹³⁶ Therefore, they have been strongly recommended by academics and been taken as the core measures in the regulatory framework.¹³⁷

¹³⁴ Iris H-Y Chiu, *Regulating (From) the Inside: The Legal Framework for Internal Control in Banks and Financial Institutions* (n23) 226

¹³⁵ The operation of *malus* is different from the 'nil' award of variable remuneration when bankers fail to meet the financial goals. First, the latter only looks at specific financial metrics rather than the bank's overall financial situation, sustainability and risk profile. Even if a bank has taken too many risks, as long as the specific metrics are fulfilled, bankers will still be awarded rather than punished. Second, without *malus*, bankers' misconduct or malpractice will not affect the grant and vesting of their variable remuneration. Third, without *malus*, losses or failures caused by decisions made in previous financial years but not within the specific vesting period of the current scheme are not considered. For instance, if the performance in the most recent three years will be assessed for an award, the failures or losses due to a decision made four years ago will not lead to the reduction of this award.

¹³⁶ Jesse Fried and Nitzan Shilon, 'Excess-pay Clawbacks' (2011) 36 (4) *Journal of Corporation Law* 722, 727

¹³⁷ FSB, *Principles for Sound Compensation Practices Implementation Standards* (September 2009), Article 9; HM Treasury, *The Walker Review*, Chapter 7, 117; HC Treasury Committee, *Banking Crisis: Reforming Corporate Governance and Pay in the City* (Ninth Report of Session 2008-09, HC519) 14-5; Jesse Fried and Nitzan Shilon, 'Excess-pay Clawback' (ibid) 722; Carolyn B. Levine and Michael J. Smith, 'The Relative Efficiency of Clawback Provisions in Compensation Contracts' (2009) Finance and Corporate Governance Conference 2011 Paper http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1531203 accessed 18 August 2016; Gian Luca Clementi *et al*, 'Rethinking Compensation in Financial Firms' in Viral Acharya and Matthew Richardson (eds), *Restoring Financial Stability: How to Repair a Failed System* (John Wiley & Sons 2009) 197; Noel D. Addy *et al*, 'Recovering Bonuses After Restated Financials: Adopting Clawback Provisions' (2009) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1463992 accessed 18 August 2016

The legislation of clawback and *malus* at the EU level is general. The CRD IV requires that up to 100% of the variable remuneration, including both current remuneration and the amounts previously earned by bankers shall be subject to clawback or *malus*.¹³⁸ If a banker participated in or was responsible for the conduct which resulted in significant losses to the institution or failed to meet appropriate standards of fitness and propriety, clawback or *malus* shall be applied to the banker's remuneration.¹³⁹ Nevertheless, the CRD IV has given the leeway to financial institutions to set up the specific criteria for the application of clawback and *malus*.¹⁴⁰

Based on the CRD IV, the UK Remuneration Code has specified the application criteria. When a bank's entire business or the banker's responsible business unit suffers a material failure of risk management, or there is reasonable evidence of the misbehaviour or material error made by the banker, the banker's vested and unvested variable remuneration shall be subjected to clawback and *malus* respectively. Moreover, if the bank or the relevant business unit suffers a material downturn of its financial performance, the unvested variable remuneration shall be subject to *malus*.¹⁴¹ Therefore, in comparison to clawback, there is one more condition to trigger *malus*. Unlike the other two conditions, which in most circumstances are attributed to bankers' own performance, the material downturn of a bank's financial performance may result from external reasons, such as systemic financial crisis or policy change. If due to external reasons the bank is temporarily underperforming, it is justified to reduce the unpaid portion since in a situation of financial difficulty bankers should not be offered with huge amounts of awards. However, with regard to the paid awards, the punishment cannot be extended to them if previous strategies are not the reasons for the current financial difficulty.

As for the length, since *malus* acts on unvested or unpaid deferred remuneration, there is no need to specify the length again. Its length is compatible with the deferral periods of variable remuneration schemes. The regulators need to specify the length of the period during which paid variable remuneration shall be subject to clawback. The CRD IV does not impose any requirement. Thus, it is within the discretion of national regulators. At the very beginning, the Remuneration Code did not specify the length of clawback. During the 2015 reform of the regulation of bankers' remuneration, the PRA and the FCA proposed to set up seven years as the minimum period of clawback for all Remuneration Code staff and ten years for

¹³⁸ The CRD IV, Article 94(n)

¹³⁹ The CRD IV, Article 94(n)

¹⁴⁰ The CRD IV, Article 94(n)

¹⁴¹ FCA, *Handbook*, SYSC 19D.3.63 and 3.64

those with senior management functions.¹⁴² Finally, these proposals have been written in the new Remuneration Code.¹⁴³

Clawback and *malus* are the new regulatory measures adopted after the GFC to cope with the problems of short-termism and excessive risk-taking. These two measures have several merits to contribute to an effective regulatory framework of bankers' remuneration. Thus, they have been highly emphasised and actively implemented by the UK regulators.

First of all, clawback and *malus* link bankers' pecuniary interests with banks' long-term development and sustainability. Nowadays, a senior banker's variable remuneration is subject to a deferral period up to seven years, plus a clawback arrangement up to ten years. As a result, the total pending period of the variable remuneration has been extended to seventeen years at maximum. Therefore, the assessment of bankers' performance substantially focuses on the long-term impact of their decisions on banks' operations, which will prevent bankers from capturing the short-lived benefits from the strategies with long-hidden risks but without long-lasting value.¹⁴⁴

Secondly, clawback and *malus* act as *ex ante* mechanisms to prevent excessive risk-taking. These two measures have a deterrence effect on bankers. Under these arrangements, the impact of bankers' decisions will be constantly examined in the long run and bankers' remuneration remains pending throughout the long periods when clawback and *malus* are being applied. Therefore, bankers will be more diligent and prudent when making decisions and will try to control themselves from misbehaving or making serious mistakes.

Last but not least, clawback and *malus* also act as *ex post* punishment mechanisms. They attach bankers' individual responsibilities to banks' risks and failures.¹⁴⁵ During the GFC, very few bankers in the troubled banks were penalised or took individual responsibilities for the disastrous losses caused by their wrong strategies and poor management.¹⁴⁶ Therefore, the FCA and the PRA have been working on the Senior Managers and Certification Regime,¹⁴⁷ which attempts to strengthen bankers' individual accountabilities to banks' risks, losses and failures. Although clawback and *malus* are not parts of the Regime, they share a similar purpose, which is to impose specific individual responsibilities

¹⁴² FCA and PRA, *Strengthening the Alignment of Risk and Reward: New Remuneration Rules* (n127) 8

¹⁴³ FCA, *Handbook*, SYSC 19D.3.61(4)

¹⁴⁴ Roberta Romano and Sanjai Bhagat, 'Reforming Executive Compensation: Focusing and Committing to the Long-term' (2009) 26 (2) *Yale Journal on Regulation* 359, 367

¹⁴⁵ Iris H-Y Chiu, *Regulating (From) the Inside: The Legal Framework for Internal Control in Banks and Financial Institutions* (n23) 227

¹⁴⁶ Deloitte, 'Senior Managers Regime: Individual Accountability and Reasonable Steps' (2016) <https://www2.deloitte.com/content/dam/Deloitte/uk/Documents/financial-services/deloitte-uk-senior-manager-regime.pdf> accessed 31 May 2017, 5

¹⁴⁷ For more details about the Regime, please refer to the introduction provided by the FCA, 'Senior Managers and Certification Regime' (*FCA website*, 09 November 2017) <https://www.fca.org.uk/firms/senior-managers-certification-regime> assessed 4 January 2018

on bankers and make them assume the consequences of their own actions, rather than shifting the consequences to the public and the government.

4.4.3 Risk-adjusted Performance Metrics

As mentioned before, the initiatives of UK banking regulators to reform bankers' remuneration have focused on how to redesign the incentive mechanism to encourage bankers' pursuits of banks' long-term development and financial stability. By extending the period of performance assessment and postponing the payment, deferral, clawback and *malus* can inspire bankers to take a long-term angle. In addition, replacing the performance metrics which focused on immediate profits and the increase of share price with the incentives oriented by prudential risk management and financial stability, is another important solution. Therefore, the UK banking regulators have made efforts to establish a risk-adjusted system of performance metrics and assessment.

The Walker Review has recommended that a risk adjustment mechanism shall be included in top executives' remuneration packages.¹⁴⁸ Namely, the financial performance metrics used to evaluate bonuses and awards shall be risk-adjusted.¹⁴⁹ The CRD IV has also mentioned that bankers' variable remuneration shall be compatible with business risks.¹⁵⁰ Based on the Walker Review and the CRD IV, the FCA and the PRA have made specific regulatory requirements on the application of risk-adjusted performance metrics.

The Remuneration Code requires that banks must ensure that any measurement of performance used to calculate variable remuneration components shall include the adjustments for all types of current and future risks and take into account capital adequacy and liquidity issues.¹⁵¹

The FCA and the PRA have specified the requirements for banks to redesign the system of performance metrics and assessment. First of all, banks have the freedom to choose the techniques and measurements for risk adjustment. Nevertheless, they must make sure those have been chosen are most appropriate to banks' circumstances.¹⁵² For appropriateness, the adoption of specific techniques and measurements shall be validated and assessed through the cooperation with banks' risk committees.¹⁵³ Although the regulators do not require the types of techniques and measurements, banks should provide a clear explanation with details that explicitly show how the full range of risks are considered when the performance metrics are decided. The explanation can be a reference of the quantification of risks or the

¹⁴⁸ HM Treasury, *The Walker Review*, Chapter 7, 110

¹⁴⁹ *Ibid*, 115

¹⁵⁰ The CRD IV, Article 94(b)

¹⁵¹ FCA, *Handbook*, SYSC 19D.3.23(1)(a)

¹⁵² FCA, *Handbook*, SYSC 19D.3.24(2) and (3)

¹⁵³ FCA, *Handbook*, SYSC 19D.3.24(5)

qualitative judgement and common sense being used.¹⁵⁴ Based on the explanation, the FCA will judge whether banks' risk adjustment mechanisms are robust or not.¹⁵⁵

It has repeatedly been emphasised by the regulators that bankers' performance assessment should be adjusted by all kinds of possible risks, including both the intrinsic risks that are inherent in a bank's business and the specific risk events that may be crystallised in the future.¹⁵⁶ The FCA and the PRA have pointed out that there was too much reliance on short-term financial indicators, such as EP, ROE, EPS and TSR. All of these metrics were calculated in accordance with the fair value accounting model,¹⁵⁷ according to which these indicators are easy to be overstated for remuneration purposes. The fair value, which is the present value of future cash flows, is calculated into the bank's current earnings, without any consideration about the uncertainties and risks in these cash flows.¹⁵⁸ As a consequence, the fair value may not precisely capture the true value of the cash flows added to the bank's financial assets. In the future, once the bank encounters any risk, the true value of those cash flows will be significantly lower than the fair value. However, the variable remuneration paid for the relevant strategies that created those cash flows has been evaluated in accordance with the fair value, rather than the true value at the end. As a consequence, bankers' performance would be overstated and they would be overpaid.

Nevertheless, it is not possible for banks to use the true value of cash flows, which cannot be confirmed until maturity. Therefore, the regulators have suggested that when using profit-based financial metrics, banks shall deduct a prudent valuation adjustment figure¹⁵⁹ from the fair value accounting figure.¹⁶⁰ After the deduction, financial indicators such as EP and ROE are turned into risk-adjusted EP and risk-adjusted ROE.

¹⁵⁴ FCA, *Handbook*, SYSC 19D.3.24(3) and (4)

¹⁵⁵ FCA, *Handbook*, SYSC 19D.3.24(4)

¹⁵⁶ FCA, *Handbook*, SYSC 19D.3.28(1)

¹⁵⁷ According to the International Accounting Standards Board, fair value is an amount at which an asset could be exchanged between knowledgeable and willing parties in an arm's length transaction. Under the fair value accounting model, assets and liabilities are re-measured periodically to reflect changes in their value. The model is most frequently applied to financial assets and liabilities. For instance, the fair value of the investments in securities, bonds and commodity is measured by current market price. However, very often there is a long period before the investments become mature, so special measurement methods will be used to estimate a fair value. This estimated value is also known as 'the present value of future cash flows'. See the definition and introduction given by Financial Times, 'Definition of Fair Value Accounting' (*Financial Times Lexicon*) <http://lexicon.ft.com/Term?term=fair-value-accounting> accessed 1 June 2017

¹⁵⁸ FCA and PRA, *Strengthening the Alignment of Risk and Reward: New Remuneration Rules (Consultation Paper)* (PRA CP15/14, FCA CP14/14, July 2014) 11

¹⁵⁹ The EBA has published a guidance about how to make prudential valuation on profits and returns. The detailed methods are out of the cover of this thesis. If interested, please refer to EBA, *Final Draft Regulatory Technical Standards on Prudent Valuation under Article 105(14) of Regulation (EU) No 575/2013 (CRR)* (EBA/RTS/2014/06/rev1, January 2015)

¹⁶⁰ FCA and PRA, *Strengthening the Alignment of Risk and Reward: New Remuneration Rules (Consultation Paper)* (n158) 11

Moreover, the UK regulators have also adopted the EBA's proposal which recommends banks to use prudent valuation adjustments to their CET 1 ratios.¹⁶¹ CET 1 ratio is not an indicator of profitability. It is a metric about a bank's capital adequacy and liquidity. The adoption of prudentially valued CET 1 ratio demonstrates that stability-oriented indicators have been used to incentivise bankers.

Risk adjustment mechanism should also be used for the evaluation of bankers' non-financial performance. For instance, poor risk management or other poor behaviours that can generate significant risks to banks shall be considered when banks determine the incentives in bankers' remuneration. If necessary, a banker's poor non-financial performance shall override the banker's achievements for those financial metrics, and therefore lead to the voidance of awards.¹⁶²

Risks were completely ignored in the pre-crisis incentive mechanism of bankers' remuneration, whereas short-term financial metrics attracted all the attention of bankers. Replacing them with risk-adjusted financial metrics, stability-oriented metrics and non-financial metrics of sound corporate governance, is a direct response to the problem of excessive risk-taking. It can materially change bankers' behaviours. Instead of focusing on short-term profits and the increase of share price, bankers will comprehensively take into account the factors such as risk control, capital adequacy, liquidity, and the effectiveness of corporate governance. Therefore, the decision-making in banks will focus more on prudential risk-taking and financial stability.

4.5 Conclusion

This chapter has discussed the UK's regulatory framework of bankers' remuneration, which is one of the responses of the UK authorities to the GFC. It gives answers to the question: What regulatory actions have been taken after the GFC to reform UK bankers' remuneration?

In the aftermath of the GFC, the UK has started to overhaul the banking regulatory system, with the purpose to promote financial stability and protect the public interest. The most significant reform is the institutional shift from the 'Tripartite System' to the 'Twin Peaks' model. The reform aimed at dealing with the flaws in the 'Tripartite System': the FSA partially incline to the regulation of conduct of business, while negligent in prudential regulation. Under the new model, banks should comply with the FCA's regulation of conduct of business and the PRA's prudential regulation.

The regulation of bankers' remuneration has been integrated into the overall reform of banking regulation. The systemic-wide reform has laid the foundation for establishing the regulatory framework of bankers' remuneration. First of all, the regulation of bankers'

¹⁶¹ Ibid

¹⁶² FCA, *Handbook*, SYSC 19D.3.41(1)

remuneration has been guided by the fundamental principles of the banking regulatory reform: financial stability and the public interest. Besides, the ‘Twin Peaks’ model has set up the FCA and the PRA as the primary regulators.

In addition, the remuneration reform in the context of general corporate governance has an impact on banks. Therefore, the measures adopted by the banking regulators, together with the major changes made by corporate governance regulators, constitute the current regulatory framework of bankers’ remuneration. In general, the measures focus on two aspects: the decision-making power of bankers’ remuneration, and remuneration policy and management.

The regulation on decision-making power includes the enhancement of the independence and responsibility of remuneration committee, and shareholder ‘Say on Pay’. Apart from the rules in the regulation of general corporate governance, the banking regulators have imposed stricter requirements on banks’ remuneration committees, in order to avoid bankers’ manipulation on their own remuneration packages, and to improve the effectiveness of banks’ remuneration and incentive systems in promoting stakeholders’ interests and risk control. ‘Say on Pay’ is a consequence of the movement of shareholder empowerment in the context of general corporate governance after the GFC. It empowers shareholders in UK quoted companies to play a decisive role in deciding executive remuneration. Therefore, it also affects the power allocation on executive remuneration in many large UK banks. However, shareholder empowerment is contradictory with the purpose to regulate bankers’ remuneration, which is to align bankers’ remuneration with the interests of all kinds of stakeholders and the bank’s long-term development. Therefore, rather than enhancing ‘Say on Pay’, banking regulators should take actions to mitigate its negative impact.

The regulation on remuneration policy and management is primarily promoted by the FCA and the PRA. The most important measures include bankers’ bonus cap, deferral, clawback and *malus*, and risk-adjusted performance metrics. Deferral, clawback and *malus*, and risk-adjusted performance metrics are the initiatives taken by the UK banking regulators, in order to curb bankers’ short-termism and excessive risk-taking. They aim at linking bankers’ remuneration with banks’ long-term development and sustainability by extending the pending period of variable remuneration and applying risk-adjusted and stability-oriented incentives. Comparatively, bankers’ bonus cap, which sets up the ceiling of the variable-fixed ratio of bankers’ remuneration and directly controls remuneration level and structure, is more interventionist. As part of the EU’s legislation, the cap is an unavoidable legal duty of the UK regulators. However, the UK is always against the EU on capping bankers’ variable remuneration. The cap is deemed counterproductive, because it conflicts with other regulatory measures and has a negative impact on banks’ competitiveness. Therefore, the cap has been implemented by the UK regulators to a minimum extent. After Brexit, there is a high possibility that the relevant provisions of the cap will be annulled.

It has been a decade since the GFC, and the UK has been exploring the efficient way to regulate bankers' remuneration for about ten years. The current regulatory framework has dramatically changed the remuneration policy and practice in the UK banking sector. Nevertheless, there are still conflicts between measures. Therefore, further reform is needed to improve the framework.

Chapter 5

The Post-crisis Changes in Bankers' Remuneration Practice and the Evaluation of the UK Regulatory Framework

5.1 Introduction

Before the GFC, bankers' remuneration relied heavily on the short-term incentives oriented by share price and profits. As a consequence, it led to excessive risk-taking and thereby serious bank failures. In order to encourage bankers' long-term performance, and to maintain financial stability and protect the public interest, during the post-crisis decade, the UK government has been exploring the effective regulatory measures for sound remuneration practice in banks and established a special regulatory framework of bankers' remuneration. Currently, the framework is comprised mainly of the measures on the power of different constituencies to decide bankers' remuneration and on remuneration level, components and structure, and incentive mechanism.

The regulatory environment of bankers' remuneration has been completely changed, from deregulated and 'light touch' to tightened and interventionist. In order to comply with the regulatory requirements, a bank needs to make great alterations to its decision-making process, as well as the level, components and structure, and incentive mechanism of bankers' remuneration. As a corollary, the regulatory measures would materially affect banks' remuneration policies and practices. In order to understand how these new measures have been implemented and how effective they are, it is necessary to examine the changes in the remuneration practice of UK banks. Based on the examination, it is possible to analyse the suitability of each regulatory measure to realise the regulatory purposes and the interactions between different measures, so as to assess the effectiveness of the entire framework. As mentioned in Chapter 4, there are conflicts among some of the measures. Empirical evidence of remuneration practice will help verify whether the conflicts really exist and to what extent they will interrupt the ongoing regulatory reform.

This chapter aims to empirically examine the post-crisis remuneration practice in the UK banking sector and dialectically evaluate the regulatory framework. It is organised as below. Section 5.2 examines the changes in bankers' remuneration practice after the GFC. Section 5.3 discusses the problems in the current regulatory framework, focusing mainly on 'Say on Pay' and bankers' bonus cap. Section 5.5 is the conclusion.

5.2 The Changes in Bankers' Remuneration Practice After the GFC

By illustrating the information and data of the UK 'Big Four' banks, the level, components and structure, and incentive mechanism of the pre-crisis bankers' remuneration have been discussed in Chapter 3. For the purpose of comparison, this section will also focus on the

remuneration level, components and structure, and incentive mechanism in the ‘Big Four’ banks from 2008 to 2016. Accordingly, the same statistical calibre will be applied.

5.2.1 The Level of Bankers’ Remuneration After the GFC

The average level of bankers’ total remuneration¹ is shown in Figure 5.1. It kept increasing gradually from 2008 to 2015 and mildly decreased in 2016. In comparison with the level before the GFC, it dropped from GBP 4.3 million in 2007 to only GBP 2.4 million in 2008. Nevertheless, bankers’ remuneration only experienced three years’ downturn and recovered to GBP 4.3 million in 2011. It then increased to even higher levels.

Clearly, the downturn from 2008 to 2010 was caused primarily by the Banking Crisis. During this period, in not only the failed banks but also those survived banks, the remuneration committees waived, or their bankers voluntarily gave up the entitlement to bonuses.² Another contributor to the downturn was that these banks’ share prices, particularly those of Lloyds and RBS, plummeted since 2008. As a consequence, the exercise prices of many share options set up before the GFC were higher than the market prices. As a result, bankers had to let their options lapse.

Although every bank was seriously affected by the financial turmoil, the degrees of their damages and their processes to recover from the GFC have been different. Obviously, during the GFC, the survived HSBC and Barclays have performed better than the failed RBS and Lloyds. Considering that between the failed and the survived banks, bankers’ remuneration practices may be different, the average remuneration level of each of the four banks has been calculated independently and shown below.

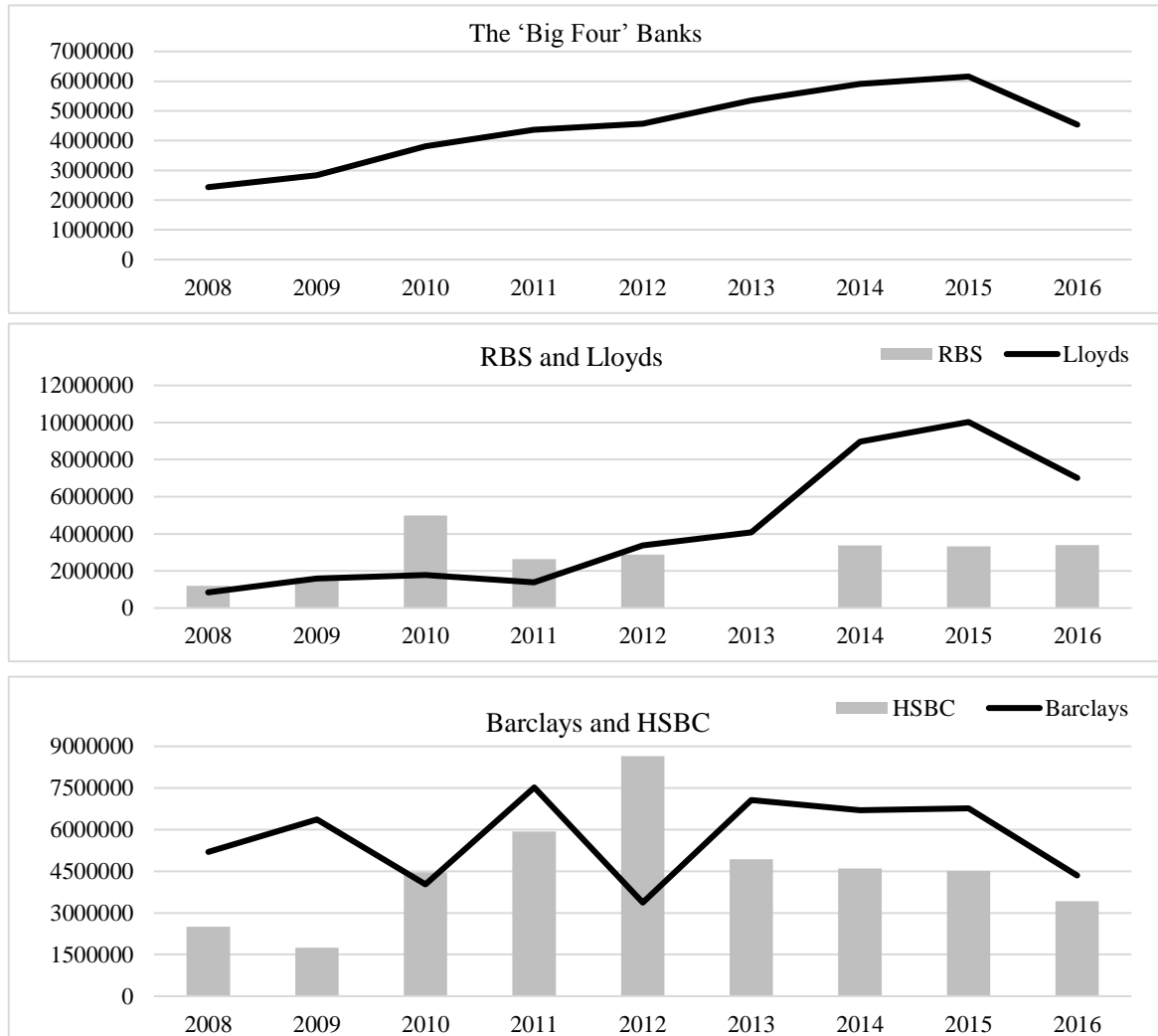
According to Figure 5.1, the remuneration levels of HSBC and Barclays were almost unaffected by the GFC. The downturn in Lloyds was longer, while it surged very fast after 2013 and has exceeded the two survived banks. RBS is the only bank whose bankers’ remuneration level after the GFC has generally been lower than the pre-crisis level.

¹ According to FCA, *Handbook*, SYSC 19D.3.4(1), the post-crisis regulation of bankers’ remuneration covers all material risk takers. Therefore, the four banks have started to disclose the information of the remuneration of the eight highest paid senior managers. However, without uniform stipulations, the detailed information disclosed by different banks is different. For instance, Lloyds discloses the amounts of variable remuneration vested in a financial year, HSBC and Barclays only disclose the amounts of the granted (allocated) variable remuneration which is subject to performance assessment in the future, while RBS discloses both the vested and the granted amounts. Besides, banks only disclose the amounts, without the details of the performance metrics and assessment. Therefore, the information of the remuneration of the eight highest paid senior managers is not useful for the analysis of the structure and incentive mechanism of bankers’ remuneration. Therefore, it will not be adopted for the empirical study in this chapter. Moreover, senior managers’ remuneration was not disclosed before the GFC. In order to be consistent with the empirical analysis of the pre-crisis remuneration practice, the information should be excluded.

² Lloyds Annual Report 2008, 86; RBS Annual Report 2008, 166; HSBC Annual Report 2008, 317; Barclays Annual Report 2008, 182

Nevertheless, the degree of decline was not dramatic.³ Therefore, the total remuneration levels of the UK ‘Big Four’ banks have not been significantly influenced by the GFC. On the contrary, bankers’ total remuneration has grown to even higher levels since 2010.

Figure 5.1 The Average Level of Bankers’ Remuneration in the UK ‘Big Four’ Banks from 2008 to 2016 (Unit: GBP) ⁴



The first regulatory response to bankers’ remuneration: the Walker Review, was released in 2009. Since then, the UK banking regulators have been strengthening the regulation of bankers’ remuneration. Therefore, the increasing trend since 2010 onwards demonstrates that the post-crisis regulation has no effect on controlling bankers’ remuneration level.

According to the UK banking regulators, the problem of bankers’ remuneration rested with the distorted adoption of equity-based remuneration, especially the distortion in the incentive mechanism, rather than the total amount of bankers’ remuneration. Therefore,

³ The remuneration level of RBS before the GFC was between GBP 4.3 million to GBP 4.8 million. After the GFC, the highest level was GBP 4.9 million in 2010 but recent years it has been stabilised around GBP 3.3 million. Please refer to the data in Appendix A.3 and D.3.

⁴ The original data, the process and criteria of data collection and the calculation methods are available in Appendix D.

simply cutting the amount cannot solve the problem of excessive risk-taking, while it will have a negative impact on banks' competitiveness.⁵ For this reason, the UK's post-crisis regulation does not focus on the control of remuneration level. Instead, it is more attentive to remuneration components and structure, and incentive mechanism.

5.2.2 The Components and Structure of Bankers' Remuneration After the GFC

5.2.2.1 The Changes in Remuneration Components

Generally, the major components of bankers' remuneration remain the same as those used before the GFC. Nonetheless, there are some minor adjustments to both variable remuneration and fixed remuneration.

Annual bonus and LTIP are still the two most important forms of variable remuneration. Before the GFC, cash was almost the only form of all annual bonus schemes of the 'Big Four' banks.⁶ On the contrary, after the GFC, the banks have started to offer a large portion of annual bonuses in shares, while cash was no longer the major form. Some banks even entirely replaced cash with ordinary shares as short-term incentives, such as the HSBC Annual Bonus Scheme and the Lloyds Annual Incentive Plan. In 2013, the requirement that at least 50% variable remuneration should be offered in shares and equivalent ownership, has been stipulated in the Remuneration Code.⁷ This requirement has further encouraged banks to use more shares as short-term incentives. Besides, some banks have innovated to introduce other types of securities. For instance, Lloyds has included notes and bonds in its Annual Bonus Scheme since 2013.⁸ Compared to equity-based remuneration, debt-based remuneration is advanced in terms of providing stability-based incentives to bankers. However, currently, using multiple kinds of securities, in particular, debt-based remuneration to incentivise bankers is neither required by the regulators nor widely adopted by banks in practice. This issue will be further discussed in Chapter 10.

The only brand-new component introduced after the GFC is a type of fixed remuneration, known as 'role-based pay' or 'role-based allowance'. Usually, a role-based pay is in the form of shares. Banks' remuneration committees will decide the specific quantities of

⁵ Patrick Jenkins, 'Bankers' Pay Remains out of Kilter with Reality' *Financial Times* (London, 24 October 2016) <https://www.ft.com/content/08e30aa8-97aa-11e6-a80e-bcd69f323a8b> accessed 12 June 2017

⁶ The only exception was Barclays. Before the GFC, 25% of its annual bonuses were in shares.

⁷ FCA, *Handbook*, SYSC 19D.3.56. The purpose of the rule which sets up the minimum proportion of share awards is to reduce the use of annual cash bonuses, in order to increase the pay sensitivity to long-term value creation. See FSB, *Principles for Sound Compensation Practices Implementation Standards* (September 2009), Article 8. Compared to cash, shares can better facilitate the rules of deferral, clawback and *malus*. It is also more flexible for banks to adjust the amounts of deferred awards according to bankers' performance in a longer period. Nevertheless, the thesis deems that the idea cannot effectively curb short-termism and excessive risk-taking because despite the advantages over cash bonuses, short-term share bonuses will still encourage bankers to pursue the immediate increase of share price. Therefore, this rule is not regarded as a major action on long-term incentives and prudential risk-taking. Due to its less importance in the regulatory framework, it was not discussed in Chapter 4.

⁸ See Appendix E.2.

shares allocated to each banker with reference to the banker's role (responsibility) and experience (skills). The payout of role-based pay is evenly distributed in a five-year period. These features make role-based pay seem like variable remuneration. However, it is essentially not performance-based. Therefore, a role-based pay should be identified as a fixed component.

Table 5.1 The Role-based Pay Arrangements in the UK 'Big Four' Banks⁹

Scheme	Years	Form	Determinant factors	Performance-based	Holding period	Maximum
HSBC Fixed Pay Allowance	2014-2016	Share	Role, skills and experience	No	5 years; annum 20%	The gap between 50% of total pay and basic salary
Barclays Role-based Pay	2014-2016	Share	Role and responsibility	No	5 years; annum 20%	Up to 100% basic salary
RBS Fixed Share Allowance	2014-2016	Share	Skills, experience and responsibility	No	5 years; annum 20%	Up to 100% basic salary
Lloyds Fixed Share Awards	2014-2016	Share	Not specified	No	5 years; annum 20%	Up to 100% basic salary

As shown in Table 5.1, all of the four banks have introduced role-based pay since 2014. The reason is that the rules of bankers' bonus cap came into effect in 2014. Role-based pay is a countermeasure taken by these banks against the cap. UK banks have straightforwardly demonstrated their intention to minimise the influence of bankers' bonus cap on banks' attractiveness to financial talents. They have been worrying that the cap will reduce the level of variable remuneration and thereby the level of total remuneration, which will eventually constrain the banks' abilities to offer competitive remuneration packages.¹⁰ As a result, increasing fixed remuneration through the introduction of role-based pay is the only tactic that banks can use to eliminate the negative impact of bankers' bonus cap.

The EBA criticised that the role-based pay arrangements were orchestrated by banks to circumvent bankers' bonus cap.¹¹ In 2014 and 2015, it twice announced that shares under role-based pay schemes must be taken as variable remuneration.¹² Nevertheless, in the UK, neither the PRA nor the FCA has responded to the EBA's announcements or taken any action to restrict banks. In practice, up to now, banks' role-based pay schemes have been continuously applied. The UK banking regulators have already shown their opposite stance

⁹ The table is designed by the author based on the information in the annual reports of the four banks.

¹⁰ HSBC Annual Report 2013, 378; Barclays Annual Report 2013, 101; RBS Annual Report 2013, 67; Lloyds Annual Report 2013, 100

¹¹ Sam Fleming *et al*, 'Watchdog Calls for Clampdown on Bankers' Allowances' *Financial Times* (London, 16 October 2014) 2

¹² EBA, *Report On the Application of Directive 2013/36/EU (CRD) Regarding the Principles on Remuneration Policies of Credit Institutions and Investment Firms and the Use of Allowances* (October 2014) 8; EBA, *Follow-up Report on Remuneration and the Use of Allowances* (November 2015) 8

against bankers' bonus cap. Their silence on EBA's intervention has indicated their indulgent attitude towards role-based pay.

Role-based pay is in the form of shares. Thus, it still aligns bankers' remuneration with shareholders' interests, in particular, share price. Moreover, shares in role-based pay schemes are unconditional. The quantities are not subject to bankers' achievements. Therefore, it may exacerbate the problems of short-termism and excessive risk-taking. The circumvention of bankers' bonus cap through the adoption of role-based pay demonstrates that the cap has been inefficiently implemented. More seriously, it has generated counterproductive effects. This issue will be discussed in detail in Subsection 5.3.2.

5.2.2.2 The Changes in Bankers' Remuneration Structure

In order to reveal the changes in bankers' remuneration structure, the proportional relationships among the fixed remuneration, short-term and long-term variable remuneration in the packages offered to the group chief executives of the 'Big Four' banks are illustrated. The changes in the post-crisis period can be divided into three sub-periods: 2008 to 2010, 2011 to 2013 and 2014 to 2016.

2008 to 2010 was the first stage after the GFC during which banks suffered the worst downturns in their businesses and reputations. Typically, the structural change in these three years was the substantial reduction of variable remuneration.

Before the GFC, the general trend was that the proportion of fixed remuneration kept declining while variable remuneration became more and more important. However, immediately after the GFC, many executive directors of the 'Big Four' banks had their bonuses waived. As shown in Figure 5.2, the percentages of fixed remuneration substantially increased due to the waivers of bonuses. In particular, HSBC and Barclays did not grant any variable remuneration to their chief executives in 2008 and 2009.

These changes at the early post-crisis stage were the banks' voluntary responses to the Crisis. On the one hand, variable remuneration was determined by bankers' achievements in profitability and shareholder returns. Since banks were trapped in the financial turmoil, bankers could not meet the financial targets to realise their awards.¹³ On the other hand, bankers' remuneration bore serious public condemnation and attracted huge attention from policy makers. In this context, banks reduced variable remuneration and bankers voluntarily gave up their bonuses, with the purposes to placate the irritated public and avoid further deterioration of their reputations.

After the most chaotic three years, banks' businesses were gradually back to normal and banks started to restructure their remuneration systems. From 2011 to 2013, there have been

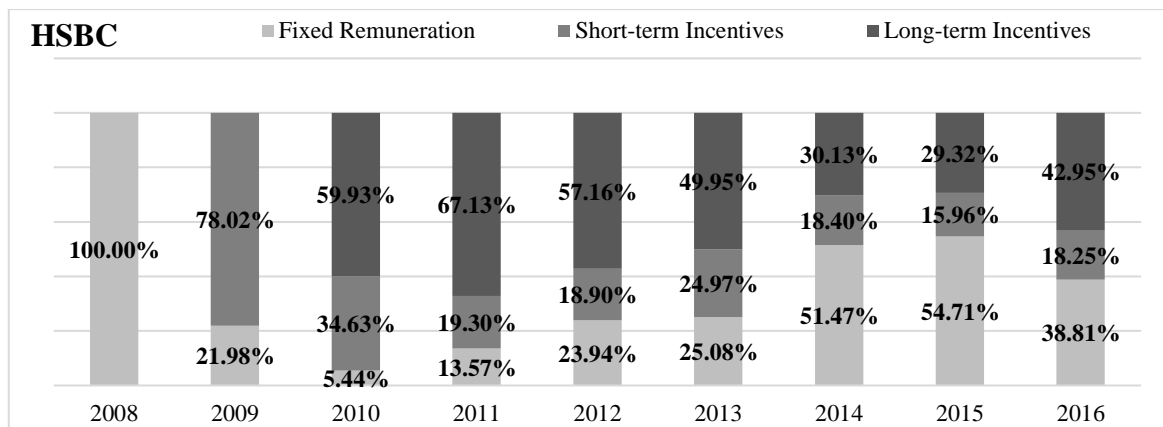
¹³ For instance, in 2008, the remuneration committees of Barclays and HSBC decided to make a material reduction of variable remuneration due to the downturns of the two banks' financial situations. HSBC Annual Report 2008, 317; Barclays Annual Report 2008, 171

many governmental investigations and policy recommendations. The FSA also published the early-stage regulation of bankers' remuneration. In particular, banks were asked to align bankers' remuneration with banks' long-term interests and stability. As a result, in the second stage, the most important change was the predominance of LTIPs.

In 2011, the majority of bankers restarted to receive variable remuneration. The proportion of short-term variable remuneration in total remuneration largely declined, whereas LTIP has become the predominant form of performance-based remuneration. The figures show that from 2011 to 2013, in the four banks, short-term bonuses only made around 20% to 30% of bankers' total remuneration. In striking contrast, the percentages of LTIPs usually ranged from 50% to 90%.

Along with LTIPs becoming predominant, the percentages of fixed remuneration declined. However, it has rebounded to the level in the early 2000s since 2014. As stated earlier, in 2014 bankers' bonus cap came into effect and banks have introduced role-based pay to boycott the impact of the cap on the total level of bankers' remuneration. As a consequence, the third stage has seen the surge of fixed remuneration and the sharp fall of variable remuneration. 2015 and 2016 are the first two years since bankers' bonus cap has been implemented and role-based pay has been introduced. It can be observed that all LTIPs have been reduced to less than 60%, while fixed remuneration has been increased to more than 30% of total remuneration. In addition, short-term variable remuneration has been further cut down to less than 10%. RBS even ceased to offer short-term incentives since 2014. In 2013 and 2014, Barclays' short-term bonus scheme was also paused.

Figure 5.2 The Structures of Bankers' Remuneration in the UK 'Big Four' Banks from 2008 to 2016¹⁴



¹⁴ The original data, the process and criteria of data collection and the calculation methods are available in Appendix F.

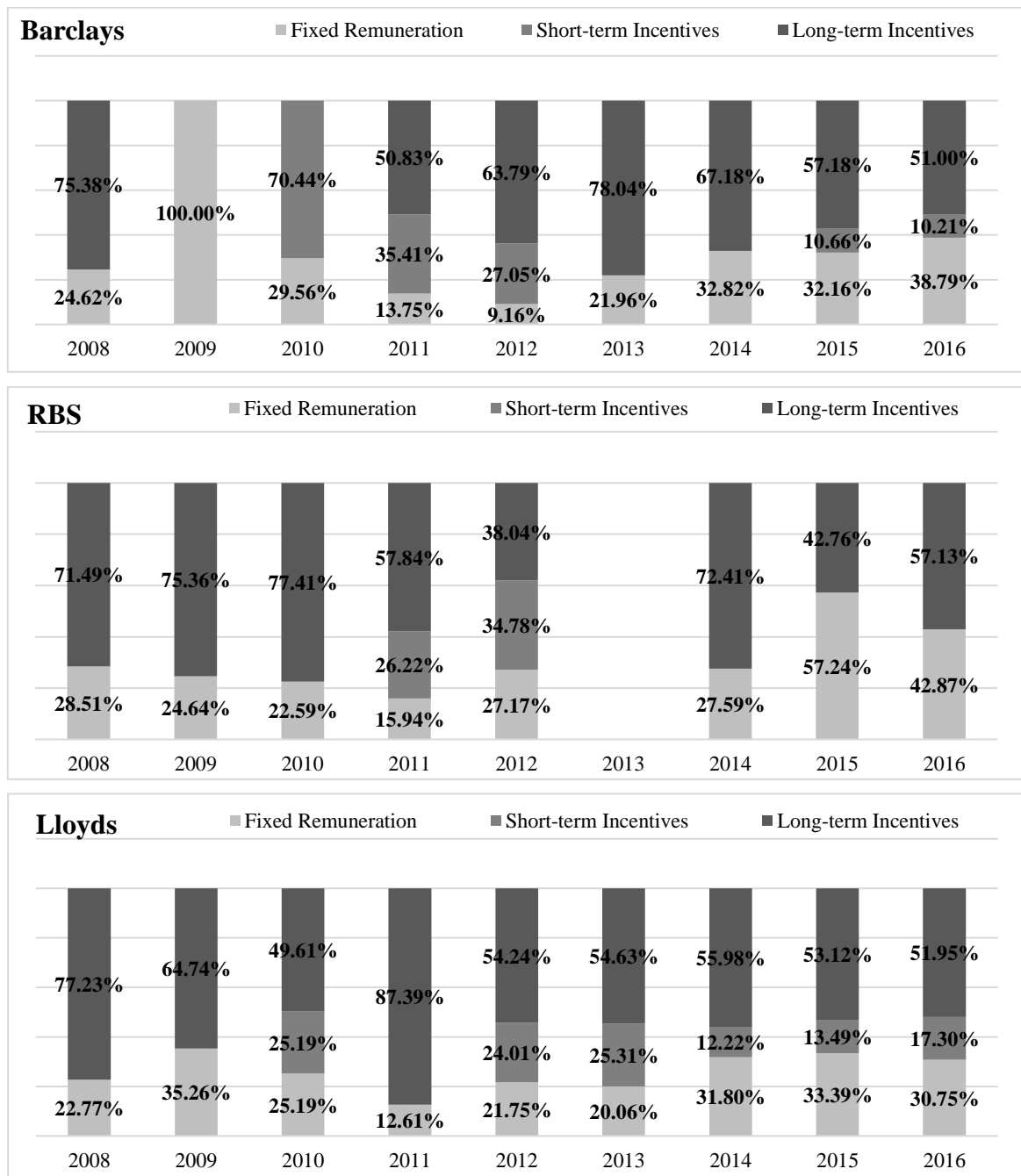


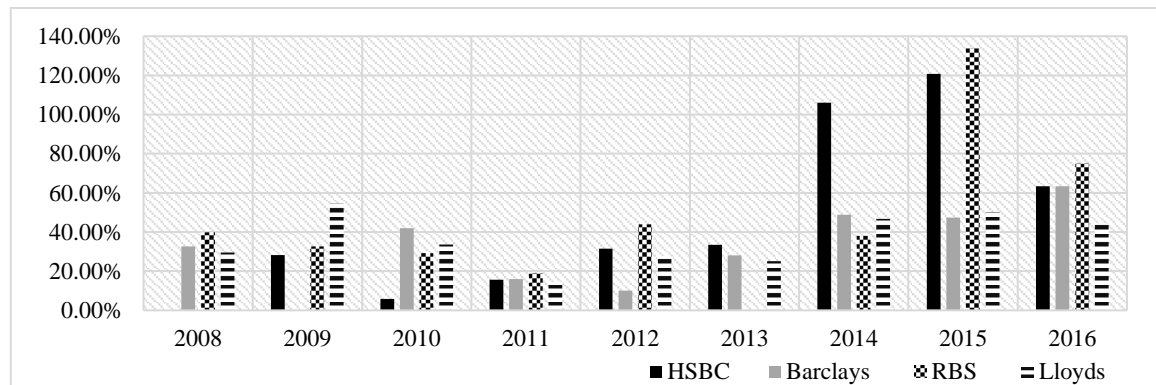
Figure 5.3 shows the ratios between fixed and variable components of the group chief executives' remuneration of the 'Big Four' banks. Limited by bankers' bonus cap, the fixed-variable ratio shall not be lower than 100%.¹⁵ With shareholders' approval, it shall not be lower than 50%. Before the cap was implemented, all of the fixed-variable ratios in the four banks were lower than 50%, apart from Lloyds in 2009. However, after 2014, the ratios

¹⁵ Bankers' bonus cap is about the variable-fixed ratio. On the contrary, Figure 5.3 shows the fixed-variable ratio, which is the reciprocal. For instance, the 1:1 cap means that the variable-fixed ratio cannot be higher than 1:1, namely, variable remuneration cannot be more than 100% of fixed remuneration. In other words, fixed remuneration cannot be less than 100% of variable remuneration. Similarly, the 2:1 cap with shareholders' approval means that variable remuneration cannot be more than 200% of fixed remuneration. In other words, fixed remuneration cannot be less than 50% of variable remuneration.

have been lifted to more than 50%.¹⁶ In HSBC and RBS, the ratios were ever more than 100%, meaning that fixed remuneration constituted more than half of bankers' total remuneration.

Bankers' bonus cap is the only piece of regulation which directly acts on the level and structure of bankers' remuneration. Based on the statistics, it can be learned that the cap has caused material changes in the structure of bankers' remuneration. However, the changes are not compatible with the expectation of the policy makers. The substantial increase of fixed remuneration will cause more costs on human resources and weaken the pay-to-performance sensitivity of bankers' remuneration. However, had banks not lifted the level of fixed remuneration, they would have had difficulties in retaining top bankers. Therefore, bankers' bonus cap has trapped banks into a dilemma. The detailed discussions about these impact of bankers' bonus cap will be provided in Subsection 5.3.2.

Figure 5.3 The Ratios Between Fixed and Variable Remuneration in the UK 'Big Four' Banks from 2008 to 2016¹⁷



5.2.3 The Incentive Mechanism of Bankers' Remuneration After the GFC

The arguments and evidence in Chapter 3 have demonstrated that the incentive mechanism was the crux of bankers' remuneration. Therefore, many measures in the UK Remuneration Code have aimed at reforming the incentive mechanism. The measures such as deferral, clawback and *malus* are aimed at extending the period of performance assessment. The adoption of risk-adjusted metrics tries to promote prudential risk-taking in banks. If these measures have material effects on bankers' remuneration practice, there will be positive changes observed in the length and performance metrics of variable remuneration.

¹⁶ Some of the figures after 2014 were slightly lower than 50%. The reason is that the calibre of this thesis does not include pension allowance in fixed remuneration. However, in accordance with the calibre used by banks, pension allowance should be added to fixed remuneration. Were pension allowance included, the levels of fixed remuneration would have been higher, and the fixed-variable ratios would have been more than 50%, meaning that the banks have complied with the rules of bankers' bonus cap.

¹⁷ The ratios are calculated by the author based on the original data in Appendix F.

5.2.3.1 The Changes in the Length of Variable Remuneration

In this period, banks have applied longer deferral arrangements to both short-term and long-term remuneration schemes. The introduction of clawback has further extended the length of variable remuneration and *malus* enhanced the effect of deferral.

As mentioned before, shares have replaced cash as the major ingredient of short-term bonuses. Moreover, since 2008 banks have voluntarily replaced annual bonuses with deferred short-term bonuses. Instead of paying annually, the ‘Big Four’ banks have allocated bankers’ bonuses in a three-year period, on a pro-rata basis.¹⁸ Namely, the total amount of the bonuses in a short-term incentive scheme is decided in the first year. Nevertheless, it will be paid separately in three years. The first one-third of the total amount depends on the performance in the first year, the second one-third portion depends on the performance in the second year, and the rest is decided by the performance in the third year.¹⁹ Therefore, although short-term bonuses primarily aim at incentivising bankers to focus on annual profitability, the three-year deferral can encourage them to take into account the influence of their strategies on the bank’s sustainability in a longer future.

In 2010, the FSA issued the requirement that banks should defer variable remuneration to at least a three-year period. In 2011, it further extended the length to three to five years, which was also taken by the FCA after it succeeded the FSA. In 2015, the FCA and the PRA enhanced the requirements of deferral again. At least 60% of the variable remuneration awarded to bankers with PRA-designated senior management functions shall be subject to a seven-year vesting period and shall not be vested until the third year.²⁰ In order to fulfil this requirement, some banks have transferred parts of the deferred bonuses in their short-term schemes into LTIPs.

The periods of LTIPs have also been substantially extended following the enactment of the enhanced requirements of deferral. Before the Crisis, the period of a LTIP was usually three years. This length was criticised by the PCBS because it was much shorter than the period over which the risks in banks could materialise.²¹ In 2011, when the FSA changed the length of deferral to three to five years, the four banks chose to apply the five-year length to their LTIPs.²² However, the detailed arrangements for the five-year deferral were different among banks. For instance, in HSBC, the five-year period was the vesting period of the awards under LTIPs. It was also the period for the assessment of bankers’ performance.

¹⁸ See Appendix E.1 and E.2.

¹⁹ HSBC Annual Report 2010, 223; Barclays Annual Report 2010, 172; RBS Annual Report 2010, 250-251; Lloyds Annual Report 2010, 130

²⁰ See the details of the rule in Subsection 4.4.2.

²¹ PCBS, *Changing Banking for Good* (First Report of Session 2013-14, HL Paper 27-II/HC 175-II) 380

²² Lloyds did not extend the deferral of its LITP to five years. The length remained three years until the revision of the Remuneration Code in 2015. Please find more details in Appendix E.3.

Differently, Barclays only assessed bankers' performance in the first three years.²³ After the three years, the vested portion should be retained in the bank for another two years, only after which could bankers deal with the awards by themselves.²⁴

After the enactment of the seven-year deferral policy, banks further reformed the deferral arrangements in their LTIPs. With the detailed stipulations, now the *modi operandorum* in the 'Big Four' are very similar: during a seven-year period, performance assessment starts from the first year, while awards are allocated from the third year. Namely, no awards will be allocated in the first and second year. From the third to the seventh year, every year one-fifth of the allocated awards will become vested to the extent of bankers' achievements.²⁵

Moreover, clawback and *malus* have been applied to all of the variable remuneration schemes of the four banks. Table 5.2 shows the time when the banks started to apply clawback and *malus*. The first regulatory requirements of clawback and *malus* were published in 2014 and 2011 respectively.²⁶ Before 2011, all of the four banks had voluntarily adopted *malus*. Besides, HSBC and RBS had introduced clawback earlier than it was written into regulation.

Table 5.2 The Timeline of the Application of Clawback and *Malus* in the UK 'Big Four' Banks²⁷

Bank	Measures	From	Length
HSBC	Clawback	2013	10 years since 2015
	<i>Malus</i> ²⁸	2010	NA
Barclays	Clawback	2015	10 years since 2015
	<i>Malus</i>	2010	NA
RBS	Clawback	2011	10 years since 2015
	<i>Malus</i>	2009	NA
Lloyds	Clawback	2015	10 years since 2015
	<i>Malus</i>	2008	NA

Banks' voluntary actions of deferral, clawback and *malus* demonstrate that they have also intended to solve the problem of short-term and excessive risk-taking generated by their previous remuneration policies and practices. From their perspective, these measures would be conducive to improving bankers' remuneration management and banks' sustainability. As a consequence, these measures have obtained industrial support. After these measures

²³ HSBC Annual Report 2012, 351

²⁴ Barclays Annual Report 2012, 88

²⁵ HSBC Annual Report 2016, 160; Barclays Annual Report 2016, 102; RBS Annual Report 2016, 91; Lloyds Annual Report 2016, 87

²⁶ FSA, *Handbook*, SYSC 19A.3.52. In 2011, the term '*malus*' was not used by the regulators yet. However, in the four banks' remuneration policies, there had been very similar requirements about reducing or cancelling unvested deferred awards.

²⁷ The table is designed by the author based on the information in the four banks' annual reports.

²⁸ In the annual reports of HSBC from 2010 to 2012, the measure was named 'clawback'. This was a misuse of the concept because the measure was written as 'unvested deferred awards can be clawed back'. Therefore, it was in fact a requirement of *malus*, see HSBC Annual Report 2012, 353. This also happened in RBS and Lloyds, see RBS Annual Report 2010, 254 and Lloyds Annual Report 2008, 80.

have been enacted in the Remuneration Code, the four banks have actively and efficiently implemented them in practice.

5.2.3.2 The Changes in Performance Metrics

Before the GFC, financial indicators based on share price and profits were predominantly used for the assessment of bankers' performance. Thus, bankers were encouraged to take risky strategies to achieve these financial goals, while ignoring banks' long-term sustainability and risk control. Therefore, regulators have required banks to apply risk adjustment to these financial performance metrics. Moreover, banks should also take into consideration financial indicators of banks' capital adequacy and liquidity, and non-financial indicators of sound corporate governance and services. These regulatory requirements have substantially changed the systems of performance metrics and assessment of UK banks.

First, the types of performance metrics are more diverse than before, covering a variety of financial and non-financial metrics. Banks have introduced many new financial metrics, which are not based on profits or the increase of share price. Instead, they are stability-oriented, such as CET 1 ratio, liquidity reserves, leverage ratio, loan loss rate and Return on Risk-weighted Assets (RoRWA). CET 1 ratio, liquidity reserves and leverage ratio describe the situation of a bank's capital adequacy and liquidity. Linking bankers' remuneration with these indicators will incentivise bankers to take deleverage actions to reduce liquidity risk and the risk of insolvency. Loan loss rate is one of the indicators of a bank's assets quality. It will encourage prudential loan-making and reduce credit risk. RoRWA refers to a bank's risk-weighted profitability, which prudentially measures a bank's profitability against risk-taking. Obviously, the introduction of these financial metrics is a crucial step to align bankers' remuneration with banks' risk control and sustainability.

After the GFC, non-financial elements have been first used as the performance metrics in LTIPs, including risk management, sustainable strategies, customer satisfaction, employee engagement and leadership, regulatory compliance, and so on. Different from financial metrics, non-financial metrics are not measured through quantitative approaches. There is no numerical target to measure bankers' non-financial performance. Instead, it is the remuneration committee's discretionary power to decide how much variable remuneration can be offered to bankers for their achievements in these non-financial aspects.²⁹

The introduction of stability-based financial metrics and non-financial metrics has diversified the types of performance metrics. The traditional financial indicators of profits and the increase of share price, including PBT, EP, EPS and TSR, are continually used. However, the weightings of them are much smaller. Before the GFC, a LTIP usually

²⁹ See Appendix E.3.

contained two of the metrics among EP, EPS and TSR. The weighting of each metric was about 50%. However, nowadays, the aggregate weighting of all financial metrics is only about 60%-70%. Moreover, the new, risk-adjusted metric RoRWA has become a very important financial metric, and it is the only single item with a weighting of more than 50%. In contrast, the aggregate weighting of those traditional financial metrics has decreased to less than 30%. The diversity of performance metrics demonstrates that the function of bankers' remuneration is no longer limited to the maximisation of shareholders' interests. It has multiple functions to achieve banks' long-term interests, prudential risk management, as well as financial stability and the public interest.

Second, the major financial metrics have been adjusted by risks. As mentioned above, RoRWA has become a very important financial metric to assess a bank's profitability against risks. As shown by its name, it is the return on Risk-weighted Assets (RWA). The formula to calculate RoRWA is:

$$RORWA = \frac{\text{Net Income}}{RWA}$$

To calculate RWA, first of all, a bank's assets are grouped into different categories according to how risky each kind of assets is. Different categories are assigned with different weightings and indicated by different coefficients. Multiplying the fair value of a type of bank assets and the corresponding coefficient, the consequence represents the weighted value of this kind of assets. Then the value of the total assets is calculated by adding up the weighted value of each kind of assets. The rationale of RWA is that some types of bank assets are riskier than others. Instead of using the fair value, calculating a bank's assets with the assigned risk weightings is a more precise way to show both the soundness and profitability of the bank's business. In other words, the fair value only reflects the quantity of a bank's assets, whereas RWA reflects the quality and riskiness of the assets.³⁰

Generally, the riskier a kind of assets is, the bigger its weighting will be. If bankers want to increase the bank's income by taking risky strategies, the figures of net income and RWA will increase simultaneously. According to the formula above, it will not result in the substantial rise of RoRWA. Therefore, RoRWA integrates a 'balance sheet management' perspective with both the income side and the costs side of a bank's business.³¹ With RoRWA as an important financial metric, bankers will be incentivised to prudentially

³⁰ Vanessa Le Leslé and Sofiya Avramova, 'Revisiting Risk-weighted Assets' (2012) IMF Working Paper WP/12/90 <http://www.imf.org/en/Publications/WP/Issues/2016/12/31/Revisiting-Risk-Weighted-Assets-25807> accessed 21 June 2017, 5

³¹ Bain Insights, 'Post-crisis, Tackling Risk at European Banks' (*Forbes*, 8 August 2013) <http://www.forbes.com/sites/baininsights/2013/08/08/post-crisis-tackling-risk-at-european-banks/#7f31b945464c> accessed 21 June 2017

consider the trade-off between high profits and high risks, and thereby properly manage their banks for the balance between profitability and sustainability.³²

Apart from the introduction of RoRWA, the 'Big Four' banks have also developed their risk appetite frameworks to describe the quantum and the types of risks embedded in banks' strategies. These frameworks have become very important guidelines for remuneration committees to deliberate bankers' performance.³³ They also enable banks to apply a risk adjustment mechanism to those traditional financial metrics. For instance, immediately after the GFC, RBS has started to use risk-adjusted EP in excess of the costs of capital and liquidity and the associated risks as the key metric for short-term variable remuneration. Lloyds has also measured its EP as the 'profit relative to the risk taken to generate that profit'.³⁴

These actions are in line with the requirement of the FCA and the PRA to build up a risk-adjusted system of performance metrics and assessment. Clearly, the regulatory intervention has given rise to material changes in the incentive mechanism of variable remuneration. In particular, the risk control function has been enhanced.

Third, apart from the general system of performance metrics and assessment which is uniformly applied to all of the directors and managers, banks have also started to apply the specific and individual-based performance metrics and assessment systems to each director in line with their responsible business and governance units. The systems of metrics and assessment shown in Appendix E are the general criteria for all members in the board and senior management. Based on the general criteria, banks can make adjustments for every individual director to schedule the specific criteria. Besides, in these banks' annual reports, the assessments of performance and the implementation reports of previous remuneration packages are also provided on an individual basis.

Before the GFC, the individually specified system of performance metrics and assessment was rare. In contrast, it has become the major pattern to assess bankers' performance and remuneration after the GFC. This is a progressive change because the individual-based criteria can more closely align a banker's remuneration with his or her personal accountabilities and duties owed to the bank.

During the post-crisis period, the regulatory environment has been changing significantly. As a consequence, banks' remuneration policies in respect of the incentive mechanism have also been adjusted very frequently. Both the banking regulators and banks have been exploring the suitable solutions. Therefore, the policies have been temporarily unstable. Nevertheless, these attempts to reform the incentive mechanism of variable remuneration

³² Ibid

³³ Barclays Annual Report 2009, 170; HSBC Annual Report 2010, 221

³⁴ RBS Annual Report 2008; Lloyds Annual Report 2010, 127

are in the correct direction. To deal with short-term and excessive risk-taking, the reform must try to establish a long-term and stability-based remuneration and incentive system. All of the changes discussed above, including the extension of the length of deferral and clawback, and the introduction of risk-adjusted and stability-oriented metrics, can demonstrate that risk control, sustainable development and public interest protection have become the core incentives for bankers.

By tracking the post-crisis changes in bankers' remuneration level, components and structure, and incentive mechanism of the UK 'Big Four' banks, it can be learned that great changes have been brought to bankers' remuneration practice by the regulatory intervention. The regulatory framework does not touch the level of bankers' remuneration. As a consequence, the average level did not drop significantly after the GFC. Nevertheless, there have been substantial structural changes, which indicate the different effects of different regulatory measures. The increasing importance of LTIPs is in line with the regulatory principle of encouraging bankers' long-term perspective. Banks' redesigns of their incentive mechanisms, which have focused on the length and the performance metrics of variable remuneration, indicate that the initiatives taken by the FCA and the PRA to promote banks' long-term development and enhance banks' risk control have made great achievements in practice. However, the new type of fixed component: role-based pay, and the surge of its proportion can prove that bankers' bonus cap has been inefficiently practised and generated counterproductive consequences.

Generally speaking, along with the implementation of the regulatory framework, the orientation of bankers' remuneration practice has shifted from immediate profits and the increase of share price to financial stability and public interest. It demonstrates that the regulatory reform is a significant progress in improving the soundness and efficiency of the remuneration and incentive system of the UK banking sector.

5.3 The Problems in the Current Regulatory Framework

Despite the achievements in reforming bankers' remuneration, the current framework is not perfect. There are limitations which have made the framework less productive than it could be. One major problem is the inappropriateness of shareholder 'Say on Pay' in the banking sector, and a more serious problem rests with the conflicts between bankers' bonus cap and other measures on bankers' remuneration incentives.

5.3.1 The Problem with Shareholder 'Say on Pay'

In Subsection 4.3.2, the recent company law reform in respect of shareholder 'Say on Pay' has been discussed. After the GFC, the trend of shareholder empowerment has emerged and

developed as an increasingly dominant principle to guide company law reforms.³⁵ The widespread adoption of ‘Say on Pay’ is an embodiment of this trend. In the UK, ‘Say on Pay’ has been enhanced by replacing shareholders’ advisory vote on directors’ remuneration policy with a binding vote. ‘Say on Pay’ is generally applied to all quoted companies across industries. Therefore, the listed banks in the UK have to comply with the rules in the same way as non-financial listed companies. However, the introduction of shareholder ‘Say on Pay’ to the banking sector is incorrect.

Theoretically, the ideological foundation of ‘Say on Pay’ contradicts with the fundamental principles to regulate bankers’ remuneration, which have been widely acknowledged after the GFC.

The ideological foundation of ‘Say on Pay’ roots in agency theory and shareholder primacy, according to which the fundamental purpose of a company is to maximise the interests of shareholders. Therefore, company law should privilege shareholders’ ultimate power of decision-making.³⁶ During the GFC, the insolvencies and the falling of share prices of non-financial companies were regarded as the failures of general corporate governance.³⁷ Specifically, it was deemed that the BOD and senior management failed to ensure sufficient value creation for shareholders. As a corollary, shareholders should be encouraged to be more active to engage in corporate governance for their own interests. Therefore, shareholder engagement has been regarded as an alternative of the BOD and senior management to achieve corporate goals.³⁸ ‘Say on Pay’ is one of the key approaches to enhance shareholder engagement.

However, banks’ directors and managers owe the duties to not only shareholders but also broader stakeholders and the public. Learning from the lessons of the GFC, banks are pivotal in the financial system and national economy, therefore, bank corporate governance should give priority to the balance of the interests between different stakeholders, and the public interest, rather than shareholders’ interests only. Moreover, shareholders’ interests are short-term and riskier, which run counter to the goal of maintaining financial stability.³⁹ In terms of bankers’ remuneration, the pre-crisis incentive mechanism of variable remuneration, which was based on agency theory and shareholder primacy, significantly contributed to bank failures. After the GFC, the ideological basis of the practice and

³⁵ Stephen M. Bainbridge, *Corporate Governance After the Financial Crisis* (OUP 2016) 205-6

³⁶ William W. Bratton and Michael L. Wachter, ‘The Case Against Shareholder Empowerment’ (2010) 158 *University of Pennsylvania Law Review* 653, 659

³⁷ Jonathan Mukwiri and Mathias Siems, ‘The Financial Crisis: A Reason to Improve Shareholder Protection in the EU?’ (2014) 41 (1) *Journal of Law and Society* 51, 52

³⁸ James McConvill, ‘Shareholder Empowerment as an End in Itself: A New Perspective on the Allocation of Power in the Modern Corporation’ (2007) 33 (3) *Ohio Northern University Law Review* 1013, 1028-9; Lorraine Talbot, ‘Why Shareholders Shouldn’t Vote: A Marxist-progressive Critique of Shareholder Empowerment’ (2013) 76 (5) *The Morden Law Review* 791, 809

³⁹ PCBS, *Changing Banking for Good* (n21) 384

regulation of bankers' remuneration has been widely acknowledged as maintaining financial stability and protecting the public interest. In particular, the reform of bankers' remuneration has focused on banks' long-term development and risk control. That is to say, bankers' remuneration should be distinguished from executive remuneration of non-financial companies.⁴⁰ Therefore, 'Say on Pay' is not compatible with the fundamental principles of the post-crisis regulation of bankers' remuneration.

At the practical level, shareholders tend to favour a remuneration system which incentivises executives to maximise shareholders' utilities.⁴¹ In Chapter 3, it has been demonstrated that shareholders tend to hold short-term and profit-maximising goals, and behave to be indifferent to the firm's long-term value and risk profile. Equity-based remuneration with the metrics of share price and immediate profits are aimed at shareholders' interests. As a result, shareholders will not dissent from such kind of remuneration arrangements.

However, as just stated, bankers' remuneration policy should take all stakeholders' interests into consideration and try to reach a balance among these interests. According to 'Say on Pay', it is shareholders rather than other constituencies who have the power to approve bankers' remuneration policy. In order to avoid shareholders' rejection, when drafting the remuneration policy, banks' boards and remuneration committees will particularly incorporate shareholders' interests in the incentives for bankers. In this sense, the effect of 'Say on Pay' will be exactly the same as the effect of short-term and equity-based remuneration. As a consequence, exercising the vote in banks will result in a terrible retrogression of bankers' remuneration back to the pre-crisis incentive model.⁴² Besides, when NEDs and remuneration committees must cater to shareholders' interests to get the remuneration plans approved, their independence will be impaired. That is to say, 'Say on Pay' can also attenuate the effectiveness of the rules of remuneration committee.

Table 5.3 shows the results of 'Say on Pay' votes exercised in the 'Big Four' banks since its reform in 2013. All of the results are overwhelmingly positive, which means that shareholders in the four banks approved all of the remuneration policies and reports. Among the 24 votes, only three received high dissent, i.e. more than 20% negative votes. In RBS and Lloyds, the approval rates were nearly 100%. Although the government has had about 70% and 40% stakes in the two banks respectively,⁴³ the figures have demonstrated that the majority of private shareholders voted for the policies of bankers' remuneration. From shareholders' perspective, the reason to approve a remuneration policy is that their interests

⁴⁰ FCA, *Handbook*, SYSC 19D.1.6

⁴¹ William W. Bratton and Michael L. Wachter, 'The Case Against Shareholder Empowerment' (n36) 667

⁴² *Ibid*, 653

⁴³ Emma Dunkley, 'Government Cuts Lloyds Bank Stake Below 1%' *Financial Times* (London, 28 April 2017) <https://www.ft.com/content/b7983010-881c-3380-b898-67b893ea3e56?mhq5j=e2> accessed 24 June 2017

can be achieved through the arrangements for bankers' remuneration and incentives, rather than the regulatory goals of financial stability and the public interest.

Table 5.3 The Results of 'Say on Pay' Votes in the UK 'Big Four' Banks from 2014 to 2017⁴⁴

Bank	Resolution	Year	Total votes of capital (%)	For (%)	Against (%)	Binding or not
HSBC	Remuneration policy	2014	51.29	79.35	20.65	Yes
	Remuneration report	2014	51.10	83.95	16.05	No
	Remuneration report	2015	45.70	76.29	23.71	No
	Remuneration policy	2016	46.71	96.05	3.95	Yes
	Remuneration report	2016	46.45	90.49	9.51	No
	Remuneration report	2017	45.94	96.47	3.53	No
Barclays	Remuneration policy	2014	65.02	93.21	6.79	Yes
	Remuneration report	2014	57.19	76.01	23.99	No
	Remuneration report	2015	69.73	97.50	2.50	No
	Remuneration report	2016	71.73	93.60	6.40	No
	Remuneration policy	2017	72.33	97.91	2.09	Yes
	Remuneration report	2017	71.74	97.22	2.78	No
RBS	Remuneration policy	2014	83.18	99.66	0.34	Yes
	Remuneration report	2014	83.62	99.81	0.19	No
	Remuneration report	2015	84.94	99.32	0.68	No
	Remuneration report	2016	91.61	99.56	0.44	No
	Remuneration policy	2017	92.09	96.33	3.67	Yes
	Remuneration report	2017	92.17	99.60	0.40	No
Lloyds	Remuneration policy	2014	69.02	97.97	2.03	Yes
	Remuneration report	2014	70.31	87.26	12.74	No
	Remuneration report	2015	73.35	97.67	2.33	No
	Remuneration report	2016	69.83	97.67	2.33	No
	Remuneration policy	2017	68.05	98.03	1.97	Yes
	Remuneration report	2017	68.76	97.92	2.08	No

In Section 5.2, it has been shown that substantial changes have been brought to bankers' remuneration practice, focusing on the promotion of long-term incentives and risk-adjusted performance metrics. Nevertheless, previous remuneration practice has been largely preserved. For instance, shares are still the predominant form of variable remuneration. Traditional financial metrics based on share price and profits are continually used. As a consequence, to a large extent bankers' remuneration is still aligned with shareholders' interests. This is an important reason why banks' shareholders have largely approved bankers' remuneration policies in recent years.

Indeed, the progressive changes have brought long-term stability and the public interest into bankers' views. However, the strength of the reform is inadequate. In order to further enhance the function of bankers' remuneration for financial stability and the public interest, alternatives of ordinary shares, such as bonds, should be used for performance-based remuneration. Besides, the weightings of stability-based performance metrics should be

⁴⁴ This table is designed by the author based on the information and data collected from the banks' announcements about the results of AGMs.

further increased.⁴⁵ However, ‘Say on Pay’ will be a big obstacle to these advanced steps. These steps, which will reduce equity-based remuneration and incentives, can make bankers more attentive to stakeholders’ interests while less prone to shareholders’ interests. However, with a binding vote, shareholders will reject further reforms of bankers’ remuneration, which will have a negative impact on their pursuits in immediate profits and shareholder returns.

Therefore, the thesis advocates that shareholder ‘Say on Pay’ in the banking sector should be abrogated to eliminate the obstacle to further reforms towards financial stability and the public interest, and the function of remuneration committee.

5.3.2 The Problem with Bankers’ Bonus Cap

5.3.2.1 The UK’s Legal Challenge Against Bankers’ Bonus Cap

Among all of the measures to reform bankers’ remuneration, bankers’ bonus cap is the most controversial one. Since the time when bankers’ bonus cap was first proposed until today, the national government, banking regulators and banking industry in the UK have always been opposed to it. They have spared no efforts to fight against the legislation and implementation of bankers’ bonus cap. After they failed to block the cap, they tried to mitigate the impact to the minimum.

As elaborated in Subsection 4.4.1, when the proposal of bankers’ bonus cap was submitted to the G20 and the EU, the UK explicitly indicated its opposition. The most important and largest action against bankers’ bonus cap was the UK government’s challenge against the relevant provisions in the CRD IV to the Court of Justice of the European Union (CJEU).

On the day of 20 September 2013, which was after the European Parliament’s resolution to enact the cap and before the deadline for the member states to implement it, the UK government lodged a legal challenge against the European Parliament and the Council to seek the annulment of bankers’ bonus cap. According to the EU law, the CJEU can annul an EU legislation on one of the four grounds: lack of competence, infringement of an essential procedural requirement being fulfilled, infringement of the treaties, and misuse of powers.⁴⁶ The UK government submitted six pleas and particularly pointed out that the relevant provisions of bankers’ bonus cap were out of the EU’s competence, without legitimacy, in violation of the fundamental principles of the EU law and customary international law, and resulting in legal uncertainty.⁴⁷ Questioning the validity, the

⁴⁵ These recommendations attempt to align bankers’ remuneration with different kinds of interests among stakeholders, while not denying the pursuit of shareholders’ interests. The essence is to keep the balances between shareholders’ interests and other stakeholders’ interests, between profits and risks, and between profitability and sustainability.

⁴⁶ The Treaty on the Functioning of the European Union, Article 263

⁴⁷ All of the six pleas were from the perspectives of EU law and international law, rather than financial law or corporate governance. Since the contents of the six pleas are out of the focus of the thesis, they are not elaborated here. For more details, please refer to Longjie Lu, ‘The End of Bankers’ Bonus Cap: How Will the

reasonability and the legal consequence of bankers' bonus cap on the basis of EU law and international law, was the expedient of UK government. Limited to the jurisdiction of the CJEU to annul an EU legislation, arguing the *de jure* defects was the only feasible way for the UK to seek the annulment of the cap. However, the pleas cannot represent the real motivations of the UK government to launch the challenge.⁴⁸ What they really worried about was that the cap would have an adverse effect on the domestic regulation of bankers' remuneration. They have argued that there is no any assessment or supporting evidence demonstrating the feasibility of the cap. The cap is incompatible with the UK's initiatives to reform bankers' remuneration, and it undermines the significant advancements that have been made to improve financial stability.⁴⁹

However, all of the six pleas were dismissed by the Advocate General (AG) of the CJEU. On a *de jure* basis, the AG provided legal explanations to justify the legitimacy of the cap and its compatibility with the EU Treaties, and denied the legal uncertainty it might bring to practice.⁵⁰ The AG's opinion was not the final decision of the CJEU and it was not legally binding. Theoretically, the UK government could insist on the suit.⁵¹ However, usually, an AG's opinion can have a significant influence on the Court's decision. As a consequence, the UK government estimated that there was little possibility to win. At the end, the legal challenge was withdrawn halfway.⁵²

Nevertheless, the UK government still maintained the opposite stance against the cap. After the withdrawal, the then Chancellor of the Exchequer George Osborne commented that 'the fact remains these are badly designed rules... These rules may be legal but they are entirely self-defeating, so we need to find another way to end rewards for failure in our bank.'⁵³ This is also the stance of the UK banking regulators. The FCA and the PRA publicly announced that the transportation of the rules would be based on the principles of 'legal

UK Regulate Bankers' Remuneration After Brexit?' (2016) 27 (7) *European Business Law Review* 1091, 1107-1112; Michael Randall and Longjie Lu, 'Capping of Bankers' Bonuses? Case C-507/13 UK v. Parliament and Council' (2015) 42 (4) *Legal Issues of Economic Integration* 383, 388-395

⁴⁸ Longjie Lu, 'The End of Bankers' Bonus Cap: How Will the UK Regulate Bankers' Remuneration After Brexit?' (ibid) 1110

⁴⁹ HM Treasury, 'Legal Challenge Launched into New Rules on Bankers' Pay' (*GOV.UK*, 25 September 2013) <https://www.gov.uk/government/news/legal-challenge-launched-into-new-rules-on-bankers-pay> accessed 26 June 2017

⁵⁰ Case C-507/13 *United Kingdom v. Parliament and Council* [2014], Opinion of Advocate General Jääskinen <http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:62013CC0507&from=EN> accessed 26 June 2017

⁵¹ Michael Randall and Longjie Lu, 'Capping of Bankers' Bonuses? Case C-507/13 UK v. Parliament and Council' (n47) 397-8

⁵² Alex Barker, 'Osborne Gives up on Challenge to Bank Bonus Cap' *Financial Times* (Brussels, 20 November 2014) <https://www.ft.com/content/12d1ba3a-7094-11e4-9129-00144feabdc0> accessed 26 June 2017

⁵³ Joe Miller, 'Osborne Abandons Challenge to EU Cap on Bankers' Bonuses' *BBC News* (London, 20 November 2014) <http://www.bbc.co.uk/news/business-30125780> accessed 26 June 2017

minimum’ and ‘strict copy-out’.⁵⁴ As a consequence, the implementation of the provisions in the CRD IV was strictly limited to the extent the UK having to follow, in order to minimise the needs for changes and the costs for firms and the regulators. In addition, in 2015 the UK also rejected the EBA’s proposal to extend bankers’ bonus cap to smaller and less complex financial institutions.⁵⁵

Why has the UK always expressed its objection and criticism on the EU bankers’ bonus cap? Is it because the cap is really problematic in practice or due to any economic, political or ideological divergence between the UK and the EU? The answer is both.

5.3.2.2 The Conflicts with Other Measures and the Counterproductive Effects

As clearly stated by the HM Treasury and the BoE, bankers’ bonus cap conflicts with the measures aimed at reforming the incentive mechanism of bankers’ remuneration, and it is counterproductive in practice.⁵⁶

The problem of bankers’ remuneration rested with the short-term and equity-based incentives in variable remuneration schemes. To solve the problem, the EU and the UK have focused on different ways. The EU’s logic of implementing bankers’ bonus cap is that reducing the proportion of variable remuneration would mitigate bankers’ motivations to take risks. Differently, the primary approach of the UK banking regulators is to replace the short-term and equity-based incentives with the long-term and stability-oriented incentives, while at the same time, keeping the predominant position of variable components in bankers’ total remuneration. Remuneration deferral, clawback and *malus*, and risk adjustment to performance metrics are all enforced in line with this idea.⁵⁷

To make an analogy, incentive mechanism is the ‘cell infected by a virus’, while variable remuneration is the ‘carrier’. The UK’s approach is to kill the virus while the EU’s approach is to kill the carrier. Currently, the EU’s approach has been adopted. It has resulted in the inefficient enforcement of other measures, which try to reform the incentive mechanism of variable remuneration. Deferral, clawback and *malus*, and risk adjustment, all aim at encouraging bankers to take into consideration the long-term interests of banks, and the

⁵⁴ FCA, *CRD IV for Investment Firms Feedback and Final Rules for CP13/6, CP13/9 (Chapter 16) and CP13/12* (Policy Statement 13/10, December 2013) 7

⁵⁵ Please refer to Subsection 4.4.1 for details.

⁵⁶ HM Treasury, ‘Legal Challenge Launched into New Rules on Bankers’ Pay’ (n49); BoE, *Detailed Answers from Bank of England Response to the European Commission Call for Evidence on the EU Regulatory Framework for Financial Services* (January 2016) <https://www.bankofengland.co.uk/-/media/boe/files/paper/2016/detailed-answers-from-boe-response-to-eu-call-for-evidence-on-the-eu-regulatory> accessed 6 January 2018, 15; ‘Bank of England Reiterates Concerns over EU Bonus Cap Plans’ (*Out-Law*, 5 February 2016) <https://www.out-law.com/en/articles/2016/february/bank-of-england-reiterates-concerns-over-eu-bonus-cap-plans/> accessed 26 June 2016

⁵⁷ This idea is not special in the UK. The general requirements of deferral, clawback and *malus* and risk adjustment have also been included in the CRD IV. However, in comparison with bankers’ bonus cap, the EU legislators have paid less attention to these measures. On the contrary, the FCA and the PRA have enacted stricter and more specific requirements to enforce these measures.

value of financial stability and public interest when making business decisions. However, the implementation of long-term and stability-based incentives relies necessarily on variable remuneration as the carrier.⁵⁸ The aforementioned measures are all relevant to bankers' performance and applied to performance-based remuneration. In order to efficiently implement these measures, variable remuneration should make a substantial part of bankers' total remuneration. However, after bankers' bonus cap came into effect, the proportion of variable remuneration has been cut down. Accordingly, a smaller portion of bankers' remuneration has been linked with performance, which means that the pay-to-performance sensitivity has decreased.⁵⁹ As a result, the functions of deferral, clawback and *malus* and risk adjustment have been impaired. The expected effects of the entire regulatory reform cannot be fully achieved.⁶⁰

The UK regulators' initiative measures on bankers' remuneration, which redesign the incentive mechanism with risk-adjusted and stability-based incentives, are in the correct direction. The effectiveness of these measures depends on that the proportion of variable remuneration maintains at a sufficient level. However, bankers' bonus cap undermines the precondition of making these measures effective. Therefore, the EU's method can be described as 'giving up eating for fear of choking'. It will not achieve the expected targets, whereas it will generate unexpected and adverse outcomes.

In practice, bankers' bonus cap has lifted the proportion of fixed remuneration. As mentioned before, UK banks have introduced a new form of fixed remuneration: role-based pay. According to the BoE, on average the proportion of fixed remuneration in UK banks increased from 28% in 2013 to 54% in 2014.⁶¹ The structural changes shown in Subsection 5.2.2 can also support this statement. Before the GFC, fixed components only constituted less than 30% of bankers' total remuneration. If banks had not increased fixed remuneration, to comply with the 1:1 ratio, the total remuneration would have been reduced by 40%. Furthermore, the EU is the only jurisdiction that has controlled the ratio between variable and fixed remuneration. Therefore, if UK banks had not increased fixed remuneration, the level of total remuneration would have been much lower than that in other financial markets. As a consequence, UK banks would have been less attractive to top financial elites.⁶²

⁵⁸ Martin Arnold, 'BoE Steps up Criticism of Bankers' Bonus Cap: Regulation' *Financial Times* (London, 17 October 2014) 2

⁵⁹ Kevin J. Murphy, 'Regulating Banking Bonuses in the European Union: A Case Study in Unintended Consequences' (2013) 19 (4) *European Financial Management* 631, 648

⁶⁰ Longjie Lu, 'The End of Bankers' Bonus Cap: How Will the UK Regulate Bankers' Remuneration After Brexit?' (n47) 1122

⁶¹ BoE, *Detailed Answers from Bank of England Response to the European Commission Call for Evidence on the EU Regulatory Framework for Financial Services* (n56) 15

⁶² 'Tilting the Playing Field' *The Economist* (Berlin, 9 March 2013) <http://www.economist.com/news/finance-and-economics/21573122-regime-change-europe-tilting-playing-field> accessed 11 August 2016

However, the increase of fixed remuneration is against the purpose to regulate bankers' remuneration. It not only reduces the pay-to-performance sensitivity but also generates more regular labour costs for banks. After the introduction of role-based pay, the amounts of total remuneration remain the same. Nevertheless, 50% of bankers' total remuneration is fixed. The amounts of fixed components must be paid to bankers regardless of the bank's business operation. That is to say, even if bankers have failed to promote the bank's development, fixed remuneration should be paid to bankers. Therefore, the regular labour costs are unavoidable. Due to the rise of regular labour costs, banks' profitability and their abilities of cost control will be dampened. Moreover, more fixed remuneration will make banks less resilient to financial difficulties. Sufficient variable remuneration with the mechanisms of clawback and *malus*, can allow banks to flexibly cancel or reduce the variable remuneration allocated or paid to bankers during financial difficulties. However, if a substantial amount must be paid to bankers regularly, banks will be more vulnerable.⁶³

In short, bankers' bonus cap is problematic and counterproductive in the UK's regulatory framework. In addition, the UK authorities have also considered the political and economic disadvantages the cap may incur to the financial industry, and the ideological divergence on the regulation of bankers' remuneration between the UK and the EU.

5.3.2.3 Concerns About the Competitiveness and the Leading Position of the UK Financial Industry

The financial industry is the pillar of the UK's economy. The City of London is one of the largest and most pivotal financial centres in the world. It is the home to one of the top stock markets and many world-leading financial institutions. According to the Global Financial Centres Index (GFCI), since the Index started in 2007 until today, London has always been the top financial centre in the world.⁶⁴

The City has a variety of comparative advantages for financial development, including stable political institutions, powerful currency, skilled workforce, fair and just business law, firm but not intrusive regulation, tax neutrality, and so on.⁶⁵ Among all kinds of factors that may influence the position of an international financial centre, the availability of skilled personnel and the regulatory environment have been chosen as the most important two

⁶³ Tim Wallace, 'Bankers' Bonus Cap Drives up Salaries, Says Bank of England' *The Telegraph* (London, 15 December 2015) <http://www.telegraph.co.uk/finance/bank-of-england/12052055/Bankers-bonus-cap-drives-up-salaries-says-Bank-of-England.html> accessed 11 August 2016. Kevin J. Murphy, 'Regulating Banking Bonuses in the European Union: A Case Study in Unintended Consequences' (n59) 645

⁶⁴ The GFCI, which includes the ranking of the world's financial centres is regularly published in every March and September. Please visit the website of Z/Yen, <http://www.longfinance.net/> accessed 27 June 2017

⁶⁵ Douglas W. Arner, 'The Competition of International Financial Centres and the Role of Law' in Karl Matthias Meessen *et al* (eds), *Economic Law as an Economic Good: Its Rule Function and Its Tool Function in the Competition of Systems* (Sellier. European Law Publishers 2009) 193, 196; Michael Morley, 'London Must Capitalise on Its Many Advantages as Global City of Choice', *The Telegraph* (17 March 2013) <http://www.telegraph.co.uk/finance/comment/9936084/London-must-capitalise-on-its-many-advantages-as-global-city-of-choice.html> accessed 23 October 2016

factors.⁶⁶ The City is highly advantageous in these two aspects. Sufficient skilled financial employees and a relatively loose but well-organised, market-oriented and business-friendly regulatory system, have helped London attract massive top businesses and investment opportunities and become the first-ranking financial centre.⁶⁷

After the GFC, strengthening banking regulation for financial stability is the main theme of global financial regulation. The UK regulators have also been aware of the necessity to keep the financial system robust and stable. At the same time, they also want to keep the balance between financial stability and market competitiveness and vitality. Therefore, the UK regulators are very cautious about the negative effects of intrusive rules.

However, the austerity measures of banking regulation at the EU level, especially the intrusive approach in bankers' remuneration, has made the UK fear of losing the City's supremacy in the global financial markets.⁶⁸ To maintain the leading position, the UK must make sure that the employment market in London can afford competitive remuneration to its financial elites. To this end, on the one hand, the regulation of bankers' remuneration should be able to curb excessive risk-taking; on the other hand, it should not be too rigid to impair the competitiveness of UK banks.

In fact, among the top ten financial centres listed by the GFCI in 2017, London is the only one where bankers' remuneration is legally capped.⁶⁹ Among London's arch-rivals, such as New York, Singapore and Hong Kong, no similar rule has been adopted. Consequently, it is possible that London will become inferior to its strong rivals in the competition for top financial employees. In 2011, HSBC announced that it was planning to move the headquarters from the UK to Hong Kong. A major cause was the negative impact of the incoming tightened regulations on its profitability.⁷⁰ Although after several years' consideration, the bank finally abandoned the leaving plan and still stays within the UK, it has alarmed the UK authorities.

After Brexit, the political-economic relationship between the UK and the EU will materially change. The UK is facing with not only more challenges but also new opportunities. On the

⁶⁶ Centre for the Study of Financial Innovation, 'Sizing up the City: London's Ranking as a Financial Centre' (June 2003) <http://www.longfinance.net/FCF/SizingUpTheCity.pdf> accessed 27 June 2017, 8; Z/Yen, 'The Competitive Position of London as a Global Financial Centre' (November 2005) <http://www.zyen.com/PDF/LCGFC.pdf> accessed 23 October 2016, 49

⁶⁷ Longjie Lu, 'The End of Bankers' Bonus Cap: How Will the UK Regulate Bankers' Remuneration After Brexit?' (n47) 1122

⁶⁸ Michael Morley, 'London Must Capitalise on Its Many Advantages as Global City of Choice' (n65)

⁶⁹ China Development Institute and Z/Yen, 'The Global Financial Centres Index 21' (March 2017) http://www.longfinance.net/images/gfci/GFCI21_05_04_17.pdf accessed 27 June 2016, 4

⁷⁰ Howard Mustoe, 'Will Britain's HSBC Move Back to Its Original Home?' *BBC News* (London, 5 May 2015) <http://www.bbc.co.uk/news/business-32529115> accessed 23 October 2016; Louise Armitstead, 'HSBC Reveals Plans to Quit London for Hong Kong' *The Telegraph* (London, 05 March 2011) <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/8363584/HSBC-reveals-plans-to-quit-London-for-Hong-Kong.html> accessed 23 October 2016

one hand, Brexit has resulted in temporary political uncertainty and economic stagflation. Consequently, sterling has dropped and remains weak.⁷¹ London is losing some of its comparative advantages as a top financial centre, and the UK is under more pressure to remain prosperous. Therefore, currently, an efficient and competitive remuneration and incentive mechanism, and a flexible, market-oriented and business-friendly system of financial regulation become more important. However, on the other hand, Brexit enables the UK to fully take back the parliamentary sovereignty of legislation, and to amend and improve its laws and regulations independently.⁷² In this sense, legally the UK will be able to annul the EU bankers' bonus cap in the future and improve the efficiency of the regulation of bankers' remuneration in line with its own needs for financial development and stability.

5.3.2.4 The UK's Adherence to the Liberal Market Discipline

Ideologically, the UK policy makers deem that bankers' bonus cap leads to excessive governmental intrusion in the financial employment market, which runs counter to the very fundamental principle of financial regulation and corporate governance in the UK - the liberal market discipline.

The UK is a typical liberal market economy.⁷³ As the home country of Adam Smith and David Ricardo, the UK has a long tradition and a solid foundation to sustain the ideology of liberal market. In particular, since 1979, the Conservative Government abandoned the post-war Keynesianism and reshaped the UK economy as a liberal market system with a flurry of measures on privatisation and deregulation.⁷⁴

The ideology of liberal market has a profound influence on the UK's business law and financial regulation. Based on the Market Efficiency Hypothesis, market price is able to capture the true value, and market force can sufficiently deliver superior competitive efficiencies, which can be converted into greater economic growth and social welfare. Therefore, liberal market is the primary mechanism to adjust the conduct of market

⁷¹ 'Uncertainty Will Shape the UK Economy in 2017' *Financial Times* (London, 29 December 2016) <https://www.ft.com/content/fa8715c4-c843-11e6-9043-7e34c07b46ef?mhq5j=e2> accessed 28 June 2017; Katie Allen, 'Majority of Managers Think Brexit Uncertainty Will Affect UK Economy' *The Guardian* (London, 28 December 2016) <https://www.theguardian.com/business/2016/dec/28/majority-of-managers-think-brexit-uncertainty-will-affect-uk-economy> accessed 28 June 2017

⁷² 'Brexit: UK Set out Plans to Replace All EU Laws' *BBC News* (London, 30 March 2017) <http://www.bbc.co.uk/news/uk-politics-39439554> accessed 28 June 2017

⁷³ Dirk Akkermans *et al*, 'Do 'Liberal Market Economies' Really Innovate More Radically than 'Coordinated Market Economies'?: Hall and Soskice Reconsidered' (2009) 38 (1) *Research Policy* 181, 181

⁷⁴ Rouven Dresselhaus *et al*, 'Great Britain and the Development of a Liberal Market Economy' (2005) European Business School - International University Schloß Reichartshausen Seminar Paper <http://www.grin.com/en/e-book/69232/great-britain-and-the-development-of-a-liberal-market-economy> accessed 28 June 2017, 4

participants and the commercial relationships between them.⁷⁵ In line with this ideology, the previous regulations on the financial system and bank corporate governance were on a market-oriented and laissez-faire basis. Therefore, the necessity and reasonability of intensive governmental intervention were very limited.⁷⁶

The lessons from the GFC have changed the UK government's regulatory concept. However, it is not a thorough change which will lead to the abandonment of the liberal market discipline. It is necessary to clarify that regulation is not the opposite of market. Regulatory tightening does not have such an implication that government will completely supplant the role of the market in allocating resources and controlling business conduct. In fact, the post-crisis regulatory reform in the UK is still based on the ideology of liberal market. However, what is different is that to the extent necessary regulatory intervention should be enhanced to actively correct or prevent market failures and provide sufficient guidance to market participants where the market itself is deficient.⁷⁷ Namely, the purpose of regulatory reform is to explore an effective way through which governmental intervention can better serve as a supplementary mechanism to achieve market competitiveness and economic growth.⁷⁸

The UK's insistence on the liberal market discipline can be reflected through the post-crisis regulatory reform of bankers' remuneration. All the initiative measures taken by the UK regulators are on an indirect basis, which means that the government will not supplant market force or business autonomy to determine the level and structure of bankers' remuneration. The measures such as deferral, clawback and *malus*, and risk adjustment, all attempt to direct banks to encourage their bankers to develop a long-term angle for financial stability and the public interest. Obviously, these measures try to correct the deficiencies in the operation of the financial employment market before the GFC. Nevertheless, none of them removes the market character of bankers' remuneration. As a result, the amounts of bankers' remuneration are still decided in accordance with bankers' performance. As long as the goals of long-term financial stability and the public interest are achieved, bankers deserve competitive remuneration packages.

However, bankers' bonus cap is different. It acts as a 'price ceiling', with which the regulators can directly and intrusively control the level and structure of bankers'

⁷⁵ Jay Cullen, *Executive Compensation in Imperfect Financial Markets* (Edward Elgar 2014) 12; Eugene. F. Fama, 'Efficient Capital Markets: A Review of Theory and Empirical Work' (1970) 25 (2) *Journal of Finance* 383, 383; FSA, *The Turner Review*, 40

⁷⁶ Philip Rawlings *et al*, 'Regulation of Financial Services: Aims and Methods' (2014) Queen Mary University of London - Centre for Commercial Law Studies Working Paper <http://www.ccls.qmul.ac.uk/media/ccls/docs/research/020-Report.pdf> accessed 23 June 2016, 8; Alan Dignam, 'Capturing Corporate Governance: The End of the UK Self-regulating System' (2007) 4 (1) *International Journal of Disclosure and Governance* 24, 24

⁷⁷ PCBS, *Changing Banking for Good* (n21) 11

⁷⁸ BIS, *Principles for Economic Regulation* (April 2011) 1-2

remuneration. If the level of fixed remuneration is settled, no matter how excellent bankers' performance is, their performance-based remuneration cannot be higher than two times of the specified amount of fixed remuneration. For those bankers whose performance deserves a set of variable awards higher than two times of fixed remuneration, their skills and contributions are undervalued. Capping their variable remuneration will also cap their competitiveness in the employment market. Therefore, the cap harms the competition and reduces the efficiency of the financial employment market, which is against the ideology of liberal market in the UK.

The UK government always reckons that measures that directly limit market competition are not the best instruments.⁷⁹ Although maintaining financial stability and protecting the public interest is the most important and urgent task of banking regulation, it cannot be at the expense of market competition and economic efficiency. Therefore, the post-crisis banking regulatory reform in the UK still regards the liberal market as the primary mechanism and focuses on how to compensate and correct the inefficiencies and defects in the market through appropriate regulatory intervention. As a result, bankers' bonus cap contradicts with this ideology and should be excluded from the post-crisis regulatory framework.

5.4 Conclusion

This chapter has analysed the changes in bankers' remuneration practice in the context of the post-crisis regulatory tightening, and discussed the effects and problems of the current regulatory framework. It has given answers to the question: how is bankers' remuneration practiced in the UK after the GFC and how does the post-crisis regulation work?

By illustrating the remuneration practices of the UK 'Big Four' banks after the GFC and comparing with their practices before the GFC, the changes in bankers' remuneration level, components and structure, and incentive mechanism have been tracked. The level of bankers' total remuneration sharply dropped in the first three years after the GFC. However, it quickly recovered and increased to higher levels. In fact, the regulation does not constrain total remuneration level. In contrast, it has made substantial changes to the components and structure, and the incentive mechanism of bankers' remuneration. In order to emphasise long-term development, LTIP has become the predominant type of variable remuneration while the proportion of short-term bonuses has dramatically decreased. However, since bankers' bonus cap came into force in 2014, in order to circumvent the influence on the total level of bankers' remuneration, the banks have introduced a brand-new type of fixed

⁷⁹ Office of Fair Trading, *Government in Markets: Why Competition Matters - A Guide for Policy Makers* (2009) https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/284451/OFT11113.pdf accessed 28 June 2017, 2

remuneration: role-based pay, which has significantly increased the level and proportion of fixed remuneration.

The incentive mechanism of variable remuneration was the crux of the problem of short-termism and excessive risk-taking. Therefore, the regulatory reform has brought material changes to the incentive mechanism. The adoption of deferral, clawback and *malus* has significantly extended the length of the vesting period of variable remuneration. The introduction of risk-adjusted and stability-oriented performance metrics has aligned bankers' remuneration with banks' sustainability and risk control. The majority of changes are conducive to realising the goals of the post-crisis banking regulatory reform, namely, maintaining financial stability and protecting the public interest. In particular, the measures aimed at changing the incentive mechanism to focus on long-term incentives and prudential risk-taking are in the correct direction. However, the current regulatory framework is not perfect. There are conflicts between the measures.

First of all, it is not proper to include shareholder 'Say on Pay' in the banking sector because it contradicts with the fundamental principles of the post-crisis regulation. 'Say on Pay' has an effect of enhancing shareholder empowerment in the pay-setting process, which will consolidate the alignment between bankers' remuneration and shareholders' interests. As a consequence, it will result in the retrogression of bankers' remuneration back to the pre-crisis incentive model, which was based on short-term profits and the increase of share price. Therefore, 'Say on Pay' should be removed from the regulatory framework of bankers' remuneration. To this end, specific measures to restrict the exercise of 'Say on Pay' in the banking sector should be taken in the future.

More seriously, bankers' bonus cap conflicts with the measures on the incentive mechanism, namely, deferral, clawback and *malus*, and risk adjustment. Bankers' bonus cap limits the proportion of variable remuneration while increasing the proportion of fixed remuneration. Therefore, it will reduce the pay-to-performance sensitivity of bankers' remuneration. However, all of the aforementioned measures are relevant to bankers' performance and applied to performance-based remuneration. As a consequence, their functions to promote long-term incentives and risk control will be refrained. In practice, bankers' bonus cap is counterproductive. It has led to the increase of labour costs to afford more fixed components and impaired the competitiveness of bankers' remuneration. Moreover, from the ideological perspective, bankers' bonus cap infringes the liberal market discipline, which is the fundamental principle of the UK business law and financial regulation. Besides, from the perspective of political economy, it harms the competitiveness of the UK financial industry. Therefore, the UK government is always against the idea of capping bankers' remuneration. However, since implementing bankers' bonus cap was the UK's legal obligation under the EU law, it has become a part of the regulation in the UK. After Brexit, the economic, political and legal relationships between the UK and the EU will materially change and the UK is confronted with more pressure to offer a proper and

sound financial regulatory system to maintain the top position of its financial industry. Therefore, it is possible, and more necessary to remove bankers' bonus cap from the current regulatory framework.

It has been a decade since the GFC. Generally speaking, the UK government's efforts to reform bankers' remuneration have been progressive and productive. However, in order to improve the regulatory efficiency, the two problems should be solved by removing shareholder 'Say on Pay' and bankers' bonus cap. Moreover, banks should be directed to diversify the forms of variable remuneration, such as introducing debt-based awards. It will help banks enhance risk control and balance the interests of different stakeholders. The policy recommendations for the further reform of bankers' remuneration in the UK will be explained in Chapter 10.

In essence, the UK's regulatory approach of bankers' remuneration is market-based. It attempts to direct banks to provide their bankers with the correct incentives, which will promote financial stability and the public interest. Nevertheless, the regulators try to leave the level and structure of bankers' remuneration within banks' discretion and avoid overly intrusive measures which will limit the proper operation of the market mechanism. In the UK, the financial employment market is still the primary mechanism to decide bankers' remuneration, while the enhanced regulation is the supplementary mechanism to compensate market deficiencies and prevent market failures. This fundamental feature of the UK's regulatory approach will be deeply discussed through the comparison with the regulation of bankers' remuneration in China.

Part III
The Regulation of Bankers' Remuneration in China

Chapter 6

Chinese Bankers' Remuneration in the Context of Transitional Banking Reform

6.1 Introduction

In comparison with the UK, the history of the modern banking system in China is very short. It had not started until 1979 when the country just launched the 'Reform and Opening' (改革开放) Policy as the fundamental guidance for economic and social reform.¹ Nevertheless, the development of the Chinese banking system is dramatic and fast. The four decades have seen tremendously successful changes. Since 1979 until the GFC, China spent three decades on shifting from a planned mono-bank system to an integrated, multi-layered and modern system.² Moreover, during the post-crisis decade, when many other major economies were weighed down with banking rescue and economic recovery, and retreated from the global financial markets, China's large banking groups have taken the opportunity to expand their overseas businesses and improve their international influence.³

Despite the great achievements, there are still many problems and defects in the banking sector. A major problem is the negative side of the predominant role of the state in banking reform, which has generated pervasive political intervention in Chinese banks.⁴ Nowadays, political intervention mainly exists in *de facto* corporate governance of banks. In particular, bankers' remuneration has long been a key channel of political intervention. Therefore, in order to transform the role of the state from the 'chief commander' to the real banking regulator, and to 'make banks into real banks' (把银行办成真正的银行),⁵ it is necessary to push forward the modernisation and marketisation reform of bank corporate governance,⁶ with an emphasis on the issue of bankers' remuneration.

The purpose of this chapter is to analyse the problem of bankers' remuneration in the context of China's transitional banking reform. It is organised in four sections. The second section introduces the reforms of China's banking system and banking regulation. The third section discusses the current problem in bankers' remuneration in China and explains why

¹ Justin Y. Lin and Zhiyun Li, 'The Reforms of Chinese SOEs and the Financial System' (中国的国有企业与金融体制改革) (2005) 4 (4) *China Economic Quarterly* 913, 920

² Richard Podpiera, 'Progress in China's Banking Sector Reform: Has Bank Behaviour Changed?' (2006) IMF Working Paper 06/71 <https://www.imf.org/external/pubs/ft/wp/2006/wp0671.pdf> accessed 30 June 2017, 3

³ Henny Sender, 'US Retreat from Global Financial System Lets China in' *Financial Times* (Hong Kong, 4 April 2017) <https://www.ft.com/content/0ea91ff4-0334-11e7-aa5b-6bb07f5c8e12?mhq5j=e2> accessed 30 June 2017

⁴ Violaine Cousin, *Banking in China* (2nd edn, Palgrave Macmillan 2011) xxi

⁵ This was said by the former Chinese leader Deng Xiaoping, see Deng Xiaoping, 'Enterprise Reform and Financial Reform' (企业改革和金融改革) in *The Selected Works of Deng Xiaoping* (邓小平文选), vol 3 (People's Publishing 1993) 192, 193

⁶ Alicia García-Herrero *et al.*, 'China's Banking Reform: An Assessment of Its Evolution and Possible Impact' (2006) 52 (2) *CESifo Economic Studies* 304, 327

reforming bankers' remuneration is a necessary and important step to bolster the deepening and development of the Chinese banking industry in the future. The fourth section makes the conclusion.

6.2 China's Banking Reform

In the era of a planned economy, China's financial system was highly centralised. It was a grand unification (大一统), which was led by the People's Bank of China (中国人民银行, PBOC).⁷ Nowadays, the PBOC is known as the central bank of China. At that time, it not only acted as the central bank with the responsibilities of monetary policy-making and financial regulation, but also undertook all credit and loan businesses.⁸ The PBOC was the sole commercial bank during that period. Therefore, the credit and loan businesses were on the basis of 'unified depositing and lending' (统存统贷). Taking deposits and making loans were all through the PBOC in line with the central government's economic plans,⁹ without a real financial market.

Under the highly centralised and unified political and economic system, China's economic and social development went into many inefficient detours. In the last decade before China's 'Reform and Opening', the country experienced a catastrophe: the 'Cultural Revolution' (文化大革命). Its national economy and financial system were paralysed. In this context, China started the comprehensive and institutional reform to establish a modern banking industry.

Chinese scholars usually divide the reform into four stages. The first stage was from 1979 to 1983, during which the modern banking system, comprised of four State-owned Commercial Banks (国有商业银行, SOCBs), was preliminarily established. The four banks took over the commercial banking function from the PBOC. In the second stage, from 1984 to 1993, the SOCBs were in the process of commercialisation. Besides, a series of new banks were established. The banking system started to be competitive and diverse. In the third stage, from 1994 to 2003, the SOCBs were released from policy-related tasks and historical burdens. Small, local banking institutions started to develop. More importantly, significant structural reforms were brought to central banking and banking regulation,

⁷ PBOC, 'The Historical Evolution of the PBOC' (中国人民银行历史沿革) (*PBOC website*) <http://www.pbc.gov.cn/rmyh/105226/105433/index.html> accessed 1 July 2017; Rixu Lan, 'The Analysis of the Evolution of China's State-owned Banking System in the Sixty Years Since the Foundation of the PRC' (建国六十年以来国有银行制度变迁分析) (2009) 4 *Studies on Socialism with Chinese Characteristics* 23, 24

⁸ Yuanyuan Peng, *The Chinese Banking Industry: Lessons from History for Today's Challenges* (Routledge 2007) 11; Alex Mo Cheung Au and Norman Law, *The Development History of the Chinese Banking Industry: from Late Qing to Now* (中國銀行業發展史: 由晚清至當下) (City University of Hong Kong Press 2011) 95

⁹ PBOC, 'The Historical Evolution of the PBOC' (n7); Gregory C. Chow, 'Developing a More Market-oriented Economy in China' (1987) 235 (4786) *Science* 295, 296; Jianhui Huang, *The History of Chinese Banking* (中国银行业史) (Shanxi Economic Press 1994) 299-301

which laid the foundation for the current regulatory system. The fourth stage which started from 2003, has observed the significant transformation of SOCBs from traditional enterprises to modern shareholding companies and their successful Initial Public Offerings (IPOs). Meanwhile, the banking sector kept booming and became more multiplied. The banking regulatory system was further improved to facilitate financial liberalisation and marketisation.¹⁰

Previous academic work does not specify a clear time point as the end of the fourth stage. This thesis tends to use the year of 2009 to divide between the fourth stage and the current period. By 2009, all of the SOCBs completed the shareholding reforms and IPOs, which can be regarded as a periodical success of the modernisation reform of the banking system. Since 2010 onwards, these banks have been rapidly developing in the international financial markets. China has become an important force to promote the reform of international banking regulation and adjust the international financial order. Moreover, more significant steps for financial liberalisation and privatisation have been taken.

This section will follow the above timeline to depict the evolution and development of the Chinese banking sector and the regulatory system.

6.2.1 The Reform of Chinese SOCBs

6.2.1.1 The Establishment and the Commercialisation

Under the planned economic system, there were only two state-owned banks: China Construction Bank (中国建设银行, CCB, named as ‘China People’s Construction Bank’ at that time) and Bank of China (中国银行, BOC). Neither of them undertook commercial banking businesses. The former was affiliated with the Ministry of Finance (财政部, MOF) as the cashier to conduct the central appropriation for infrastructure construction. The latter was a department in the PBOC in charge of the business of foreign exchanges.¹¹

In order to establish a professional central banking system and a modern commercial banking system,¹² four state-owned banks were formed to take over the credit and loan businesses from the PBOC. In 1979, Agricultural Bank of China (中国农业银行, ABC), which was withdrawn in 1965, was reorganised. CCB and BOC became independent from

¹⁰ Xueqin Hu and Yong Chen, ‘The Evolution and Development of Chinese Banking Industry in the Thirty Years Since the Reform and Opening’ (改革开放三十年来中国银行业的发展与变迁) (2008) 17 *China Finance* 64, 64; Dezhi Luo, ‘1949-2002: The Research of the Evolution of Chinese Banking Industry’ (1949-2002: 中国银行制度变迁研究) (PhD Thesis, Fudan University 2008) Chapter 3-4

¹¹ Yuanyuan Peng, *The Chinese Banking Industry: Lessons from History for Today’s Challenges* (n8)13; BOC, ‘A Brief History of BOC’ (中国银行历史沿革梗概) (*BOC website*) http://www.boc.cn/aboutboc/ab1/200808/t20080814_972.html accessed 2 July 2017; ‘The Developing History of CCB’ (中国建设银行发展史) (*China Finance Net*, 12 July 2016) <http://news.financeun.com/News/2016712/2013cfn/161517378400.shtml> accessed 2 July 2017

¹² Muqiao Xue, ‘Some Comments on the Duties of Bank’ (对银行工作的一点意见) in *The Selections of Xue Muqiao’s Economic Articles* (薛暮桥经济论文选) (People’s Publishing 1984) 334, 334-5

the MOF and the PBOC. In 1984, Industrial and Commercial Bank of China (中国工商银行, ICBC) was established.¹³ Since then, the PBOC started to focus on monetary policies and banking regulation, while the four professional banks were specialised in commercial banking in their designated divisions: agriculture, infrastructure, foreign trade and exchanges, and industries and commerce. At the same time, the Chinese government started the reform of replacing national finance appropriation with bank loans (拨改贷) in the field of infrastructure.¹⁴ This reform fundamentally shifted the role of banks to real financial intermediaries and improved the importance of bank lending in economic development.¹⁵

The establishment of the four professional banks was the starting point of China's modern banking industry, which had a profound influence on the structure of today's banking system. The four professional banks later became leading SOCBs and have been known as the 'Big Four' banks in China.

Dividing the four banks' specialities to serve different economic departments demonstrated that the character of the planned economy was preserved. There was little overlapping between these banks' businesses. Therefore, the competition between them was very weak.¹⁶ However, at the macroeconomic level, the Chinese Communist Party (中国共产党, CCP) had been aware of the importance of the market economy and made the historic decision to introduce market mechanism and promote market competition.¹⁷ In the banking sector, since 1985, the government started to organise more commercial banks.¹⁸ Most of them later became Joint-Stock Commercial Banks (股份制银行, JSCBs).

A special case was Bank of Communications (交通银行, BCM). It was founded in 1908 (the Qing Dynasty, 清代), while withdrawn by the PRC government in 1954. In 1987, the PRC government decided to reorganise BCM.¹⁹ In history, BCM was organised under a

¹³ The State Council of the PRC (中华人民共和国国务院), *The Notice of Re-establishing ABC* (关于恢复中国农业银行的通知) (No. 56, 1979); The State Council of the PRC, *The Decision on the PBOC's Professional Function of Central Banking* (国务院关于中国人民银行专门行使中央银行职能的决定) (No. 146, 1983); Yuwen Wang, 'The Reform of Chinese Banking' (论中国银行体制的改革) (2010) (4) 1 *Tsinghua Law Review* 73, 73; Jianhui Huang, *The History of Chinese Banking* (n9) 309

¹⁴ The State Council of the PRC, *The Provisional Regulations on Loans for Infrastructure Construction* (基本建设贷款试行条例) (August 1979)

¹⁵ Gang Yi, *The Records of Thinking on China's Financial Reform* (中国金融改革思想录) (The Commercial Press 2009) 282

¹⁶ Justin Y. Lin and Zhiyun Li, 'The Reforms of Chinese SOEs and the Financial System' (n1) 923

¹⁷ The Third Plenary Session of the 12th Central Committee of the CCP (中国共产党第十二届三中全会), *The Decision of the CCP Central Committee on the Reform of the Economic System* (中共中央关于经济体制改革的决定) (October 1984)

¹⁸ Justin Y. Lin and Zhiyun Li, 'The Reforms of Chinese SOEs and the Financial System' (n1) 923

¹⁹ The establishment of BCM was part of the Qing government's Gengzi New Deal (庚子新政) to develop capitalist liberal economy. It was one of the two pillar banks during the Northern Warlords government (北洋政府) period and the second largest commercial bank during the Kuomintang government (国民党政府) period. Before the PRC, BCM had made great contributions to the financial system of China and developed sound international influence and reputation. Therefore, the reorganisation of the bank was believed helpful

joint shareholding system between the government and the private sector. The PRC government kept this tradition. BCM became the first shareholding bank in contemporary China. Nevertheless, since the state is the largest shareholder of BCM, it is usually regarded as the fifth SOCB in China.²⁰ The reason to continue with the shareholding system was not only the tradition. Moreover, the government noticed that the business form of the four professional banks: socialist public enterprise, was a feature of the planned economy, which was no longer suitable for the reform to develop a market economy.

BCM's reorganisation and the establishment of several JSCBs launched the marketisation process of the Chinese banking industry. Absorbing deposits and making loans in same economic departments encouraged the competition between banks. Gradually, the divisions of specialities among the four professional banks faded away.²¹

In 1993, the government started a new round of substantial reform, which focused on the commercialisations of the four professional banks. The aim of the reform was to release the banks from the responsibilities of supporting national finance and undertaking policy lending.²² In 1994, three policy banks were established by the State Council of the PRC to take over the policy-based functions from the four banks.²³ At the same time, the four banks completed the transformations to wholly state-owned commercial banks and started to operate as real business organisations.

6.2.1.2 The Governmental Rescue in Chinese Version: The Removal of NPLs

Despite the efforts to develop a modern and market-based banking system in the late 1980s and early 1990s, there were still serious problems. The most serious one, which was almost turned into a banking crisis, was the high ratio of NPLs in Chinese SOCBs.²⁴

The problem of NPLs was unbelievably serious in the late 1990s and early 2000s. According to the previous PBOC governor Mr Dai Xianglong, the NPL ratio of the whole

for the development of the Chinese banking industry, especially at the international level. See Jianhui Huang, *The History of Chinese Banking* (n9) 130; BCM, 'The Online Museum of One Hundred-year BCM' (百年交行网上博物馆) (*BCM website*) <http://museum.bankcomm.com/museum/index.htm> accessed 3 July 2017

²⁰ There is no consensus among academics whether BCM is a SOCB or not. It was never completely owned by the state and the proportion of state ownership in BCM is less than the other four SOCBs. Nevertheless, in the official documents (such as in the PBOC's statistics), BCM is always mentioned together with the 'Big Four' as the five large and nationwide commercial banks. Some academics also use the phrase 'Big Five' to refer to them. This thesis adopts this opinion and regards BCM as the fifth SOCB.

²¹ Justin Y. Lin and Zhiyun Li, 'The Reforms of Chinese SOEs and the Financial System' (n1) 923

²² The State Council of the PRC, *The Decision to Reform the Financial System* (关于金融体系改革的决定) (No.91, 1993)

²³ The three policy banks are: China Development Bank (国家开发银行), The Export-import Bank of China (中国进出口银行) and Agricultural Development Bank of China (中国农业发展银行).

²⁴ YK Mo, 'A Review of Recent Banking Reforms in China' in The Bank for International Settlements (eds), 'Strengthening the Banking System in China, Issues and Experience' (1999) Bank for International Settlements Policy Paper Series No. 7 <https://www.bis.org/publ/plcy07.htm> accessed 19 December 2017, 90, 92

banking sector in 1998 was 25%.²⁵ This figure was calculated with the old four-category classification of loans adopted in China. This calibre would underestimate NPL ratio in comparison with the five-category classification, which is the international standard. Moreover, if excluding non-SOCBs, the ratio of SOCBs would be much higher. In 2002, Dai disclosed that the NPL ratio of the ‘Big Four’ banks was 29% according to the five-category classification.²⁶

However, in comparison with the data provided by Dai, the professional and academic estimations were much higher. For instance, Moody estimated that the NPL ratio of the Chinese banking industry before 1999 was about 40%.²⁷ The data in 2001 given by the Bank for International Settlements was 42%. In the histories of other economies, this level could already trigger a serious banking crisis.²⁸ Table 6.1 shows the NPL ratios of the ‘Big Four’ banks from 1994 to 2004, which were calculated by a Chinese economist in line with the five-category classification.²⁹ The figures in 1998 and 1999 were above 40%.

Table 6.1 The NPL Ratios in China’s ‘Big Four’ Banks from 1994 to 2004 (Unit: %)

Year	Ratio	Year	Ratio	Year	Ratio
1994	25.00	1998	40.00	2002	26.10
1995	27.00	1999	44.00	2003	19.74
1996	29.40	2000	34.18	2004	15.57
1997	32.00	2001	30.37		

Such a high NPL ratio was far more serious than almost all the other banks in the world. From 2001 to 2004, the average NPL ratio of the top 50 banks in the world was only 2.73%.³⁰ Before the GFC, the average NPL ratio of the US banking sector was usually around 1% and that in Europe was less than 3%.³¹ In Canada, the ratio was just 0.5%.³² Even compared to a banking industry which was unsound during that period, China’s NPLs problem was still far more serious. For instance, during the ‘Lost Ten Years’ (失われた 10 年) from the early 1990s to early 2000s in Japan’s economy, the Japanese banking sector

²⁵ Yulu Chen and Qinwang Guo, *Major Issues and Policies in China’s Financial Reform*, vol.4 (Enrich Professional Publishing 2016) 112

²⁶ John Wong, *Zhu Rongji and China’s Economic Take-off* (Imperial College Press 2016) 223

²⁷ Ibid

²⁸ Ming-huei Wu, ‘The Discussions on the NPLs in Chinese SOCBs’ (中國國有商業銀行不良貸款之探討) (2006) 6 *Economic Research* 263, 273

²⁹ Huaqiang Shi, ‘The NPLs on SOCBs’ Balance Sheets, Adjustment Factors and Seriousness: 1994 -2004’ (国有商业银行账面不良贷款、调整因素和严重程度：1994-2004) (2005) 12 *Journal of Financial Research* 25, 28

³⁰ Ibid, 32

³¹ Nicolas Veron, ‘European Banks: Bumpy Transition on a New Policy Regime’ in Olivier Blanchard and Adam S. Posen (eds), *Reality Check for the Global Economy* (Peterson Institute for International Economics 2006) <https://piie.com/system/files/documents/piieb16-3.pdf> accessed 5 July 2017, 23, 24

³² See the data provided by the World Bank in 2005: The World Bank, ‘Bank Nonperforming Loans to Total Gross Loans (%)’ (The World Bank website) <https://data.worldbank.org/indicator/FB.AST.NPER.ZS?locations=CA> accessed 5 July 2017

was suffering from a long-lasting crisis. In these circumstances, its NPL ratio peaked at 8% in 2001.³³

Even in comparison with other developing countries, the NPL ratio in China was still higher. The average ratio of the top 50 banks in Asia (excluding Japan) before 2003 was 6.27%, and that of the top 50 banks in Central European transitional countries was 8.32%.³⁴

What was wrong with the lending business in the Chinese banking sector, especially the ‘Big Four’ SOCBs? Why was the NPLs problem so dreadful that it was able to cause a banking crisis? However, there was no any banking crisis in the modern history of the Chinese banking sector. How did the industry finally survive?

The objective of China’s economic reform is to establish and develop the socialist market economy. The fundamental principle is ‘keeping public ownership as the dominant part of the economy and mutually developing other multiple forms of ownership’ (以公有制为主体，多种所有制经济共同发展). Therefore, the state-owned sector is the mainstay of the national economy. It has been endowed with governmental preference and supported by a variety of industrial, financial, tax policies and subsidies.³⁵ Bank loans, especially those offered by SOCBs were predominantly obtained by State-owned Enterprises (SOEs). According to the statistics provided by Chinese economists, from 1985 to 1996, averagely the loans provided to SOEs made more than 80% of total bank loans.³⁶

The property rights of SOEs, including SOCBs, are possessed and controlled by the government on behalf of the people. From the public interest view, the government should allocate and use the resources of SOEs to realise economic efficiency and social welfare enhancing. Besides, the government also has private interests in SOEs: only with robust control over important economic resources, can the government’s objective of political stability be maintained.³⁷ Therefore, developing SOEs and keeping their dominant role is of utmost importance for China’s social-economic development and political stability.³⁸

³³ Benjamin Nelson, ‘Dealing with a Banking Crisis: What Lessons Can Be Learned from Japan’s Experience?’ (2014) 54 (1) Bank of England Quarterly Bulletin 36, 43

³⁴ Huaqiang Shi, ‘The NPLs on SOCBs’ Balance Sheets, Adjustment Factors and Seriousness: 1994 -2004’ (n29) 33

³⁵ Hong Sheng and Nong Zhao, *China’s State-owned Enterprises: Nature, Performance and Reform* (World Scientific 2013) 52-73

³⁶ Jie Zhang, ‘The Structure and Evolution of Chinese State-owned Financial System’ (中国国有金融制度的结构与变迁) (Shanxi Economic Press 1998) 157

³⁷ Berry Fong-Chung Hsu *et al*, ‘Banking Liberalisation and Restructuring in Post-WTO China’ (2005) 21 (1) Banking and Finance Law Review 23, 29

³⁸ Rafel La Porta *et al*, ‘Government Ownership of Banks’ (2002) 57 (1) The Journal of Finance 265, 266; Wendy Dobson and Anil K. Kashyap, ‘The Contradiction in China’s Gradualist Banking Reforms’ (2006) 2 Brookings Papers on Economic Activity 103, 115

SOEs need a large number of funding to realise their responsibilities in profit-making, technical innovation, employment absorption and social welfare supply.³⁹ In the 1980s and 1990s, SOEs were still dominant in almost all economic departments.⁴⁰ As the owner, it was the duty of the government to provide capital to SOEs. However, when national finance was not enough to satisfy the needs of SOEs, the government had to require SOCBs to provide loans.

China's financial system is characterised as bank-centric. This character was particularly strong in the early stage when the capital market and private finance were underdeveloped.⁴¹ In the 1990s, bank lending, making 80% of enterprise finance, was almost the only way for the government to bolster the operations of SOEs.⁴²

Legally, the nature of a bank loan is debt, and the relation between SOCBs and SOEs is borrower and lender. However, in the eyes of SOEs, bank loans were just another way of the government's capital support. The funding from SOCBs was regarded as governmental guarantees, which they should be entitled to using freely. As a consequence, SOEs disregarded their abilities and responsibilities to pay for the loans, while trying to utilise bank loans to the maximum.⁴³ Usually, SOEs needed to compete with each other for bank loans. Instead of showing banks sound operation and profitability, SOEs would try to lobby the government (in many cases it was through local governments) to impose pressure on SOCBs (including local branches), or directly establish a stable *guanxi* with the banks.⁴⁴ In this sense, the function of bank loans was distorted. They became the approach of rent-seeking for SOEs to secure the privilege of using the country's credit capital.⁴⁵

Although SOCBs had been commercialised and given more discretion on lending, they still faced with the heavy burdens of policy loans.⁴⁶ Before the establishment of the three policy banks, policy loans roughly constituted one-third of total bank loans.⁴⁷ As defined by Nicolas Lardy, policy loans are the loans extended at the behest of the governmental

³⁹ Ming-huei Wu, 'The Discussions on the NPLs in Chinese SOCBs' (n28) 272

⁴⁰ Justin Lin *et al.*, 'Competition, Policy Burdens and State-owned Enterprise Reform' (1998) 88 (2) *American Economic Review* 422, 422

⁴¹ Jianbo Lou, 'China's Bank Non-performing Loan Problem: Seriousness and Causes' (2000) 34 (4) *The International Lawyer* 1147, 1159

⁴² *Ibid.*, 1160

⁴³ Songguo Li and Yuefei Zhang, 'The Trade-off Between Cost and Profit and the Behavioural Choice Under Interest Gaming: The Analysis on the Formation of the NPLs in SOCBs and the Solutions' (本利权衡和利益博弈下的行为选择——国有商业银行不良贷款形成机理剖析及其化解途径) (2003) 1 *The Financial Forum* 10, 11; Violaine Cousin, *Banking in China* (n4) 12

⁴⁴ Jianbo Lou, 'China's Bank Non-performing Loan Problem: Seriousness and Causes' (n41) 1164

⁴⁵ Jie Zhang, 'The Bad Debts and Debt-paying Gaming in SOCBs' (国有银行的不良债权与清债博弈) (1997) 6 *Journal of Financial Research* 55, 58-60

⁴⁶ Robert Cull and Lixin Colin Xu, 'Bureaucrats, State Banks, and the Efficiency of Credit Allocation: The Experience of Chinese State-owned Enterprises' (2000) 28 (1) *Journal of Comparative Economics* 1, 6

⁴⁷ Nicholas R. Lardy, *China's Unfinished Economic Revolution* (Brookings Institution 1998) 85

authorities at the central and local levels rather than as a result of normal decision-making in commercial banks.⁴⁸ Undoubtedly, policy loans were all obtained by SOEs.

However, it has been widely proven that Chinese SOEs were outperformed by private businesses in terms of efficiency and profitability.⁴⁹ In 1999, more than 40% of SOEs were losing money.⁵⁰ The reasons for the inefficiency of SOEs were multiple, including the administration-oriented management, the burdens to provide social welfare products, corruptions, and so on.⁵¹ Finally, the inefficiency led to many SOEs' incompetence to repay the loans. The large-scale defaults resulted in tremendous NPLs in SOCBs.

Besides, policy loans could also be particularly used to help loss-suffering SOEs.⁵² Usually, these loss-suffering SOEs had already defaulted on their previous bank loans. However, the only method to maintain their operations was to roll over the loans.⁵³ Namely, SOEs had to obtain new loans from SOCBs to cover their overdue debts. As a consequence, the hole of NPLs became bigger and bigger.

In a long period, China lacked an explicit deposit insurance system.⁵⁴ However, SOCBs were fully protected by the implicit governmental guarantee.⁵⁵ At the core of the financial system, SOCBs are 'too centric to fail'. In whatever situation, the government will not let them go bankrupt. The implicit governmental guarantee fostered the moral hazard in SOCBs' lending activities to SOEs. They would not make any careful or prudential analysis of SOEs' debt-paying abilities before lending money to them.⁵⁶ Therefore, the problem of NPLs was exacerbated.

In short, the root reason for the tremendous NPLs in Chinese SOCBs was the distortion of the institutions and the policies of the state-owned economy. Specifically, commercial bank loans were distortedly used as direct governmental subsidies and SOCBs functioned as the government's cashier to SOEs.

⁴⁸ Ibid, 83

⁴⁹ Hong Sheng and Nong Zhao, *China's State-owned Enterprises: Nature, Performance and Reform* (n35) 175

⁵⁰ Charles Booth, 'The 2006 PRC Enterprise Bankruptcy Law: The Wait Is Finally Over' (2008) 20 Singapore Academy of Law Journal 275, 278

⁵¹ Justin Lin *et al*, 'Competition, Policy Burdens and State-owned Enterprise Reform' (n40) 422

⁵² Jianbo Lou, 'China's Bank Non-Performing Loan Problem: Seriousness and Causes' (n41) 1167

⁵³ Ibid, 1170; Songguo Li and Yuefei Zhang, 'The Trade-off Between Cost and Profit and the Behavioural Choice Under Interest Gaming: The Analysis on the Formation of the NPLs in SOCBs and the Solutions' (n43) 12

⁵⁴ China's deposit insurance scheme has been established in May 2015.

⁵⁵ Michael Faure and Jiye Hu, 'Towards a Deposit Guarantee Insurance in China? A Law and Economics Perspective' (2013) 1 (2) The Chinese Journal of Comparative Law 1, 8

⁵⁶ Nicholas R. Lardy, *China's Unfinished Economic Revolution* (n47) 83

In the late 1990s, the accumulated NPLs were so huge that the ‘Big Four’ SOCBs were trapped in the situation of ‘technical bankruptcy’.⁵⁷ The problem became a major obstacle to further banking reform. In order to solve the problem, the Chinese government adopted a very simple and direct method: removing NPLs from banks’ balance sheets through capital injections.

In 1999, the government established four asset management corporations (资产管理公司, AMC) to carry out the removal of NPLs. Each AMC was arranged for one SOCB. They were: Huarong (华融) for ICBC, Cinda (信达) for BOC, Great Wall (长城) for ABC and China Oriented (东方) for CCB. The four AMCs received funds from the MOF and the PBOC to inject capital in the ‘Big Four’ SOCBs. The AMCs also issued bonds to the banks, with collaterals provided by the MOF. By 2000, the funds and bonds used to write off the NPLs in the ‘Big Four’ amounted to Renminbi (RMB) 1.4 trillion.⁵⁸ By 2005, the AMCs further received another tranche of NPLs which amounted to RMB 1.3 trillion from the SOCBs. In total, RMB 2.7 trillion NPLs were removed from the banks’ balance sheets.⁵⁹

The removal of NPLs was an expedient to prevent a potential banking crisis and get prepared for the opening to the international financial markets. The positive effect was that at a very critical moment, it rescued the Chinese banking system from collapsing, maintained China’s economic and social stability, and paved the way for the internationalisation of the Chinese financial industry.

However, the direct capital injection was an embodiment of the implicit and unlimited governmental guarantee for the state-owned banking sector. It was an intrusive approach on the basis of strong state power, not a market-based approach. The consequence was that the NPLs were finally assumed by national finance, i.e. taxpayers. It negatively implied that China’s reform of banking marketisation and modernisation was far from completion. Political intervention and administrative orientation in Chinese SOCBs largely remained. Therefore, the removal of NPLs was commented as ‘only being meaningful at the accounting level, not the institutional level’.⁶⁰ Therefore, in order to substantially push forward the modernisation and marketisation of the banking system, further reforms at the institutional level are indispensable.

⁵⁷ Nicholas R. Lardy, ‘The Challenge of Bank Restructuring in China’ in The Bank for International Settlements (eds), ‘Strengthening the Banking System in China, Issues and Experience’ (n24) 17, 31

⁵⁸ OECD, *Credit Risk and Credit Access in Asia* (OECD Publishing 2006) 132

⁵⁹ Jiangfeng Li, ‘Non-performing Loans and Asset Management Companies in China: Legal and Regulatory Challenges for Achieving Effective Debt Resolution and Recovery’ (2013) 1 PKU Transnational Law Review 85, 122

⁶⁰ Xiufang Wang, ‘The Institutional Distortion Under the Distorted Institutions: A Case Study of the Removal of NPLs in SOCBs’ (扭曲制度下的制度扭曲: 国有商业银行不良资产剥离案例研究) (2001) 3 Journal of Financial Research 98, 99

6.2.1.3 The Shareholding Reforms and the IPOs

The seriousness of NPLs reflected the low efficiency of previous reform of banking marketisation and modernisation. The main obstacle was the distortion of state ownership. By the end of 2003, the ‘Big Four’ SOCBs were still wholly state-owned enterprises and constrained by the old, ossified administrative institutions. These institutions preserved too much political intervention, making the operations of the SOCBs akin to those of governmental organs. In contrast, the fifth SOCB, BCM, and a number of JSCBs have already been organised as shareholding companies and been operating under a modern corporate governance model. As a consequence, the banking sector was much more competitive than before. The performance of BCM and JSCBs outstood the ‘Big Four’. In this context, the negativity of the institutional obstacle became more serious.

In 2003, the Chinese authorities launched a systemic and bold reform in the ‘Big Four’ SOCBs, focusing on the transformations to shareholding companies and the IPOs. The purposes of the reform were to remove the obstructive and ossified institutions, remould the SOCBs as real modern corporations, introduce an advanced and efficient corporate governance model, and further develop a modern banking system.⁶¹

The reform followed four steps: restructuring property rights, adopting the shareholding system, introducing overseas strategic investors, and going public.

Before the reform, the full state ownership in SOCBs was exercised by the State Council and its agents: the MOF and the PBOC. The government had dual roles: the planner and manager of social-economic affairs and the owner of SOEs. In practice, the two roles were difficult to be separated and the government often unduly intervened in business activities.⁶² To deal with this issue, the government established the Central Huijin Investment Ltd. (中央汇金投资有限责任公司, CHI Ltd.) in December 2003, as the *ad hoc* agent of the government to exercise the ownership rights and obligations in SOCBs.⁶³ The establishment of the CHI Ltd. did not change the ownership structure of SOCBs. They were still wholly controlled by the government. Nevertheless, it split the two different functions of the government in managing social-economic affairs and exercising the ownership in SOCBs, which was conducive to mitigating political intervention.

⁶¹ ‘The National Conference on Financial Work’ (全国金融工作会议) (*News of the CCP*, 7 February 2002) <http://dangshi.people.com.cn/GB/151935/176588/176941/177529/10681340.html> accessed 7 July 2017

⁶² Masahiko Aoki and Yingyi Qian (eds), *Corporate Governance in Transitional Economies: Inside Control and the Role of Banks* (转轨经济中的公司治理结构——内部人控制和银行的作用) (China Economic Publishing 1995), Preference

⁶³ Huanping Shi and Chunhong Xiong, ‘The Function, Nature and Future Development of CHI Ltd.’ (论中央汇金投资公司的职能、性质和未来发展) (2006) 23 (6) *Journal of East Jiaotong University* 1, 1

Immediately after the establishment, the CHI Ltd. invested United States Dollars (USD) 45 billion in BOC and CCB as the equity capital.⁶⁴ The two banks were selected as the pilots of the transformations to shareholding companies. Following the schedule made by the China Banking Regulatory Commission (银监会, CBRC),⁶⁵ the two banks established a standard model of modern corporate governance, comprised of shareholders' meeting, the board of directors, supervisory board and senior management, as well as many corporate governance devices, such as risk management and personnel management.⁶⁶ By September 2004, the two banks formally transformed into shareholding companies. Following the same steps, ICBC and ABC also completed their shareholding reforms in 2005 and 2008 respectively.⁶⁷ Formally, all of the SOCBs, including BCM which adopted the shareholding corporation model since its reestablishment, have become modern and large corporations.

After the shareholding reforms, the five SOCBs started to introduce overseas strategic investors as minority shareholders, in order to diversify their ownership structures, improve profit efficiency and competitiveness, and promote the institutional reforms of corporate governance.⁶⁸

However, foreign financial institutions showed more suspicion than confidence in Chinese SOCBs. They were afraid of the risks in business operation, law and regulation, and the internal control system of SOCBs.⁶⁹ In fact, the suspicion came down to the concern that the Chinese banking sector was not operating on the market mechanism. Therefore, the SOCBs experienced very tough negotiation processes with foreign strategic investors, especially when some investors suddenly decided to withdraw. By 2005, apart from ABC, the other four banks finally obtained the investments of top international financial institutions, such as Goldman Sachs and Temasek Holdings.

All of the above efforts paved the way for the IPOs of these SOCBs. From 2005 to 2010, the five banks completed their IPOs of both A Share (at Shanghai Stock Exchange, 上交所, SHSE) and H Share (at Hong Kong Stock Exchange, 香港交易所, HKSE). For every individual bank and the entire Chinese banking sector, the IPOs were great successes. In particular, the IPO of ICBC raised USD 19 billion equity, making it the world's largest

⁶⁴ PBOC Annual Report 2003
<http://www.pbc.gov.cn/chubanwu/114566/115296/115340/2884716/index.html> accessed 7 July 2017

⁶⁵ The CBRC was established in 2003 and replaced the PBOC as the primary banking regulator in China. The details will be explained in Subsection 6.2.3.

⁶⁶ CBRC, *The Guidelines for the Corporate Governance Reform and Regulation of BOC and CCB* (关于中国银行、中国建设银行公司治理改革与监管指引) (No.12, March 2004), Article 4 and 7

⁶⁷ Su Bei, 'ICBC Reveals Reform Plan' *China Daily* (Beijing, 23 April 2005)
http://www.chinadaily.com.cn/english/doc/2005-04/23/content_436817.htm accessed 7 July 2017

⁶⁸ Liming Li, *The Last Stand: The Shareholding Reform of China's SOCBs* (背水一战: 中国国有银行股份制改革) (CITIC Press 2008) 108

⁶⁹ *Ibid*, 110-29

IPO.⁷⁰ Table 6.2 shows the details of the five SOCBs' transformations to shareholding companies and their IPOs.

Table 6.2 The Chinese SOCBs' Transformations to Shareholding Companies and IPOs⁷¹

Bank	Capital injection from CHI Ltd.	Time of transforming to shareholding company	Time of IPO	Place of IPO	Capital raised from public shares
BOC	RMB 22.5 billion	August 2004	June 2006	HKSE	Hong Kong Dollar (HKD) 86.7 billion
			July 2007	SHSE	RMB 20 billion
CCB	RMB 22.5 billion	September 2004	October 2005	HKSE	HKD 71.58 billion
			September 2007	SHSE	RMB 57.12 billion
ICBC	RMB 124 billion	October 2005	October 2006	HKSE	HKD 124.95 billion
				SHSE	RMB 46.44 billion
ABC	RMB 130 billion	January 2009	July 2010	HKSE	HKD 12.2 billion
				SHSE	RMB 68.53 billion
CBM	RMB 3 billion	February 1987	June 2005	HKSE	HKD 17.29 billion
			May 2007	SHSE	RMB 3.19 billion

As stated, the previous reform to commercialise SOCBs had very limited contributions to the modernisation and marketisation of Chinese banking. The removal of NPLs was a method which 'only cured the symptoms, not the disease' (治标不治本).⁷² More seriously, the institutional distortion of the state ownership left dreadful problems to the banking sector. Chinese authorities were very clear about the significance of a sound and efficient banking system to the ongoing economic development.⁷³ Therefore, a crucial and thorough reform was indispensable for dealing with the institutional drawbacks and establishing a real modern and market-based banking system. The reform was the last stand (背水一战)⁷⁴ and no failure could be borne by the Chinese financial system.

The completion of the IPOs of all SOCBs signified the periodical success of the reform, which has a historic significance in the development of the Chinese banking system. China used three decades to preliminarily realise the modernisation and marketisation of its banking sector. The efforts in the three decades, in particular, the reforming steps to

⁷⁰ Brain Bremner, 'China's ICBC: The World's Largest IPO Ever' *Bloomberg* (Tokyo, 27 September 2006) <https://www.bloomberg.com/news/articles/2006-09-26/chinas-icbc-the-worlds-largest-ipo-ever> accessed 7 July 2007

⁷¹ The information is collected from: The World-wide Fund for Nature, 'The Strategy Towards Sustainable Development of Banking: The Research on the Reform Progress and Developing Trend of Chinese Banking' (迈向可持续发展的银行业战略:中国银行业改革进程和发展趋势研究) (No.CN088781, July 2008) http://www.wwfchina.org/content/press/publication/08bankreport_cn.pdf accessed 7 January 2018, 58; 'ABC Raising \$22.1 Billion Through A+H Shares, Becoming the Global King of Financing' (农行 A+H 共筹 221 亿美元, 晋升全球集资王) *Sina Finance* (Beijing, 16 August 2010) <http://finance.sina.com.cn/stock/hkstock/ggIPO/20100816/07018486302.shtml> accessed 7 July 2017

⁷² Hongquan Dou, *The Analysis of Bank Corporate Governance* (银行公司治理分析) (CITIC Press 2005) 6

⁷³ 'A Great Big Banking Gamble' *The Economist* (Beijing, Hong Kong and Shanghai, 27 October 2005) <http://www.economist.com/node/5081090> accessed 7 July 2017

⁷⁴ This was said by the previous Prime Minister Wen Jiabao. See 'Wen Jiabao: SOCBs Must Follow the Market Disciple' (温家宝: 要使国有银行走市场化道路) *people.com.cn* (Beijing, 14 March 2004) <http://www.people.com.cn/GB/shizheng/1024/2389818.html> accessed 7 July 2017

transform the SOCBs into modern listed corporations, have laid the foundation for the fast development and internationalisation of the Chinese banking industry in the aftermath of the GFC.

6.2.2 The Diversification of the Chinese Banking System

Along with the reforms in SOCBs, the non-state-owned banking sector has also kept growing rapidly.

JSCBs play a leading role in the non-state-owned banking sector. In general, the so-called ‘JSCBs’ refers to banks which are organised in the form of shareholding corporation and with multiple shareholders. Literally, nowadays, the majority of Chinese banks are joint-stock companies, including the five SOCBs. However, in the Chinese banking sector, ‘JSCBs’ is a term which specifically refers to those nationwide, large banks in which the government (including local governments) is not the majority shareholder or holds no equity. The ownership structure is the key to distinguish JSCBs from SOCBs. Different from the predominant state ownership in SOCBs, JSCBs are usually founded or sponsored by multi-source capital.

Following the commercialisations of SOCBs, many JSCBs were established in the late 1980s and 1990s, with the attempts to diversify the banking sector and introduce the competition mechanism. The competition between banks has vivified the financial market and impelled the reform and development of SOCBs.⁷⁵ Some JSCBs also acted as the pilots to adopt the modern corporation model, which provided the government with more experience to get prepared for the shareholding reforms of SOCBs.

Table 6.3 The Establishments and the IPOs of Chinese JSCBs⁷⁶

Bank	Time of establishment	Initiator(s)	Time of IPO	Place(s) of IPO
China Merchants Bank (招商银行)	April 1987	China Merchants Group (招商局集团)	April 2002	SHSE
			September 2006	HKSE
CITIC Bank (中信银行)	April 1987	CITIC Group (中信集团)	April 2007	SHSE & HKSE
China Minsheng Bank (中国民生银行)	January 1996	59 enterprises	December 2000	SHSE
			November 2009	HKSE
Industrial Bank (兴业银行)	August 1988	The government of Fujian (福建) Province	February 2007	SHSE
Shanghai Pudong Development Bank (上海浦东发展银行, SPDB)	October 1992	The government of Shanghai and 17 SOEs in Shanghai	November 1999	SHSE
China Everbright Bank (光大银行)	August 1992	China Everbright Group (光大集团)	August 2010	SHSE
			December 2013	HKSE

⁷⁵ Junbo Xue and Yuan Teng, ‘The Distortion of JSCBs and the Correction’ (试论股份制银行的异化及其矫正) (2002) 28 (10) *Journal of Finance and Economics* 29, 29

⁷⁶ The information is collected from the JSCBs’ websites.

Ping An Bank (平安银行)	February 1987	NA ⁷⁷	April 1991	Shenzhen Stock Exchange (深交所)
Hua Xia Bank (华夏银行)	October 1992	Shougang Group (首钢集团)	September 2003	SHSE
Zheshang Bank (浙商银行)	June 1993	SOEs in Zhejiang (浙江) Province	March 2016	HKSE
China Guangfa Bank (广发银行)	September 1999	The government of Guangdong (广东) Province and local SOEs	NA	NA
Hengfeng Bank (恒丰银行)	October 1987	State-owned financial institutions	NA	NA
China Bohai Bank (渤海银行)	September 2005	SOEs, overseas strategic investors and private companies	NA	NA

Table 6.3 shows the details of the establishments and IPOs of the twelve JSCBs. Currently, nine of them are listed companies.

The original backgrounds of the JSCBs are complex. In fact, the majority of them have had strong connections with the government or the state-owned sector. These banks were either established as a subsidiary of a large SOE group, sponsored by local governments or jointly sponsored by local governments and local SOEs. However, after the introduction of strategic investors and the completion of IPOs, nowadays, the majority of them do not have a majority shareholder.

In particular, there are two JSCBs with less than 5% state capital. Minsheng Bank is the only one which is completely supported by private capital.⁷⁸ The other one is Ping An Bank. It experienced several rounds of mergers and acquisitions. Nevertheless, its majority shareholder: Ping An Group, a private financial group, has always played the leading role.

Compared to SOCBs, JSCBs are less committed to policy loans and other administrative burdens.⁷⁹ They are more discretionary in making business decisions for their own interests and development objectives. In practice, JSCBs have been more efficient in business operations and investment activities and more progressive during the reforms of modernisation and marketisation.

Apart from SOCBs and JSCBs, there have been more and more small and medium-sized (SMS) banks in the Chinese financial market. Generally, SMS banks include: Urban Commercial Banks (城市商业银行, UCBs), Rural Commercial / Cooperative Banks (农村

⁷⁷ The predecessors of Ping An Bank include Shenzhen Development Bank (深圳发展银行) and Shenzhen Commercial Bank (深圳商业银行). The former was established in 1987 and went public in 1991. The latter was taken over by Ping An Group in 2006 and renamed as Ping An Bank. In 2012, Shenzhen Development Bank and Ping An Bank merged to the new Ping An Bank. 'About Ping An Bank' (*Ping An Bank website*) <http://bank.pingan.com/aboutpingan/index.shtml> accessed 9 July 2017

⁷⁸ Shen Wei, *The Anatomy of China's Banking Sector and Regulation* (Wolters Kluwer 2014) 107

⁷⁹ *Ibid*, 108

商业/合作银行, RCBs) and private banks (民营银行). According to the CBRC, by the end of 2015, there have been 1,068 SMS banks.⁸⁰

Usually, UCBs and RCBs converted from previous urban or rural credit cooperatives. Credit cooperatives are local credit institutions with the purpose to support local businesses, agricultural development and household expenses.⁸¹ Since the mid-1990s, UCBs and RCBs began to develop into modern financial institutions following the mergers or reorganisations of credit cooperatives and the introduction of overseas investors.⁸²

In terms of size, history, ownership structure, profitability and services, SMS banks are very different from each other. Some listed UCBs, such as Beijing Bank (北京银行), is even bigger than some JSCBs. Well-developed UCBs have expanded their businesses to many other provinces and even at the international level. The booming of UCBs and RCBs has made great contributions to the prosperity of small, private businesses and local economy.

Private banks are still brand-new in the Chinese banking sector. In March 2014, the CBRC launched a trial programme to license five pioneer banks which are purely sponsored by domestic private companies.⁸³ Each private bank specialises in providing financial services to a designated industry. The trial programme signifies that the policy obstacle to domestic private capital entering into the banking industry has eventually been removed. These private banks are expected to further promote the marketisation and competitiveness of the banking sector and to support the development of SMS businesses.

Now the banking sector in China is far more diverse and active than before. A multi-layered and modern banking system has been established. At the same time, banking regulation in China has also developed from 'nil' to a professional system, which is comprised of laws, regulations and policies, and compatible with international standards.

6.2.3 The Evolution of Banking Regulation in China

In the era of a planned economy, the PBOC was the only commercial bank in charge of all deposits and loans in line with the central government's plans and budgets.⁸⁴ Moreover, there were no other types of financial businesses, such as investment banking or insurance. Therefore, without a real market, banking regulation, as a function of modern government, was not necessary at all.

⁸⁰ CBRC Annual Report 2015, 23

⁸¹ The organisational model of credit cooperatives is similar with that of UK building societies. They are mutual financial organisations owned by and providing funding to all the members.

⁸² Michael N.T.Tan, *Corporate Governance and Banking in China* (Routledge 2013) 89

⁸³ Jamil Anderlini, 'China Opens Door to Private Banks' *Financial Times* (Beijing, 11 March 2014) <https://www.ft.com/content/7096239e-a8e0-11e3-bf0c-00144feab7de?mhq5j=e2> accessed 10 July 2017

⁸⁴ Miao Han, *Central Bank Regulation and the Financial Crisis: A Comparative Analysis* (Palgrave Macmillan 2015) 158

After the two-layer banking system, which was comprised of the PBOC as the central bank and the four professional banks, was formed, the PBOC started to take the responsibility of banking regulation. Nevertheless, the businesses of the four professional banks were predominantly scheduled through the government's policies. As a consequence, the PBOC only played a role as the conveyancer and implementer of central policies. The banking regulation system was not really established.

Following the commercialisations of the 'Big Four' banks, the reestablishment of BCM and the foundations of a handful of JSCBs and local banks, the financial market emerged and started to develop. A rising market demanded robust legal infrastructure and a benign regulatory environment to maintain its order and protect market participants.⁸⁵ However, at the nascent stage, the laws and regulations pertaining to banking were completely blank. In 1995, China enacted the first Commercial Banking Law of the PRC (中华人民共和国商业银行法) and the first PBOC Law of the PRC (中华人民共和国人民银行法). The PBOC Law authorised the PBOC with two functions: monetary policy-making and financial regulation.⁸⁶ The Commercial Banking Law listed the specific commercial banking activities that should be regulated by the PBOC, such as licence authorisation, capital regulation, as well as the regulation of business conduct and corporate governance.⁸⁷ The two pieces of law signified the establishment of a preliminary legal framework and the beginning of modern banking regulation in China.

Nevertheless, banking regulation during this period when the PBOC was the sole regulator was still highly dominated by politics.⁸⁸ It was partly because that in the nascent period, traditions and institutions of the planned economy were largely preserved. Besides, a hidden reason was that the PBOC's function of banking regulation was distorted by the political tension between the central government and local governments on financial control. Through the collusion with the PBOC local branches, provincial governments could control local financial resources to resist the central policies of financial reform.⁸⁹ As a result, the operation of the PBOC's regulatory system was eroded.

The year of 2003 observed the substantial change in China's banking regulatory framework. By enacting the Law of the PRC on Banking Regulation and Supervision (中华人民共和国

⁸⁵ Richard A. Posner, 'Creating a Legal Framework for Economic Development' (1998) 13 (1) World Bank Research Observer 1, 3; Ralph Chami *et al.*, 'A Framework for Financial Market Development' (2009) IMF Working Paper 09/156 <https://www.imf.org/en/Publications/WP/Issues/2016/12/31/A-Framework-for-Financial-Market-Development-23128> accessed 7 January 2018, 38

⁸⁶ The PBOC Law of the PRC 1995, Article 2

⁸⁷ The Commercial Banking Law of the PRC 1995, Article 11, 24, 28, 38 and 59

⁸⁸ Miao Han, *Central Bank Regulation and the Financial Crisis: A Comparative Analysis* (n84) 1

⁸⁹ The relationship between China's central government and local governments is out of the theme of this thesis. For detailed discussions, please refer to: Victor Shih, 'Dealing with Non-performing Loans: Political Constraints and Financial Policies in China' (2004) 180 *The China Quarterly* 922, 925-7; Berry Fong-Chung Hsu *et al.*, 'Banking Liberalisation and Restructuring in Post-WTO China' (n37) 44-6

国银行业监督管理法), China established a professional banking regulatory body: the CBRC. The commonly acknowledged reasons to replace the PBOC's function of banking regulation with the CBRC include: reducing the PBOC's workload, dealing with the conflicts between monetary policies and financial regulation, modernising and professionalising the regulatory framework, adapting to the international financial environment, and so on.⁹⁰ More importantly, the structural reform also aimed at decoupling the conduct of banking regulation from political intervention. Establishing a new body would be easier to cut off the old informal connections between the PBOC and other governmental bodies and political powers.

The CBRC-led banking regulatory framework has been practising in China for fifteen years,⁹¹ and the operation of the framework has been successful. First of all, the CBRC is more independent from political interference. It directly subordinates to the State Council, so the interference from local governments and other parallel governmental departments of the central government can be isolated.⁹² Therefore, the effectiveness of the CBRC to carry out banking reform has been improved. Besides, the CBRC has been very progressive in the professionalisation and modernisation of banking regulation. Its regulatory approach closely follows the advanced experience of developed financial markets, such as the UK, the US, and so on.⁹³ It also keeps pace with the international standards. Within the CBRC, there is a 'self-assessment' group. Its work is to assess the effectiveness of the CBRC's regulatory activities in accordance with the Core Principles for Effective Banking Supervision issued by the BCBS.⁹⁴ By 2006, the CBRC promulgated more than 200 pieces of regulatory documents, covering capital adequacy, market entry, risk management, corporate governance, and so on.⁹⁵ Although the Chinese banking sector weathered the GFC, the CBRC has actively advocated and implemented the post-crisis international standards on banking regulation, with a special emphasis on prudential regulation and risk control.

In retrospect, the reform of the Chinese banking system and banking regulation is a transitional process from uniformity to diversity, from central planning to market competition, from isolation to internationalisation, and from politicisation to legalisation. Great achievements have been made. However, the transitional process has not been

⁹⁰ Weiping He, *Banking Regulation in China: The Role of Public and Private Sectors* (Palgrave Macmillan 2014) 52; Stefan Brehm and Christian Macht, 'Is a New Broom Sweeping Clean? The Emergence of the China Banking Regulatory Commission' (2005) 60 (2) *The Swiss Review of International Economic Relations* 169, 170

⁹¹ The CBRC is at the core of the Chinese banking regulatory system. Besides, the PBOC and the MOF also play a minor role.

⁹² The Law of the PRC on Banking Regulation and Supervision 2003, Article 5

⁹³ CBRC Annual Report 2006, 52

⁹⁴ *Ibid*, 80

⁹⁵ *Ibid*, 53

completed yet. In particular, the modernisation and marketisation reform of bank corporate governance, with the issue of bankers' remuneration at the core, is lagging far behind.

6.3 The Necessity to Reform Bankers' Remuneration

6.3.1 The Current Situation of China's Banking Reform

As stated, China spent about thirty years in preliminarily realising the modernisation and marketisation of its banking industry. With the five leading SOCBs, twelve competitive JSCBs and a great number of SMS banks, China's banking industry has already developed into a market of monopolistic competition.⁹⁶ This status seems very close to the financial markets in some developed economies, such as the UK. In terms of assets, China's 'Big Four' have exceeded the UK's 'Big Four'. It seems that the major banks in China have achieved substantial commercial success. However, the Chinese authorities and banking regulators still reckon that the banking sector needs to be further reformed and developed. Specifically, recent years have observed the sluggishness of the Chinese banking sector. During 2013 to 2016, despite the continuous increase of net profit, the increase rate has sharply slowed down, dropping from 14.5% to 2.4%. On the contrary, the NPL scale and ratio continue to grow further.⁹⁷ These new challenges in banking development are partially caused by the downward of the national economy and the structural reform on traditional heavy industries. The issue of overcapacity in heavy industries, such as steel and mining, is due to the government's economic stimulus strategy adopted during the Financial Crisis, which was focused on the expansion of real estate and infrastructure industries. Following the macroeconomic policy, Chinese banks also inclined to support these projects, resulting in a new round of accumulation of NPLs.⁹⁸ Clearly, the decision-making of banks has been deeply affected by the government's policies, while the influence on banks' business efficiency and sustainability has still been insufficiently considered. Thus, the new problems in banking development also demonstrates that banks' decision-making mechanisms are still inefficient.

In comparison to the liberal financial markets in the West, China's financial development is always intervened by the government. Academics also sharply point out that political intervention, which is a typical character of underdeveloped financial systems, still

⁹⁶ Lin Ji and Lihong Guo, 'Analysis of the Relationship Between Chinese Banking Competition and Risk-taking: An Empirical Study Based PR Model' (2015) International Conference on Circuits and Systems 327, 327

⁹⁷ KPMG, 'Mainland China Banking Survey 2017' (2017) <https://assets.kpmg.com/content/dam/kpmg/cn/pdf/en/2017/08/2017-mainland-china-banking-survey.pdf> accessed 30 April 2018, 5-7

⁹⁸ Yongding Yu, 'China's Policy Responses to the Global Financial Crisis' (2009) Australian Government Productivity Commission Richard Snape Lecture <https://www.pc.gov.au/news-media/lectures/yongding/2009-yongding.pdf> accessed 30 April 2018, 10-1

dominates the internal governance and business operation of Chinese banks.⁹⁹ Despite the fast growth and expansion of the Chinese banking industry and the government's efforts to provide professional banking regulation and supervision, the reform of bank corporate governance remains unfinished.

In other words, the reform of banking regulation in China has been completed at the technical level, while nascent at the ideological level.

The 'completion at the technical level' means that China has introduced the majority of the commonly acknowledged and adopted 'techniques' for a modern banking market and a professional regulatory framework. For example, the establishment of JSCBs, the restructuring of local banks and the openness to foreign and private banks, have created sufficient market competitors. The gradual liberalisation of interest rate has intensified the competitiveness of the banking sector. The SOCBs' transformations from traditional SOEs to shareholding companies, the introduction of overseas institutional investors and the IPOs of the major banks have introduced the advanced organisational system, ownership structure and financing approach. The regulatory measures taken by the CBRC in line with international standards, such as the requirements on market entry, capital adequacy, reserve funds, liquidity, NPL ratio, and so on, have laid the foundation for a professional prudential regulatory framework.

All of these actions are the 'core techniques' to construct the formal infrastructure of a modern banking system. They form a standard model which is summarised from the common successful experience of those early-developed financial systems. No matter in the UK, the US, Hong Kong and other industrialised economies, despite the nuances in detail, the banking systems of these highly developed financial markets share many typical merits. These merits benefit from the adoption of those core techniques. These techniques have been proven effective for financial growth by these early-developed economies, despite that they have different political, legal, cultural institutions and traditions. For late-developing economies, they are the prepared instruments to be learned and used. Therefore, it can be observed that many emerging markets have tried to mimic these techniques to modernise their banking systems.¹⁰⁰ There has been a gradually enhancing trend of convergence on the approaches of banking development among different economies.¹⁰¹

⁹⁹ Rafael La Porta *et al*, 'Government Ownership of Banks' (n38) 266

¹⁰⁰ Dwight Jaffee and Mark Levonian, 'The Structure of Banking Systems in Developed and Transition Economies' (2001) 7 (2) *European Financial Management* 161,178; Robert Dekle and Madhavi Pundit, 'The Recent Convergence of Financial Development in Asia' (2015) *Asia Development Bank Economics Working Paper Series No. 440* <https://www.adb.org/sites/default/files/publication/167316/ewp-440.pdf> accessed 20 July, 17

¹⁰¹ Nicholas Apergis *et al*, 'Convergence Patterns in Financial Development: Evidence from Club Convergence' (2012) 43 (3) *Empirical Economics* 1011, 1035-6

The convergent trend demonstrates that the divergences in ideological and political conventions, as well as legal and cultural traditions, do not significantly affect the adoption of these techniques of modern banking. To a large extent, China's reform of banking modernisation and marketisation in the first three decades can be regarded as the introduction and utilisation of the standard techniques of modern banking infrastructure, which have been successfully exercised by developed financial markets. This mimicking process is less impeded by China's particularities in politics, legal systems and cultural traditions.

However, banking development and banking regulation are not just a process of importing the techniques of modern banking. On the contrary, the reform of banking modernisation and marketisation inherently includes the changes at the ideological level, which requires that the internal governance of individual banks, the interaction between banks, and the relationship between banking regulators and banks, should be formed in line with the market discipline. Currently, China's banking reform at the ideological level has not been accomplished yet.

Following the successes of the shareholding reforms and IPOs of major Chinese banks, it is necessary to apply modern corporate governance thoughts and mechanisms to operate banks.¹⁰² However, different from the introduction of banking techniques, the reform in this dimension cannot be successful in a short period, or by simply mimicking the standard setup of modern corporate governance. Corporate governance cultures and institutions are beyond 'techniques'. They are highly embedded in the political, legal and cultural conventions and traditions.¹⁰³

For transitional economies, whose institutional origins are conspicuously heterogeneous with the Anglo-American model or the models in other developed economies, in order to comprehensively modernise their banking systems, it is very important to cultivate the spirit of modern corporate governance in banks' practice.¹⁰⁴ In comparison with establishing the modern banking infrastructure at the technical level, accepting and using the values of the liberal market and business autonomy to shape banks' internal governance and decision-making is far more complex and difficult.

¹⁰² CBRC 'Corporate Governance Reform' Research Team (银监会“公司治理改革”课题组), *Improving Corporate Governance Is the Core of SOCBs' Reform* (完善公司治理是国有商业银行改革的核心) <http://www.cbrc.gov.cn/chinese/home/docView/1253.html> accessed 20 July 2017

¹⁰³ Katharina Pistor, 'The Governance of China's Finance' in Joseph Fan and Randall Morck (eds), *Capitalising China* (University of Chicago Press 2012) 35, 35

¹⁰⁴ Erik Berglöf, 'Corporate Governance in Transition Economies: The Theory and Its Policy Implications' (转轨经济中的公司治理结构: 理论及其政策含义) in Masahiko Aoki and Yingyi Qian (eds), *Corporate Governance in Transitional Economies: Inside Control and the Role of Banks* (n62) 73, 81; Hongquan Dou, *The Analysis of Bank Corporate Governance* (n72) 5

Judge Richard Posner described a possible approach to arranging the order of economic-social reform for transitional countries. He explained that economic progress could be achieved without much law or even without any law. For late-developing countries, a comprehensive institutional reform is very costly and time-consuming. The process is full of uncertainties and intricacies. If all of the old institutions have been destroyed at once, and if the weak economic, social and legal foundations cannot afford the proper and efficient transplant and application of modern institutions, the entire reform will be stifled. Therefore, his prescription is to defer the institutional reform at the nascent stage. Instead, policy makers can adopt specific rules to make partial changes to the economic-social system. At the very beginning, it helps improve the efficiency of administrative and economic organisations. When the modernising country has gradually become more prosperous, endogenously, it will have more demands and resources for a comprehensive institutional reform.¹⁰⁵ Posner summarised this model of institutional modernisation as the ‘rule-first strategy’. He also illustrated a country’s approach of economic-social reform to support the reasonability of his view. The country is China.¹⁰⁶

China’s banking reform follows the same approach of its economic-social reform. If the view of Posner is applied to explain China’s banking reform, it can be found that the division of the reform between the technical and ideological level is compatible with his ‘rule-first strategy’. The techniques of modern banking are the efficient rules to support the growth and development of the banking sector at the initial stage, which China has completed in the first thirty years. Then the booming banking sector has demanded further and substantial changes to deepen and accomplish the reform of marketisation and modernisation. In other words, the accumulation of previous rule changes have endogenously generated the demand and laid the foundation for further steps, which should essentially focus on cultivating the spirit of modern bank corporate governance.

6.3.2 The Role of Political Intervention

Political intervention in the Chinese banking sector is deeper, more often and more complex than in many liberal financial markets.¹⁰⁷ Nowadays, the government no longer directly controls banks’ businesses through central plans, policies or administrative commands. Nevertheless, the political intervention in banks’ corporate governance predominantly remains,¹⁰⁸ which has an essential impact on banks’ strategies. Political intervention is the

¹⁰⁵ Richard A. Posner, ‘Creating a Legal Framework for Economic Development’ (n85) 3

¹⁰⁶ *Ibid*, 4

¹⁰⁷ Sebastian Heilmann, ‘Policy-making and Political Supervision in Shanghai’s Financial Industry’ (2005) 14 (45) *Journal of Contemporary China* 643, 645

¹⁰⁸ Donald Clarke, ‘Law Without Order in Chinese Corporate Governance Institutions’ (2010) 30 *Northwestern Journal of International Law and Business* 131, 143; Katharina Pistor, ‘The Governance of China’s Finance’ (n103) 35

major reason for the scepticism on China's previous achievements in its banking reform.¹⁰⁹ In particular, the reform is usually deemed as 'analogous in appearance but not in spirit',¹¹⁰ which means that it only changes superficially rather than fundamentally.¹¹¹

As mentioned before, China's banking reform is at the turning point from the application of modern banking techniques to the acceptance of the spirit and thoughts of modern bank corporate governance. The role of political intervention at the two levels are very different. At the technical level, it was primarily positive. However, at the ideological level, it becomes mainly negative.

The initial process to establish the basic structure of modern banking and the regulatory framework in China was full of difficulties. Domestically, China faced with the weak economic foundation, low industrial productivity, the scarcity of capital and the ossified and inefficient planned economic system. Internationally, China was isolated from the global markets. Moreover, as a late-developing country, it was disadvantaged in terms of the endowment of financial resources. In an underdeveloped country without the tradition of the market economy but in the face of an unfavourable and hostile international economic environment, the government's strong and concentrated political control was necessary for accomplishing the original capital accumulation and the fundamental economic construction. Specifically, political control over each financial institution secured the government's power over the whole nation's capital and resources. It was crucial to exercising the 'top-down' reform, through which the government's financial and economic policies would be effectively implemented. In fact, the fast and efficient establishment of the modern banking system primarily benefited from the effective power of the Chinese government which enabled it to orchestrate the whole schedule and master the order of the reforming steps.

On the contrary, comprehensive, one-step and rapid privatisation at the beginning of economic transition may lead to financial instability and breakdown, associated with economic disorder, the sharp fall in output, and inflationary explosion.¹¹² As summarised by Ronald McKinnon, the governments of transitional economies should not undertake the

¹⁰⁹ Violaine Cousin, *Banking in China* (n4) 56-7

¹¹⁰ This is translated from a Chinese idiom '形似而神不似'. See Xiuli Wei, 'The Chinese Corporate Governance Dilemma: Conflicts Between Culture and Structure' (我国公司治理难题: 文化与结构的冲突) (2005) 4 *Finance and Economics* 118, 118; Shuli Hu, 'The View of Shuli: Measuring Corporate Governance with International Criteria' (舒立观察: 以国际标尺丈量公司治理) (*Caixin*, 11 December 2015) http://m.opinion.caixin.com/m/2015-12-11/100885594.html?utm_source=yidianzixun&utm_medium=yidianzixunApp&utm_campaign=Hezuo accessed 15 July 2017

¹¹¹ Violaine Cousin, '中监为体、西监为用 or the Specifics of Chinese Bank Regulation' (2011) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1874896&rec=1&srcabs=1545870&alg=7&pos=8 accessed 15 July 2017

¹¹² Ronald I. McKinnon, *The Order of Economic Liberalisation: Financial Control in the Transition to a Market Economy* (2nd edn, Johns Hopkins University Press 1993) 190

processes of privatisation and liberalisation all at once in case of the meltdown of the national economy. The basic precondition for relaxing the political control over banks and other financial institutions is when the economy can keep growing stably and securely.¹¹³ It is undoubtedly that nowadays China's banking development has already come through the initial stage. China's economy has realised rapid and sustainable growth. Chinese banks' performance during the GFC demonstrates the high-level stability of the banking system. That is to say, the precondition for relaxing the political control over Chinese banks has been satisfied.

Nowadays, the financial market in China has been more mature, in particular, the private sector has been flourishing. The market mechanism has started to play a more important role in promoting financial development and competition. In contrast, the function of political intervention to accumulate and utilise all the social strengths and national resources to focus on economic transition has been terminated. If political intervention remains at the same degree, it will result in excessive interference in banks' businesses and have an adverse impact on the operational efficiency and productivity growth of banks. As a consequence, political intervention will become a significant obstacle to deepening and pushing forward the marketisation and modernisation of the entire banking sector.¹¹⁴

As stated, instead of through direct central plans, currently political intervention is mainly exercised through imposing influence on banks' internal governance. In this sense, the removal of political intervention is inherently based on the reform at the ideological level, which is to use modern corporate governance thoughts and mechanisms to manage and operate banks.

In addition, the major Chinese banks have become more and more important in the international financial markets, and the Chinese banking regulator: the CBRC has intensified its engagement in making and implementing the international banking regulatory standards.¹¹⁵ Clearly, China is keen and ambitious to improve its position in the international financial markets and to play a crucial role in building up the post-crisis financial order.¹¹⁶ Specifically, China has actively promoted the BCBS Principles for Enhancing Corporate Governance, which was enacted in 2010. According to the CBRC, the majority of its proposals have been included in this document.¹¹⁷ It demonstrates that the Chinese banking regulator has noticed the importance of the modern and market-based

¹¹³ Ibid, 6

¹¹⁴ Rafael La Porta *et al*, 'Government Ownership of Banks' (n38) 267

¹¹⁵ Christopher D. Luehr, 'Red Banking: Chinese State-owned Commercial Bank Reform and the Basel II Accord' (2011) 20 (1) Minnesota Journal of International Law 171, 184

¹¹⁶ Chao Xi, 'Domestic Politics as International Norms: China's Changing Roles in International Banking Regulation' (2014) 30 Banking and Finance Law Review 69, 83

¹¹⁷ Ibid, 75

corporate governance mechanism and been attempting to promote it to the Chinese banking sector.

Obviously, the principles of modern bank corporate governance will help improve the soundness and competition of the international financial markets, which will be conducive to a benign environment for Chinese banks to undertake their international developing strategies. However, as the advocator of these principles, if the country's major banks, some of which are among the Global Systemically Important Banks (G-SIBs), are still operating under substantial political intervention rather than a modern corporate governance system, how can China and Chinese banks be trusted by the international financial markets? Therefore, Chinese banks must be reformed to operate in line with the spirit of modern bank corporate governance. They should become the good examples and lead the way for other emerging financial markets.

To summarise, after the original capital accumulation and the preliminary establishment of a modern banking system, the historical task of political intervention has finished. Facing with a more multiple and competitive domestic financial market and the increasingly important position in the international financial markets, the removal of political intervention is imperative. Furthermore, the removal relies fundamentally on that the internal governance and business operation of banks are truly based on modern and market-based corporate governance mechanisms. With regard to realising the goal of 'making banks into real banks' set up by Deng Xiaoping, this is an indispensable and crucial step. Therefore, a resolute and bold reform of bank corporate governance is needed.

6.3.3 Bankers' Remuneration as a Channel for Political Intervention

Bankers' remuneration is one of the key issues in bank corporate governance. After the GFC, reforming bankers' remuneration is at the core of the banking regulatory reforms in many major economies. Similarly, in China, establishing a market-based and modern remuneration and incentive system is also a crucial part of the transitional reform of bank corporate governance. However, in the majority of Chinese banks, bankers' remuneration was heavily subject to political intervention.¹¹⁸

6.3.3.1 The Administrative and Politicised Personnel Management

As just mentioned, nowadays, the Chinese government no longer makes direct decisions on banks' businesses through central plans, policies or administrative commands. Instead, governmental control is through an implicit way: the political intervention in bank corporate governance. In particular, the traditional administrative and politicised approach to managing and incentivising top personnel in banks has been overwhelmingly retained. This

¹¹⁸ Xiangchao Hao, 'The Correlation Between Executive Remuneration, Political Promotions and Bank Performance in Mainland China' (高管薪酬、政治晉升與大陸銀行業績相關性研究) (2014) 2 (4) *Journal of Cross-strait Finance* 31, 37

is the dominant channel through which the power of the state and the CCP over the banking system is effectively exercised.¹¹⁹

In the era of the planned economy, the internal governance of all kinds of economic and social organisations was administrative and politicised. Every enterprise was state-owned as a unit of the public sector, and the operation was completely in the same way as that of a governmental organ.¹²⁰ In terms of personnel management, both SOEs and governmental bodies followed the dual, parallel systems - the state administration and the CCP.¹²¹

In a governmental organ, all of its internal or affiliated branches and the personnel are organised in accordance with the state administrative system and positioned in the administrative hierarchy. For example, the MOF is a ministerial organ in the State Council. It governs many internal branches, such as the Budget Department (预算司), the Law and Treaty Department (条法司), the Tariff Department (关税司), and so on. The state, as well as ministerial, department and lower-level organs form the organisational hierarchy of the government. According to an organ's position in the organisational hierarchy, its officials also have their administrative levels (行政级别) in the bureaucratic hierarchy. The Prime Minister is at the state level (国家级), the minister of the MOF is at the ministerial level (部级)¹²² and the leaders of different departments in the MOF are at the department level (司局级). The salaries of governmental officials and civil servants are determined by the position of their governmental organ in the organisational hierarchy and their own levels in the bureaucratic hierarchy.

Parallel with the administrative system, the CCP system also governs and disciplines governmental organs and personnel. The CCP's committees (党组织) in all organs are the Party's basic apparatuses. They play a leading and decisive role in internal governance and personnel management. The administrative leaders of a governmental organ are also the leaders of the CCP committee in this organ. For instance, the MOF minister is also the secretary of the CCP committee (党组书记) in the MOF. The vice ministers of the MOF are the vice secretaries of the CCP committee and the departmental leaders can act as ordinary committee members. Moreover, the leaders who are at the top positions in important governmental organs, such as the ministries of the State Council, the CBRC, the PBOC, and so on, are often selected as the members of the CCP Central Committee (中共中央委员会), which is the paramount authority of the Party.

¹¹⁹ Katharina Pistor, 'The Governance of China's Finance' (n103) 42

¹²⁰ Li-Wen Lin, 'State Ownership and Corporate Governance in China: An Executive Career Approach' (2013) 3 Columbia Business Law Review 743, 756

¹²¹ Ibid, 754

¹²² The full title of this level is provincial & ministerial level (省部级). Officials of local governments are also allocated in the bureaucratic hierarchy. A provincial governor's administrative level is the provincial level, equivalent to the ministerial level.

It is not the aim of the thesis to discuss the political and administrative structures of the Chinese government and the CCP. Nevertheless, they have fundamentally shaped and profoundly influenced the organisational systems and personnel management models in the majority of Chinese banks, including all SOCBs, and those JSCBs and local banks that are sponsored by local governments and SOEs.¹²³ Complying with the system of state administration, banks' personnel management was administration-based. Complying with the CCP system, it was politicised.

The government and the CCP had the absolute power over the management of bankers, including appointment, dismissal, salary, incentives and promotion.¹²⁴ Tang Shuangning was the chairman of one of the Central-controlled Financial Institutions (CCFIs, 中央金融企业).¹²⁵ What he said during an interview has afforded much good for thought about the operation of bankers' remuneration in China.

*'I am the chairman of Everbright Bank. I am also the chairman of Everbright Group, Everbright Securities, Everbright Limited, and so on. In accordance with the requirements of the Central (government), I should get my pay from Everbright Group. My payment should be decided by the MOF. How much they decide, then how much I get. Besides, my payment should be reported to the CCP Central Organisation Department (中共中央组织部, COD).'*¹²⁶

Bankers in SOCBs and other state-related banks did not behave as professional bankers. Instead, they were the leading cadres of the state and the CCP in the financial sector.¹²⁷ Therefore, they behaved, and they were identified as public officials. First of all, bankers were included in the system of state administration. The leading positions in banks were entitled to the corresponding administrative levels in the bureaucratic hierarchy, which were usually decided by the bank's size, its position in the banking system and bankers' own positions in the bank.¹²⁸ For instance, before transferring to shareholding companies, the president (行长) of a SOCB was the 'first chair' in the bank, also written as 'yibashou' (一把手) by academics. The 'first chair' was administratively equivalent to a vice minister and

¹²³ Katharina Pistor, 'The Governance of China's Finance' (n103) 36

¹²⁴ Li-Wen Lin, 'State Ownership and Corporate Governance in China: An Executive Career Approach' (n120) 751

¹²⁵ CCFIs are the state-owned financial institutions directly controlled by the Chinese central government. See 'The List of CCFIs' (中央金融企业名录) (MOF website) http://jrs.mof.gov.cn/jinrongleiqiyeguoyouzichanguanli/201501/t20150123_1183782.html accessed 27 July 2017

¹²⁶ China Everbright Group is a CCFI. It is the initiator and the largest shareholder of Everbright Bank, see Table 6.3. 'How Much Is a Chairman's Annual Remuneration?' (董事长的年薪是多少?) *People's Television* (Beijing, 18 January 2012) <http://tv.people.com.cn/GB/14644/135863/16913709.html> accessed 14 November 2017

¹²⁷ Kjeld Erik Brødsgaard, 'Politics and Business Group Formation in China: The Party in Control' (2012) 211 *The China Quarterly* 624, 633

¹²⁸ Zhaofeng Wang, 'Corporate Governance Under State Control: The Chinese Experience' (2012) 13 (2) *Theoretical Inquiries in Law* 487, 492

entitled to the deputy ministerial level (副部级) in the bureaucratic hierarchy.¹²⁹ Furthermore, there was a CCP committee in each bank, which functioned in the same way as those in governmental organs: acting as an essential decision-making force. The president headed the CCP committee and acted as the secretary, with vice presidents as vice secretaries and other senior managers as members.¹³⁰ Moreover, the ‘first chairs’ in important and top-ranking SOEs, usually known as Central-controlled Enterprises (CCEs, 央企),¹³¹ also had the opportunities to be selected as the members of the CCP Central Committee. Chinese SOCBs are CCEs. Therefore, their top bankers could be included in the decision-making power of the CCP.

Table 6.4 shows the career trajectories of the last presidents of the ‘Big Four’ before their shareholding reforms. BCM has been organised as a shareholding company since the very beginning, so it is excluded. Clearly, among the five bankers, three of them held substitute memberships in the CCP Central Committee during their tenures as SOCBs’ presidents. That is to say, the top bankers in China’s SOCBs held not only high-ranking levels in the state administrative system but also important positions in the political system. This phenomenon was not unique in SOCBs. It was also observed in some JSCBs with strong entanglements with the government or the state-owned sector. For instance, Everbright Bank and Hua Xia Bank were both founded by large SOE groups. The former ‘first chairs’ of these two banks: Wang Mingquan and Liu Haiyan, were also the substitute members of the 16th CCP Central Committee during their tenures in these JSCBs.¹³² Moreover, in the JSCBs with local governmental backgrounds, their top bankers also had the opportunities to become the members of the CCP provincial committees, which are the paramount authorities at the provincial level in China’s political system.¹³³ For example, Gao Jianping who has been the chairman of Industrial Bank since 2002 until now, has been consecutively selected as the member of the CCP provincial committee in Fujian.¹³⁴

¹²⁹ Kjeld Erik Brødsgaard, ‘Politics and Business Group Formation in China: The Party in Control’ (n126) 628; ‘How High Is the Administrative Level of the ‘First Chairs’ in Central-controlled Enterprises?’ (央企“一把手”的行政级别有多高?) (*Phoenix Finance*) <http://finance.ifeng.com/news/special/gqybs/> accessed 17 July 2017

¹³⁰ Lynette Ong, ‘The Communist Party and Financial Institutions: Institutional Design of China’s Post-reform Rural Credit Cooperatives’ (2009) 82 (2) *Pacific Affairs* 251, 271; Sebastian Heilmann, ‘Policy-making and Political Supervision in Shanghai’s Financial Industry’ (n107) 650

¹³¹ CCEs are the SOEs directly controlled by the central government, including both financial and non-financial enterprises. Therefore, CCFIs belong to CCEs. SOCBs belong to both CCFIs and CCEs.

¹³² Please refer to the Baidu Baike (百度 百科) profile of Wang <https://baike.baidu.com/item/%E7%8E%8B%E6%98%8E%E6%9D%83> accessed 25 July 2017

¹³³ The secretary of the CCP provincial committee is the top official of that province. For more details, please refer to footnote 40 in Chapter 8.

¹³⁴ Please refer to the Baidu Baike profile of Gao <https://baike.baidu.com/item/%E9%AB%98%E5%BB%BA%E5%B9%B3/4113075> accessed 25 July 2017. The government of Fujian Province is the largest shareholder in Industrial Bank, see Table 6.3.

The CCP Central Committee and the CCP provincial committees are comprised of normal members and substitute members. Substitute members will be included in the decision-making process when normal members are insufficient due to death, retirement, and so on. Conventionally, bankers were only substitute members. Nonetheless, the position could confirm a banker's political and social status, and would open the door and lay the foundation for their future careers as politicians.

6.3.3.2 The Administrative and Politicised Remuneration and Incentive Mechanism

In the 1980s and 1990s, when equity-based remuneration was prevailingly used in Western banks, Chinese bankers were still paid and managed in accordance with the *Nomenklatura* System, which is a typical Soviet model for monitoring and incentivising the leading cadres of the state and the Party.¹³⁵ *Nomenklatura* refers to a list managed by a country's communist party, which contains the leading officials who hold or are planned to be arranged to the key posts in the bureaucratic system.¹³⁶ In China, the *Nomenklatura* System is applied to a broader sphere. The concept is used to describe the formal and informal norms and institutions which constitute the power of the CCP and the government over the appointment, transfer, promotion and dismissal of leading public cadres. Based on the *Nomenklatura* System, the remuneration and incentive systems of Chinese banks had very special features.

First of all, in terms of bankers' performance metrics, financial or economic objectives were considered but not principal. In comparison with Western private banks which are primarily running for economic profits and efficiency, the majority of Chinese banks have been taking substantial social and political responsibilities on behalf of the government, such as providing social welfare and employment.¹³⁷ During the transitional reform, the most important duty of bankers was not pursuing high economic efficiency or profitability. Instead, providing full and robust support to the implementation of central reform policies and maintaining the stability of the financial system were of utmost importance.¹³⁸

Reform was full of uncertainties. For the Chinese government, financial instability could result in not only economic meltdown, but also political turbulence and social crisis. Therefore, during the reform, especially at the early stage, banks and bankers were expected to primarily achieve macro-level objectives in political and social dimensions. Interestingly,

¹³⁵ Kjeld Erik Brødsgaard, 'Institutional Reform and the *Bianzhi* System in China' (2002) 170 *The China Quarterly* 361, 365

¹³⁶ Kjeld Erik Brødsgaard, 'Politics and Business Group Formation in China: The Party in Control' (n127) 633

¹³⁷ Qingsong Liu and Xing Xiao, 'The Promotion Incentive and Compensation Incentive for Executives in SOEs: Based on Executives' Dual Identities' (国有企业高管的晋升激励和薪酬激励: 基于高管双重身份的视角) (2015) 34 (2) *Technology Economics* 93, 94

¹³⁸ Daxing Jiang, 'Why SOEs Need Administrative Governance: An Overlooked Efficiency Interpretation' (国企为何需要行政化的治理: 一种被忽略的效率性解释) (2014) 36 (5) *Modern Law Science* 14, 24

when Chinese public media eulogised the renowned Chinese bankers who led the significant structural changes of their banks, enforcing the government's reform policies, taking moderate reform steps to minimise all kinds of risks and enhancing the channel of 'top-down' political control, were emphasised as their major achievements, whereas the banks' economic performance during their tenures were not necessarily considered.¹³⁹

Secondly, instead of pecuniary benefits, the core incentive for bankers was political promotion, namely, the opportunities to climb to higher ranks in the bureaucratic hierarchy and more important positions in the CCP system.¹⁴⁰ The most important principle of the *Nomenklatura* System is that 'the Party manages cadres' (党管干部原则). It means that all CCP members at leading and senior positions in the public sector should be subject to the Party's decisions of personnel allocation. In addition, there is a 'cadre transfer system' (干部流转制度) within in the CCP, which is applied to the cadres in the *Nomenklatura* list. These cadres should comply with the transfer arrangements made by the COD, which is responsible for the personnel management of the Party.¹⁴¹ Transfers are usually across different ministerial organs in the State Council, local governments, CCP organs, as well as major SOEs and public utility organisations. The performance of cadres at their previous posts will impact the COD's assessments and the decisions of their next posts. During the transfer, excellent achievements will help cadres get promoted.¹⁴²

As shown in Table 6.4, the five bankers all transferred among different positions in the PBOC, other ministerial organs specialised in finance and economy, local governments and financial CCEs, before they became the top managers of SOCBs. For them, if the economic, political and social objectives were achieved during their tenures in SOCBs, they would have the opportunities to move to higher positions in the government, and get promoted in both systems of state administration and the CCP.¹⁴³ For instance, before joining BOC, Zhou Xiaochuan was a vice governor of the PBOC. The bureaucratic rank of this position was the deputy ministerial level. In the CCP system, he was only an ordinary member of the CCP committee in the PBOC, and not included in the Central Committee. The transfer from the PBOC to BOC was from the government system to the enterprise system, and his

¹³⁹ 'A Non-typical Banker Jiang Jianqing' ('非典型'银行家姜建清) (*Sina Finance*, 9 May 2016) <http://finance.sina.com.cn/zg/observation/2016-05-09/zg-ixryhhi8553992.shtml> accessed 24 July 2017; 'Understanding Xiao Gang' (解读肖钢) (*NetEase Finance*, November 2012) <http://money.163.com/special/jieduxiaogang/> accessed 24 July 2017

¹⁴⁰ Taye Mengistae and Lixin Colin Xu, 'Agency Theory and Executive Compensation: The Case of Chinese State-owned Enterprises' (2004) 22 (3) *Journal of Labour Economics* 615, 619

¹⁴¹ Sebastian Heilmann, 'Regulatory Innovation by Leninist Means: Communist Party Supervision in China's Financial Industry' (2005) 181 *The China Quarterly* 1, 17

¹⁴² Kjeld Erik Brødsgaard, 'Politics and Business Group Formation in China: The Party in Control' (n127) 634

¹⁴³ Fang Hu and Sidney Leung, 'Top Management Turnover, Firm Performance and Governmental Control: Evidence from China's Listed State-owned Enterprises' (2012) 47 *The International Journal of Accounting* 235, 239

bureaucratic rank maintained the same. However, the post as the ‘first chair’ of BOC secured him the substitute ticket to the CCP Central Committee. Furthermore, after he left BOC, his political career significantly brightened up. At the positions of the governors of the China Securities Regulatory Commission (证监会, CSRC) and the PBOC, he was promoted to the chief ministerial level and finally became a formal member in the CCP Central Committee. Since then, Zhou stays in the political system. Until today, he has served as the Central Bank governor of the world’s second-largest economy for more than fifteen years and been globally known as a famous Chinese reformist and politician.

For those bankers who were at senior positions in banks but not ‘first chairs’, they could first be promoted within banks. For them, banks’ CCP committees had the power to assess their performance and recommend them to higher positions in banks.¹⁴⁴

Clearly, the assessments of Chinese bankers’ performance and the incentives for them were completely separated. Before the GFC, through equity-based remuneration, Western bankers enjoyed tremendous benefits from the achievements they made in shareholder returns.¹⁴⁵ In contrast, even if Chinese bankers made great achievements in economic profits, political promotion was the only way to award them.

Thirdly, since bankers were only awarded opportunities of political promotion, their remuneration did not serve as a modern incentive mechanism.¹⁴⁶ That is to say, no matter how excellent achievements were made to fulfil economic, political or social objectives, bankers’ salaries would not be increased accordingly. As cadres of the state and the Party, bankers were paid in line with the salary system for governmental officials and civil servants. Usually, it was only made up of fixed salary in cash and decided by their ranks in the bureaucratic hierarchy and the positions in the CCP system. Therefore, for bankers at the same level, their salaries were not hugely differentiated, regardless of the performance of their banks and their own.¹⁴⁷

Political incentives and fixed income are the particular features of the incentive mechanism for governmental officials. Therefore, during the early stage of the banking and financial reform, Chinese bankers were subject to the management and incentive mechanism of the bureaucratic system.

¹⁴⁴ Nicholars Howson, ‘China’s Restructured Commercial Banks: *Nomenklatura* Accountability Serving Corporate Governance Reform?’ in Martha Avery *et al* (eds), *China’s Emerging Financial Markets: Challenges and Global Impact* (1st edn, John Wiley and Sons 2009) 123, 144

¹⁴⁵ Frank Easterbrook, ‘International Corporate Differences: Markets or Law?’ (1997) 9 (4) *Journal of Applied Corporate Finance* 23, 28

¹⁴⁶ Donald Clarke, ‘Law Without Order in Chinese Corporate Governance Institutions’ (n108) 143

¹⁴⁷ Eric Chang and Sonia Wong, ‘Political Control and Performance in China’s Listed Firms’ (2004) 32 (4) *Journal of Comparative Economics* 617, 622

Table 6.4 The Career Trajectories of Presidents in Chinese SOCBs (Pre-shareholding Reform)¹⁴⁸

Bank, president and tenure ¹⁴⁹		Brief career trajectory before SOCBs	Political post during the tenure in SOCBs	Reason for termination	Brief career trajectory after SOCBs (including political post)
ICBC	Liu Tinghuan 1997-1999	1. The governor of a city-level subsidiary of PBOC (the secretary of the CCP committee) 2. The ICBC vice president (the vice secretary of the CCP committee)	The substitute member of the 15th (1997-2002) CCP Central Committee	Rotation and promotion	The PBOC vice governor (the vice secretary of the CCP committee)
BOC	Liu Mingkang 2000-2003	1. The vice governor of Fujian Province 2. The vice president of China Development Bank (CDB) ¹⁵⁰ 3. The PBOC vice governor (the vice secretary of the CCP committee) 4. The chairman of Everbright Group (the secretary of the CCP committee)	The substitute member of the 16th (2002-2007) CCP Central Committee	Rotation and promotion	1. The CBRC governor (the secretary of the CCP committee) 2. The member of the 17th (2007-2012) CCP Central Committee
CCB	Zhou Xiaochuan 1998-2000	1. The member of the State Commission for Restructuring the Economic Systems (国务院经济体制改革委员会, SCRES) ¹⁵¹ 2. The BOC vice president 3. The PBOC vice governor (the member of the CCP Committee)	None	Rotation and promotion	1. The CSRC governor (the secretary of the CCP committee) 2. The PBOC governor (the secretary of CCP committee) 3. The member of the 16th and 17th CCP Central Committee
ABC	Shang Fulin 2000-2002	The PBOC vice governor	The substitute member of the 16th CCP Central Committee	Rotation and promotion	1. The CSRC governor (the secretary of the CCP committee)

¹⁴⁸ The information about bankers' careers is collected from their biographies published in banks' annual reports and the Index of China's Leaders and Cadres (中国领导干部资料库) <http://cpc.people.com.cn/gbzl/index.html>, as well as their profiles at Wikipedia and Baidu Baike.

¹⁴⁹ Conventionally, all the presidents were also the secretaries of the CCP committees in these SOCBs.

¹⁵⁰ CDB is a policy bank which is wholly owned by the state and directly managed by the State Council.

¹⁵¹ The SCRES was ever an organ of the State Council which was responsible for directing the economic reforms. It was repealed in 1998.

					<p>2. The CBRC governor (the secretary of the CCP committee)</p> <p>3. The member of the 17th and 18th (2012-2017) CCP Central Committee</p>
	<p>Yang Mingsheng 2003-2007</p>	<p>1. The president of a provincial subsidiary of ABC</p> <p>2. The ABC vice president (the vice secretary of the CCP committee)</p>	None	Rotation and promotion	<p>1. The vice governor of the China Insurance Regulatory Commission (CIRC, 保监会) (the member of the CCP committee)</p> <p>2. The chairman of China Life Insurance Company (中国人寿)¹⁵² (the secretary of the CCP committee)</p> <p>3. The member of the 18th CCP Central Commission for Discipline Inspection (中共中央纪律检查委员会, CCDI)¹⁵³</p>

6.3.3.3 Bankers' Remuneration Still Subject to Political Intervention

The administrative and politicised personnel management system and remuneration system in banks preserved the typical characteristics of the planned economy. Before the shareholding reforms of Chinese banks, bankers were rigidly subject to these systems.

After the transformations to shareholding companies and the IPOs, the basic structure of modern corporate governance has been established in major Chinese banks, which includes AGM, the BOD, supervisory board and senior management. However, it is hard to make the corollary that banks' *de facto* corporate governance will be highly compatible with the *de jure* framework written in company law, corporate governance regulation and banks'

¹⁵² China Life Insurance Company is a large CCE.

¹⁵³ The CCDI is the highest internal-control institution in the CCP, which is responsible for enforcing internal rules and regulations, supervising and disciplining CCP members and combating corruption and malfeasance in the governmental system and the CCP system. In addition, all levels of local governments, governmental organs, and state-owned social and economic organisations should establish the Commission for Discipline Inspection (纪委, CDI).

articles of association.¹⁵⁴ In fact, academics have sharply pointed out that the pre-reform approach which has enabled political intervention in bank's internal governance has been turned into a shadow and implicit system and remains dominant, whereas the formal structure of modern corporate governance is more symbolic and decorative than practical.¹⁵⁵

Why is political intervention still dominant after the introduction of a modern corporate governance model? A major reason is that bankers' remuneration and incentive system has not been immediately reformed along with the modernisation trend of corporate governance structure.¹⁵⁶

Under the structure of modern corporate governance, bankers have obtained new titles, such as chairman and executive director. They should be identified as professional financial executives. However, still being managed and incentivised by traditional norms and institutions, the real behavioural and decision-making modes of bankers have been kept closely compatible with those of bureaucrats.¹⁵⁷ Therefore, bankers would still try to fulfil the government's requirements, in order to maximise the opportunities to be promoted in the bureaucratic hierarchy. Bankers are at the core of banks, their thoughts and behaviours have a decisive impact on the operations of banks and the banking system. Therefore, through the traditional remuneration and incentive system, the government and the CCP can still control the top personnel in the banking sector, and thereby impose political intervention in banks' decision-making processes.

Clearly, after the market mechanism has been preliminarily established and the basic structure of modern corporate governance has been introduced, bankers' remuneration and incentive system has become the only retained channel for political intervention. However, this channel is pivotal and influential.

It has been argued that Chinese banking reform has completed at the technical level, which focused on establishing the basic infrastructure of modern banking. However, the reform at the ideological level, which is to use modern corporate governance thoughts and mechanisms to operate banks, is still ongoing. At the two different levels, the role of political intervention is significantly different. Currently, at the ideological level, political intervention should be mitigated. To this end, a modern and market-based corporate governance model should be practically functional in banks. In this sense, if bankers'

¹⁵⁴ Sonja Opper and Sylvia Schwaag-Serger, 'Institutional Analysis of Legal Change: The Case of Corporate Governance in China' (2008) 26 *Washington University Journal of Law & Policy* 245, 247

¹⁵⁵ Nicholars Howson, 'China's Restructured Commercial Banks: *Nomenklatura* Accountability Serving Corporate Governance Reform?' (n144) 145

¹⁵⁶ Sebastian Heilmann, 'Regulatory Innovation by Leninist Means: Communist Party Supervision in China's Financial Industry' (n141) 17

¹⁵⁷ Jiangyu Wang, 'The Political Logic of Corporate Governance in China's State-owned Enterprises' (2014) 47 *Cornell International Law Journal* 631, 651

remuneration and incentive system is not put on the reform agenda, the entire reform of banking modernisation and marketisation cannot be completely achieved.

All in all, the necessity to reform bankers' remuneration in Chinese banks is inherently determined by the process of China's transitional reform of banking marketisation and modernisation. At the current stage, in order to push forward and deepen the transitional reform, the primary task is to use the thoughts and mechanisms of modern bank corporate governance to replace the role of political intervention in banks' internal governance and decision-making. In this process, establishing a modern and market-based remuneration and incentive system is of crucial significance.

6.4 Conclusion

This chapter has reviewed the transitional banking reform undertaken in China and discussed the necessity to reform bankers' remuneration and incentive system. It gives answers to the question: what has been the problem of bankers' remuneration in China in the context of transitional banking reform?

China's reform of banking modernisation and marketisation started in the late 1970s. At that time, the country's banking business was highly unified and centralised. The PBOC was the mono-bank in charge of all deposit-taking and lending activities. The reform started with the professionalisation of the PBOC as the central bank and the transfer of the commercial banking function to four professional, state-owned banks: ICBC, ABC, BOC and CCB. Consequently, the two-tier banking system was established.

The history of China's banking reform is primarily the history of Chinese SOCBs. In the late 1980s and early 1990s, the government completed the reforms of commercialisation in the four professional banks and reorganised the fifth state-owned bank, BCM. Since then, the five SOCBs have played a leading role in China's financial and economic development. From late 1990s until 2010, during the two decades, the Chinese authorities took a series of bold and significant actions on SOCBs, including the removal of NPLs, the introduction of overseas strategic investors, the transformations of the 'Big Four' banks to shareholding companies and the IPOs of the five SOCBs. Finally, the SOCBs completed the historic stride from wholly central-controlled enterprises to modern and international banking groups. During these processes, the powerful control of the government guaranteed the efficient enforcement of these reform measures. Therefore, the process of banking modernisation has been primarily pushed and scheduled by the government, rather than a spontaneous consequence of financial development.

Simultaneously, the Chinese authorities launched the reform in the non-state-owned banking sector. Since the late 1980s, a number of JSCBs were established. After the shareholding reforms, the introduction of overseas capital and the IPOs, they have also become large and nationwide modern banking groups. Following the similar steps,

thousands of credit cooperatives have been reorganised into local commercial banks. Moreover, in 2014, based on the full openness policy of the banking sector to private capital, more and more private banks have been established. The prosperity of the non-state-owned banking sector has further multiplied the Chinese banking system and improved the system-wide competitiveness.

China spent about three decades to achieve the great transition. Moreover, by learning from the advanced experience of developed financial markets, and the international standards of banking regulation, China has established an integrated and professional banking regulatory framework.

Since the GFC, China's banking reform entered the fourth decade, during which the task to push forward and deepen the reform has focused on the introduction and application of modern corporate governance thoughts and mechanisms. In terms of the market structure and the formal laws and regulations, the Chinese banking sector is very close to developed financial markets. However, the internal governance of banks is still heavily subject to the traditional administrative and politicised approach, through which political control is dominant in banks' decision-making. Compared to introducing the techniques of modern banking infrastructure, using modern corporate governance thoughts and mechanisms to operate banks is more difficult and time-consuming. Nevertheless, it is necessary for shifting the banking reform from the technical level to the ideological level.

The achievements made in the first three decades should be principally attributed to the powerful control and intervention of the government. It ensured the effective implementation of the 'up-down' reform, and the stability of the financial system and the macroeconomic environment. However, since the market mechanism is playing a more and more important role, political intervention in banks' internal governance has gradually become a major obstacle in the ongoing reform of banking modernisation and marketisation. Therefore, removing political intervention is an inherent goal to establish the modern and market-based corporate governance system and accomplish the transitional banking reform.

Bankers' remuneration is one of the key issues in bank corporate governance. In Chinese banks, it is one of the areas that have heavily been subject to political intervention whereas less reformed by modernisation and marketisation steps. Bankers in major Chinese banks have been managed as the cadres of the state and the CCP. Their incentives have been arranged in accordance with the political and bureaucratic discipline, not the market discipline. Their remuneration has been decided by the government, not banks' BODs. As a consequence, bankers have made decisions based on the economic, social and political goals of the government, rather than market operation or banks' financial situations. Clearly, bankers' remuneration and incentive system remains an important channel for political intervention. Therefore, the reform of establishing a modern and market-based

remuneration and incentive system becomes an imperative step for removing the political intervention in banks and deepening the banking reform.

In comparison with developed financial markets, such as the UK, the problem of bankers' remuneration in China is very special. It is not due to the failure of the market or the absence of necessary regulation. On the contrary, the problem in China rests with the absence of the market mechanism in deciding bankers' remuneration and the excessive intervention by the government. Whether this problem could be perfectly solved or not is crucial to the final success of China's ongoing banking reform. Therefore, it is necessary to launch the modernisation and marketisation reform of bankers' remuneration in China.

Chapter 7

The Regulatory Framework of Bankers' Remuneration in China

7.1 Introduction

In order to push forward and deepen the modernisation and marketisation reform of the Chinese banking system, and to support the long-term prosperity of China's economy, it is necessary to establish a sound and productive corporate governance structure and apply modern corporate governance thoughts and mechanisms to operate banks. In particular, reforming the remuneration and incentive system is a crucial part of the modernisation and marketisation of bank corporate governance. However, previously there were very limited initiatives taken by the Chinese government to help banks improve their corporate governance mechanisms and remuneration systems.

After the GFC, the needs to further push forward the transitional banking reform and to develop in the international financial markets have made the Chinese banking regulators aware of the criticality of reforming bankers' remuneration. At the same time, the remuneration failures in developed financial markets during the GFC have alerted the Chinese banking regulators the importance of establishing a professional and appropriate regulatory framework of bankers' remuneration. On the one hand, the regulation can serve as the guidance for Chinese banks to adopt modern and market-based remuneration and incentive systems. On the other hand, it is a protective mechanism for avoiding the similar problems that occurred in the West due to market distortion.¹

Therefore, in 2010, with reference to the FSB Principles for Sound Compensation Practices Implementation Standards, the CBRC enacted the first formal and specific regulation of bankers' remuneration in China: the Regulatory Guidelines on Sound Remuneration in Commercial Banks (商业银行稳健薪酬监管指引, hereafter the 'CBRC Guidelines') (No.14, March 2010). It demonstrates that the CBRC wants to enhance the reform of bankers' remuneration by closely following the international standards. Apart from the CBRC, in the same year, the MOF has also promulgated the Measures for the Regulation of Managers' Remuneration in Central-controlled Financial Institutions' (中央金融企业负责人薪酬审核管理办法, hereafter the 'MOF Measures') (No.10, February 2010), which is specifically monitoring the remuneration and incentive systems of CCFIs, including the five SOCBs.² Moreover, other financial institutions that are controlled by CCFIs should

¹ 'CBRC Managers Responded the Media About the Regulatory Guidelines on Sound Remuneration in Commercial Banks' (银监会有关负责人就《商业银行稳健薪酬监管指引》答记者问) (*The PRC Government website*, 10 March 2010) http://www.gov.cn/zwhd/2010-03/10/content_1552368.htm accessed 26 July 2017

² For the list of CCFIs, please refer to footnote 125 in Chapter 6.

also comply with the MOF Measures.³ There are two JSCBs in this scope: Everbright Bank and CITIC Bank.⁴ For all the other banks, the MOF Measures are not binding, but still highly persuasive.⁵ These two regulatory documents primarily constitute the current regulatory framework of bankers' remuneration in China. In addition, there are some relevant rules in other regulations of corporate governance.

This chapter will elaborately introduce and analyse the measures incorporated in the CBRC Guidelines, the MOF Measures and other relevant regulations. It will draw a comprehensive landscape of the Chinese regulatory framework of bankers' remuneration. The chapter is scheduled as below. Section 7.2 briefly introduces the formal corporate governance structure in Chinese banks, which is organised in line with the rules of law and regulation. Section 7.3 discusses the regulatory measures on the decision-making power of bankers' remuneration. Section 7.4 discusses the measures on bankers' remuneration policy and management. Section 7.5 summarises the important features of the regulatory framework. Section 7.6 is the conclusion.

7.2 The Formal Corporate Governance Structure in Chinese Banks

Nowadays, the majority of Chinese banks have adopted the form of modern corporation and been organised in line with the formal corporate governance structure stipulated by the rules of law and regulation. The rules in relation to bank corporate governance include the general articles for all companies and the special articles for banks. The general articles are in the Company Law of the PRC (中华人民共和国公司法) and the CSRC Code of Corporate Governance for Listed Companies (证监会上市公司治理准则, hereafter the 'CSRC Code') (No.1, January 2002). The special articles refer to the CBRC Guidelines on Corporate Governance for Commercial Banks (银监会商业银行公司治理指引, hereafter the 'Guidelines for Bank Corporate Governance') (No.34, July 2013).

According to the Company Law, there are two different types of company: limited liability company (有限责任公司) and company by shares (股份有限公司). In the banking sector, the second type is more commonly adopted by banks. The standard corporate governance structure of a company by shares in China is made up of AGM, the BOD, supervisory board and senior management. The AGM is the supreme organ of a company, which has the power

³ *The MOF Measures*, Article 32

⁴ CITIC Group is a CCFI. It holds 65.37% shares in CITIC Bank. Everbright Bank does not have a single controlling shareholder. Nevertheless, the shares controlled by several CCFIs together also exceed 50%. These CCFIs are affiliated parties and can take concerted actions. See CITIC Bank Annual Report 2016, 122 and Everbright Bank Annual Report 2016, 67. (Usually, Chinese banks which are listed at both the SHSE and the HKSE publish two versions of annual reports, one for A Share and the other for H Share. Without special explanation, the cited annual reports in this thesis are all for the A Share market).

⁵ *The MOF Measures*, Article 32

to make resolutions on significant affairs.⁶ The BOD is answerable to the AGM and responsible for comprehensive management and operation.⁷ The BOD in a bank must be comprised of both executive directors and NEDs.⁸ The senior management in a bank usually includes the president, vice presidents, chief officers of different business units and the secretary of the BOD. The main duty of the senior management is to implement the decisions made by the BOD.⁹ In terms of checks and balance, the mechanism in Chinese corporate governance is hybrid, which is a combination of the Common Law's independent directors and the Civil Law's supervisory board.¹⁰ In a Chinese company, the NEDs and the members of the supervisory board independently oversee or supervise the conduct of executive directors and senior managers.

As discussed in Chapter 5, in the Anglo-American world, in the aftermath of the GFC, there is a trend of enhancing shareholder activism and engagement. However, the thesis has also argued that banking regulators should be clear that bank corporate governance is special. Instead of exclusively maximising shareholders' interests, banks and bankers should try to keep the balance between different stakeholders' interests and maintain financial stability.

In the West, the view that bank corporate governance should maintain financial stability and protect the public interest was not paid attention to or widely acknowledged until the GFC. In contrast, the governance of Chinese banks has always been stability-oriented. As stated before, the development of the Chinese banking sector is along with the transitional economic-social reform, which is full of uncertainties and risks. Therefore, the government has reserved strong power over the banking system to control the order and steps of the reform and avoid economic, political and social instability. That is to say, the principles of maintaining financial stability and protecting the public interest are completely accepted by the Chinese banking regulators. For instance, the CBRC particularly forbids the *ultra vires* by banks' shareholders, which will violate the power allocated to the BOD and senior management by the rules of law, or interrupt managerial and operational activities.¹¹ The purpose is to ensure that the BOD and senior management can independently make decisions within the sphere of their lawful power and responsibilities. By maintaining the independence of the BOD and senior management, the CBRC wants them to make decisions which will protect the interests of different stakeholders.¹²

⁶ The Company Law of the PRC 2013, Article 98

⁷ CBRC, *The Guidelines for Bank Corporate Governance*, Article 19

⁸ CBRC, *The Guidelines for Bank Corporate Governance*, Article 21

⁹ CBRC, *The Guidelines for Bank Corporate Governance*, Article 67

¹⁰ Junhai Liu, 'Experience of Internationalisation of Chinese Corporate Law and Corporate Governance: How to Make the Hybrid of Civil Law and Common Law Work?' (2015) 26 (1) *European Business Law Review* 107,122

¹¹ CBRC, *The Guidelines for Bank Corporate Governance*, Article 10 and 40

¹² CBRC, *The Guidelines for Bank Corporate Governance*, Article 19

It needs to be clarified that this chapter only discusses the formal institutions, rules and measures adopted by the Chinese regulators to reform bankers' remuneration. Therefore, this section has focused only on the *de jure* structure of bank corporate governance. Many academics have argued that the *de facto* corporate governance in Chinese companies is based on alternative and shadow norms and institutions.¹³ However, this is excluded from the discussions in this chapter. The informal and shadow norms and institutions relevant to bankers' remuneration will be analysed in next chapter.

7.3 The Regulation on the Decision-making Power of Bankers' Remuneration

7.3.1 The Chinese Version of Shareholder 'Say on Pay'

In terms of the decision-making power of executive remuneration, usually, there are three approaches among different jurisdictions: primarily allocated to shareholders, primarily allocated to the BOD and distributed between the two constituencies. As discussed in Subsection 4.3.2, after the implementation of the binding 'Say on Pay' vote, the decision-making power of directors' remuneration in UK banks has substantially shifted from the BOD to shareholders.

In China, shareholders have been authorised the decision-making power of directors' remuneration since 1993 when the first Company Law was enacted.¹⁴ This is the general principle applied to all companies. The CSRC Code specifies in detail that the directors' remuneration plan should be made by the BOD and then submitted to the AGM for a final decision.¹⁵ However, the assessments of directors' performance and the implementation of the remuneration plan are carried out by the BOD.¹⁶ The BOD also has the full power to determine senior managers' remuneration.¹⁷ Clearly, these rules are completely the same as the post-crisis arrangements of the UK 'Say on Pay': in listed companies, shareholders are empowered to decide the policy of directors' remuneration, and all the other affairs in relation to executive remuneration are exercised by the BOD. This is not a consequence of legal transplant. The Chinese 'Say on Pay' has been promulgated in 2002, about ten years earlier than the UK. The two jurisdictions have coincidentally implemented very similar rules on the decision-making of executive remuneration in listed companies.

Nevertheless, compared to the UK 'Say on Pay', the stipulations in China are very general and unprecise. In both the Company Law and the CSRC Code, AGM is empowered to 'decide' (决定) directors' remuneration. However, the issues such as how the AGM should

¹³ Sonja Opper and Sylvia Schwaag-Serger, 'Institutional Analysis of Legal Change: The Case of Corporate Governance in China' (2008) 26 *Washington University Journal of Law & Policy* 245, 257

¹⁴ The Company Law of the PRC 2013, Article 37

¹⁵ *The CSRC Code*, Article 71

¹⁶ *The CSRC Code*, Article 72

¹⁷ *The CSRC Code*, Article 79

make the decision on directors' remuneration plan and what kinds of following actions should be taken if the AGM disagrees with the plan are not elaborated. Without sufficient or detailed stipulations, shareholder 'Say on Pay' would be unenforceable. In practice, alternative or informal rules would factually annul the power of shareholders. For instance, the CBRC supports a different approach to allocating the decision-making power in banks.

7.3.2 The CBRC: 'Director Primacy' for Stakeholders' Interests

The Chinese shareholder 'Say on Pay' is applied to all listed companies incorporated in China, including listed banks. However, the regulatory philosophy of the CBRC on bank corporate governance is restricting the interference by shareholders and maintaining the independence of the BOD for the protection of stakeholders' interests. According to the CBRC Guidelines, the BOD of a bank takes the full charge of, and is ultimately responsible for the policy and management of all employees' remuneration (including directors and senior managers). Specifically, it is necessary to establish a remuneration committee within the BOD. The committee's main duties include drafting the remuneration plan, designing the remuneration management system, and monitoring the implementation process and outcomes. The senior management shall implement the BOD's resolutions on remuneration.¹⁸ However, the CBRC Guidelines keep reticent about whether the AGM should play a role in the pay-setting and implementation processes.

The CBRC's empowerment to banks' boards, who owe responsibilities to all stakeholders, contradicts with the traditional view of shareholder activism and empowerment adopted by the Chinese Company Law and the CSRC Code. At the *de jure* level, the conflict between the CBRC Guidelines and the CSRC Code can be simply solved. Both of them are the administrative rules (部门规章) made by the ministerial organs of the State Council. Therefore, they are equivalent to each other. Nevertheless, the CBRC Guidelines are special provisions. According to the doctrine of *lex specialis derogat generali*, they should prevail over the general provisions in the CSRC Code.¹⁹ The real *de jure* conflict is between the CBRC Guidelines and the Company Law because the latter is a piece of legislation, which should be prioritised. Theoretically, the CBRC Guidelines cannot exclude the AGM from the decision-making process of bankers' remuneration. Therefore, the CBRC Guidelines have kept reticent, in order to sidestep shareholder 'Say on Pay'.

In practice, banks have chosen to comply with the Company Law procedurally. No matter SOCBs, JSCBs or SMS banks, all stipulate in the articles of association that the AGM has the power to decide directors' remuneration. Nevertheless, in practice, banks' actions are different. For instance, by checking some samples of banks' public statements in 2016, it has been found that some banks clarified that directors' remuneration plans would be

¹⁸ *The CBRC Guidelines*, Article 17

¹⁹ The Legislation Law of the PRC (中华人民共和国立法法) 2015, Article 83

subject to the AGM's approval,²⁰ whereas some other banks directly published the remuneration plans and implementation outcomes decided by the BODs.²¹

As argued in Subsection 5.3.1, the theoretical foundation of 'Say on Pay' contradicts with the primary purposes of the regulation of bankers' remuneration. 'Say on Pay' still focuses on the maximisation of shareholders' interests, while the regulation of bankers' remuneration should aim at maintaining financial stability and protecting the public interest. Therefore, the CBRC's regulatory philosophy on the allocation of the decision-making power is compatible with the international principles of banking regulation and the widely acknowledged values in the global financial markets. However, limited by the Company Law, this view cannot be explicitly written or exercised.

In principle, the view of empowering the BOD to protect stakeholders' interests demonstrates that the CBRC's regulation is advanced and conducive to the reform of bankers' remuneration. Nevertheless, executive directors are at the core of the BOD. In major Chinese banks, traditionally, executive directors are the important financial cadres in this country, who have been bureaucrat-minded. In practice, empowering them would distort the function of banks' BODs. Instead of pursuing the public interest, these executive directors would adhere to political intervention. More detailed analysis of the distortion of the CBRC's 'director primary' model will be provided in Chapter 9.

7.4 The Regulation on Remuneration Policy and Management

7.4.1 The Caps on Bankers' Remuneration

Among all the international recommendations for the regulation of bankers' remuneration, remuneration cap is avoided. Until now, the EU is the only jurisdiction in developed financial markets that has adopted a cap on bankers' remuneration. In China, the banking regulators have a couple of rules to control the level and structure of bankers' remuneration.

Chinese bankers' remuneration is also comprised of fixed remuneration and variable remuneration. Fixed remuneration includes basic salary and welfare benefits. Welfare benefits refer to social insurances (社会保险) and housing provident fund (住房公积金), which are similar to the pensions provided for UK bankers.²²

²⁰ ABC, 'The Public Notice of the BOD's Resolution No.2016-030' (农行董事会决议公告临 2016-030 号) http://www.abchina.com/cn/AboutABC/investor_relations/announcements/a-announcement/201608/P020160829306259921928.pdf accessed 28 July 2017

²¹ ICBC, 'The Public Notice of the BOD's Resolution No.2016-021' (工行董事会决议公告临 2016-021 号) <http://v.icbc.com.cn/userfiles/Resources/ICBCLTD/download/2016/dshA20160831.pdf> accessed 28 July 2017

²² To be contextually coherent with the discussions of bankers' remuneration in the UK, welfare benefits will also be excluded from Chinese bankers' fixed remuneration.

The forms of variable remuneration in Chinese banks are very simple. Cash bonus is almost the only type of variable remuneration. Equity-based remuneration, which is prevailing in Western financial markets, has rarely been adopted in China. The reason for the undeveloped situation of equity-based remuneration will be discussed in next subsection.

7.4.1.1 The ‘Bonus Cap’ in Chinese Version

Both the CBRC Guidelines and the MOF Measures stipulate that bankers’ performance-based remuneration should be limited to three times of fixed remuneration. This requirement is very similar to the EU bankers’ bonus cap. It means that the ratio between variable and fixed remuneration cannot be higher than 3:1. In comparison with the EU cap, the Chinese version is more straightforward: the ratio must be applied to all banks in any circumstances. Bank shareholders are not entitled to the power to approve a higher ratio. However, the 3:1 ratio is much higher than the 1:1 ratio in the EU, which means that in China the restriction on the proportion of variable remuneration is less strict.

7.4.1.2 The MOF’s Restrictions on Basic Salary and Total Remuneration

The MOF has also imposed specific restrictions on the levels of bankers’ fixed remuneration and total remuneration. Usually, fixed remuneration can be determined by banks by taking into consideration a banker’s position and responsibilities, the average level of basic salary in the market, the bank’s operation and profitability, and so on.²³ However, for SOCBs and state-related banks, MOF requires that the level of basic salary must be calculated in line with the formula provided in the MOF Measures. The formula is:²⁴

$$\begin{aligned} \text{Basic Annual Salary} = & 5 \times \text{The Average Salary of CCE Employees of Last Year} \\ & \times \text{Adjustive Coefficient} \times \text{Distributive Coefficient} \end{aligned}$$

The average salary of CCE employees in last year (上年度中央企业在岗职工平均工资) is the average figure of the salaries of all employees in CCEs, including CCFIs and non-financial enterprises. This figure is given by the MOF directly. The adjustive coefficient (调节系数) is determined by the position level (职位等级) of a bank. The MOF has designed a system to assess banks’ position levels, which is made up of a variety of factors about banks’ business scales and financial situations.²⁵ Each position level is allocated with a specific adjustive coefficient by the MOF. Usually, larger, more profitable and universal banks are at higher position levels and have bigger adjustive coefficients. Since the position level is applied to banks rather than individual bankers, all bankers in the same financial

²³ *The CBRC Guidelines*, Article 6; *The MOF Measures*, Article 6

²⁴ *The MOF Measures*, Article 7

²⁵ A bank’s position level is decided by the bank’s total assets (20%), operational revenue (20%), staff number (20%), total profits (20%), market scale (10%) and the complexity of the bank’s services and products (10%). The figures in the brackets are the weightings of these factors. The score of each factor is the figure of the factor multiplying the corresponding weighting. The aggregate score, by adding up the scores of each factor, determines the bank’s position level. *The MOF Measures*, Article 8

institution have the same adjustive coefficient. The distributive coefficient (分配系数) is calculated on an individual basis. The MOF stipulates that the top leader, which usually refers to the ‘first chair’ (the chairman of the BOD) in a bank, is allocated with a distributive coefficient of 1 and other bankers’ are allocated in between 0.6 to 0.9. Within the interval of 0.6 to 0.9, banks’ BODs can make discretionary decisions to decide each banker’s distributive coefficient.

Obviously, most of the factors and coefficients used to calculate a banker’s basic salary are directly decided by the MOF, whereas banks’ discretion and autonomy are very limited. Therefore, in terms of deciding the fixed remuneration in SOCBs and state-related banks, the MOF’s role is dominant and intrusive. Moreover, due to the 3:1 variable-fixed ratio, the MOF’s rules can influence the amount of variable remuneration, and thereby the level and structure of the whole remuneration package.

Moreover, in emergent circumstances, the MOF capped the total level of bankers’ remuneration. Although the Chinese financial system weathered the GFC without any serious collapses, the entire recession of the international financial markets had a negative impact on the operations of Chinese banks. In this context, the MOF required that bankers’ total remuneration in the financial year 2008 shall not be higher than 90% of that offered to bankers in 2007. For any banks that suffered profit decreasing in 2008, the remuneration should be further reduced by 10% after the aforementioned 90% cap was applied. That is to say, the remuneration in profit-decreasing banks shall not be higher than 81% of that in 2007. The emergent cap was uniformly applied to all financial institutions, including SOCBs and all the other banks.²⁶

In UK banks, the waiver of bonuses was bankers’ personal and voluntary conduct. The UK regulators did not make any formal requirement to largely lower bankers’ remuneration as an emergent response to the GFC. In contrast, the MOF directly imposed the requirement of cutting down total remuneration level on all Chinese banks, regardless of their business situations and the performance of individual bankers. In fact, Chinese banks were much less affected by the GFC than Western banks. However, the MOF’s approach was far more intrusive and tough than any Western policy maker. Even the EU bankers’ bonus cap, which has been described as the ‘toughest rule’ on bankers’ remuneration in the West, has given some leeway to banks to decide the level of fixed remuneration. In comparison, the MOF intrusively decides the level of fixed remuneration and cuts down bankers’ total remuneration. These actions demonstrate that the MOF’s regulatory approach has largely preserved the character of tight and close control.

²⁶ MOF, *The Notice About the Remuneration Allocation for Managers in State-owned Financial Institutions in 2008* (关于国有金融机构 2008 年度高管人员薪酬分配有关问题的通知) (No.23, April 2009), Article 9

7.4.1.3 The CCP's Unpublished Remuneration Cap

Apart from the rules issued by the CBRC and the MOF, the CCP has also imposed an internal command on CCEs to control the level and structure of managers' remuneration, which materially affects bankers' remuneration of SOCBs.

In December 2013, the CCP Central Committee established the Central Leading Group for Comprehensively Deepening Reforms (中共中央全面深化改革领导小组, hereafter the 'Leading Group'), which is the key force of the Party to promote and reinforce the far-reaching and profound reforms in China.²⁷ At the fourth meeting held on 18 August 2014, the Leading Group decided to launch the Reform Scheme on Managers' Remuneration in CCEs (中央管理企业负责人薪酬制度改革方案).²⁸ However, the details of this scheme and its implementation process are not openly published. As a consequence, the information can only be obtained from media broadcast.

An essential resolution of this meeting is cutting down the extra high remuneration in CCEs, in order to make sure the remuneration level is appropriate and the structure is reasonable.²⁹ Based on this resolution, the MOF and the Ministry of Human Resources and Social Security (人力资源部与社会保障部, MHRSS) collaboratively drafted a regulation which planned to cut down the total remuneration of CCEs' managers by 30% in 2015 and control each manager's annual remuneration within RMB 600,000 (approximately GBP 60,000 in 2014).³⁰ However, according to an official in the MHRSS, the cap on the annual total amount was later changed from RMB 600,000 to 'within eight times of the average salary of all CCEs' employees in last year'.³¹

These policies were planned to be uniformly applied to both non-financial and financial CCEs since 2015. However, there was no official disclosure about whether and how these policies have been implemented. Nevertheless, some clues can be detected from the

²⁷ The leader of the Leading Group is the General Secretary (总书记) of the CCP, President Xi Jinping. Prime Minister Li Keqiang and other important dignitaries are group members. See 'Diagrammatising the CCP Central Leading Group for Comprehensively Deepening Reforms' (图解中央全面深化改革领导小组) *CCP News* (Beijing, 23 January 2014) <http://cpc.people.com.cn/n/2014/0123/c164113-24208994.html> accessed 4 December 2016

²⁸ 'Xi Jinping Held the Fourth Meeting of the Central Leading Group for Comprehensively Deepening Reforms' (习近平主持召开中央全面深化改革领导小组第四次会议) *Sina News* (Beijing, 18 August 2014) <http://news.sina.com.cn/c/2014-08-18/174730704694.shtml> accessed 4 December 2016

²⁹ Ibid

³⁰ 'A Major Surgery on Executive Remuneration in CCEs' (央企高管薪酬“大手术”) (*Xinhua Online* (Beijing, 26 August 2014) <http://www.xinhuanet.com/fortune/cyjj/14.htm> accessed 4 December 2016; 'Senior Managers' Remuneration in SOCBs May Be Decreased by 70% and No More than RMB 600,000' (国有银行高管薪酬将削减七成, 年薪不能超过 60 万) *Tencent Finance* (Beijing, 25 August 2014) <http://finance.qq.com/a/20140825/010363.htm> accessed 12 December 2017

³¹ BBC, 'China's 72 CCEs Formally Carried Out the Reduction and Disclosure Policies on Managers' Remuneration' (中國 72 家央企負責人正式實施降薪並公開薪酬) (*BBC Chinese*, 3 January 2015) http://www.bbc.com/zhongwen/trad/china/2015/01/150103_china_stateowned_corporation_salary accessed 30 July 2017

information of bankers' remuneration disclosed in the SOCBs' annual reports. Since 2015, top bankers, including executive directors, presidents and vice presidents in the five SOCBs have received less than RMB 900,000 as their annual payments. This level was much less than what these bankers had earned before 2014, which was roughly more than RMB 1.5 million. It shows that the total remuneration levels of SOCBs have declined by more than 30% after the Leading Group's fourth meeting was held in 2014. Moreover, according to the SOCBs' annual reports in 2015 and 2016, all of them have announced that 'since 2015, the remuneration of the chairman of the BOD, executive directors, president, vice presidents and other senior managers will be in line with the government's policy of reforming managers' remuneration in CCEs'.³² Although the banks kept the contents of the CCP's policy confidential, it can be confirmed that a tough 'cutting down' policy based on the resolution made in the fourth meeting has been applied to SOCBs.

From a legal perspective, the CCP's resolution is not a part of the formal regulatory framework. Nonetheless, it would decisively affect the implementation of the formal regulation. The CCP's remuneration cap is essentially different from the caps adopted by the CBRC and the MOF. The 'bonus cap' in the CBRC Guidelines keeps pace with the regulatory experience of the EU. Moreover, it is less strict than the EU's stipulations, and it still provides some leeway to banks to decide bankers' remuneration. The MOF's restriction on bankers' fixed remuneration is much more intrusive since banks have little discretion to decide the basic line of fixed remuneration. Nevertheless, banks are still partially free since the distributive coefficient is decided by banks. In addition, the MOF's requirement to reduce bankers' total remuneration in 2008 was only a temporary and emergent policy. On the contrary, the CCP's remuneration cap is a regular and direct control over bankers' remuneration. It entirely disempowers SOCBs to decide bankers' remuneration and paralyses the relevant formal rules issued by the CBRC and the MOF. It demonstrates that the *Nomenklatura* System still has a substantial effect against the marketisation and modernisation reform of bankers' remuneration.

7.4.2 Equity-based Remuneration and Long-term Incentives

7.4.2.1 The Suspension of Equity-based Remuneration

Equity-based remuneration originated from the business practice in the West and developed into a highly marketised method of incentivising employees. However, due to the short history of China's market economy, equity-based remuneration was not introduced to Chinese companies until 2005.

In 2005, the CSRC promulgated the Regulatory Measures for the Equity-based Incentives of Listed Companies (For Trial Implementation) (上市公司股权激励管理办法 (试行)) (No.151, December 2005) to encourage listed companies, including listed financial

³² For instance, see ICBC Annual Report 2016, 113

institutions to adopt modern incentive mechanisms. From 2006 to 2008, the CSRC and other regulatory bodies further issued a flurry of regulations to guide and promote the use of equity-based remuneration.³³ During these three years, except ABC, the other four SOCBs completed their IPOs. Many JSCBs also became public companies.³⁴ Therefore, right before the GFC, these listed banks had launched or prepared to launch their equity-based incentive schemes.³⁵

However, the failure of many top-ranking banks in Western financial markets during the GFC exposed the flaws of the inappropriate use of equity-based remuneration. In comparison with the West, neither the financial market nor the system of financial regulation in China has been maturely developed. Therefore, being afraid of causing the similar problem, the MOF issued an emergent notice: the Notice on the Issues About the Removal of Equity-based Incentives in State-owned Financial Institutions (关于清理国有控股上市金融企业股权激励有关问题通知) (No.65, July 2008). In this notice, the MOF announced an injunction, according to which without specific legal authorisation, all of the state-owned financial institutions were not allowed to adopt equity-based remuneration. Moreover, those schemes which had been launched or been prepared to launch must be removed.³⁶ In fact, the injunction affected not only SOCBs but also other banks. Facing with the tightened macro-policy environment and the regulators' unfavourable attitude, banks had to cease the equity-based remuneration plans in their infancy.³⁷ As a consequence, equity-based remuneration was completely removed from the Chinese banking sector. The only exception was the Stock Appreciation Rights (SARs) scheme adopted by Merchants Bank since in 2007. The details of the scheme will be provided in Chapter 8.

Until today, the Chinese banking regulators have not released any official announcement to lift the temporary ban on equity-based remuneration. Nevertheless, in 2013, the then CBRC

³³ These documents include: State-owned Assets Supervision and Administration Commission (国有资产监督管理委员会, SASAC), *The Regulatory Measures for Listed SOEs to Exercise Equity-based Incentives (At Overseas Markets)* (国有控股上市公司(境外)实施股权激励试行办法) (No.8, December 2006); SASAC, *The Regulatory Measures for Listed SOEs to Exercise Equity-based Incentives (At Domestic Market)* (国有控股上市公司(境内)实施股权激励试行办法) (No.175, December 2006); CSRC, *The No.1, 2 and 3 Memorandum About Equity-based Incentives* (股权激励有关事项备忘录 1、2、3号) (2008)

³⁴ For the details of Chinese banks' IPOs, please refer to Table 6.2 and 6.3.

³⁵ 'Merchants Bank Plans to Launch A Share Equity Incentives' (招行拟推 A 股股权激励) *Caixin* (Beijing, 19 March 2008) <http://finance.caixin.com/2008-03-19/100065782.html> accessed 2 August 2017; 'BCM Preparing the Equity-based Incentive Mechanism for Executives' (交通银行酝酿高管股权激励制度) *Sohu Finance* (Guangzhou, 15 September 2005) <http://business.sohu.com/20050915/n240393220.shtml> accessed 2 August 2017

³⁶ MOF, 'The MOF Emergently Stopped the Equity-based Incentives in State-owned Listed Financial Institutions' (财政部紧急叫停国有金融上市企业股权激励) (*MOF Website*, 31 July 2008) http://www.mof.gov.cn/zhengwuxinxi/caijingshidian/zgnet/200808/t20080801_60416.html accessed 2 August 2017

³⁷ MOF, *The Notice on the Issues About the Managers' Remuneration in State-owned and State-controlled Financial Institutions* (关于金融类国有和国有控股企业负责人薪酬管理有关问题的通知) (No.2, January 2009), Article 6

Governor Shang Fulin indicated that the regulators would gradually restart the trial implementation of equity-based remuneration in banks. At the same time, in order to avoid the remuneration failures in the West, equity-based remuneration plans should focus on long-term incentives.³⁸ In practice, after 2014, several Chinese banks have reintroduced equity-based remuneration. These banks include SOCBs, JSCBs and local banks. For instance, in 2015, BCM launched the pilot plan of equity-based remuneration.³⁹ In the history of China's banking reform, BCM has always been playing a role as the pioneer to explore new approaches of business operation and corporate governance. During the processes of shareholding reform, capital reorganisation and IPO, BCM was always the first among the SOCBs to feel the way for others. Therefore, BCM's trail scheme signals that the policy makers have partially relaxed the restriction on equity-based remuneration and been exploring a gradual and moderate way to develop modern incentive mechanisms in the banking sector.

In developed financial markets, the incentive mechanism of equity-based remuneration stimulated bankers to take excessive risks. The real problem was that the design of equity-based awards was prone to short-term profits and the increase of share price. Nevertheless, the post-crisis reforms taken by Western banking regulators demonstrate that if the incentive mechanism can be appropriately designed to promote prudential risk management and long-term sustainability, the adoption of equity-based remuneration can be beneficial to financial stability and the public interest.

In China, in order to reduce the uncertainties and risks during the transitional banking reform, financial and economic stability has always been emphasised by the banking regulators. In addition, the government has maintained strong power to intervene in banks' internal governance and decision-making processes. As a result, banks' operations and bankers' activities are always stability-oriented. The Chinese banking sector lacks a risk-taking culture. Therefore, the problems of managerial short-termism and excessive risk-taking are rare. However, too much emphasis on stability and excessive state control have hindered financial competitiveness and the efficiency of bank corporate governance. Different from developed financial markets where the application of equity-based remuneration should be controlled for prudential risk-taking, in the Chinese banking sector, it should be encouraged to push forward the modernisation and marketisation of bankers' remuneration system and bank corporate governance. Thus, if equity-based remuneration

³⁸ 'Shang Fulin Indicated that Bank's Equity-based Remuneration May Be Restarted After Suspended for Five Years' (尚福林表态银行股权激励有望重启, 此前已经暂停 5 年) *Sina Finance* (Guangzhou, 18 September 2013) <http://finance.sina.com.cn/china/20130918/071916794577.shtml> accessed 2 August 2017

³⁹ 'BCM Leading the Pilot Reform; Equity-based Incentives Mostly Expected' (交通银行带头试点改革, 股权激励最受期待) *Sina Finance* (Beijing, 17 June 2015) <http://finance.sina.com.cn/stock/s/20150617/084122453241.shtml> accessed 2 August 2017

had not been suspended, the reform of bankers' remuneration in China would have been more progressive than the current situation.

Nevertheless, in 2008, developed financial markets were struggling with the problem of equity-based remuneration and had not figured out an efficient regulatory solution. The Chinese banking regulators had no experience in dealing with the risks and failures in the exercise of equity-based remuneration. In this context, the suspension was the safest way, though it has had many negative effects. From this point of view, the decision of the Chinese banking regulators is understandable.

7.4.2.2 Deferral, Clawback and *Malus*

Western banking regulators have taken a series of measures to solve the problem of equity-based remuneration. For example, deferral, clawback and *malus* are the most important regulatory measures taken by the UK regulators to encourage long-term incentives and risk control. The international banking regulators have also recommended these measures. Therefore, the CBRC has introduced these measures and required banks to apply them to cash-based variable remuneration.

The purpose to adopt deferral, clawback and *malus* is to make sure that the payment periods of bankers' remuneration are compatible with different kinds of risks in banks' business operations.⁴⁰ Thus, an appropriate part of bankers' performance-based remuneration should be scheduled into long-term incentive schemes.⁴¹ The CBRC Guidelines stipulate that for bankers who have a significant impact on banks' risk-taking activities, at least 40% of the performance-based remuneration shall be subject to deferral. The deferral arrangement should contain a lockup period of no less than three years. Besides, for those bankers at the main positions in banks, the deferred proportion shall be no less than 50%. During the lockup period, the deferred remuneration shall be paid no faster than a pro-rata basis. Based on the threshold, banks can set up a higher percentage of deferral or adopt a longer lockup period in accordance with banks' operational situations and risk profiles.⁴²

Moreover, the CBRC Guidelines require banks to apply clawback and *malus* to performance-based remuneration when bankers' activities have caused excessive risk exposure. Same as the UK approach, clawback is applied to paid performance-based remuneration and *malus* to deferred unpaid portion.⁴³ However, the provisions about clawback and *malus* are too general and ambiguous. The lengths of clawback and *malus* and the conditions to apply the two measures are not specified in the CBRC Guidelines. As

⁴⁰ *The CBRC Guidelines*, Article 11

⁴¹ *The CBRC Guidelines*, Article 14

⁴² *The CBRC Guidelines*, Article 16. The MOF Measures have also incorporated these rules, see Article 18.

⁴³ *The CBRC Guidelines*, Article 16

a consequence, banks do not know in what circumstances clawback and *malus* should be applied and how to apply them. It seems that the CBRC leaves much discretion to banks. However, without clear instructions, the two measures have become unenforceable in practice: none of the Chinese banks has incorporated clawback or *malus* in their remuneration systems. More practical evidence and discussions about the implementation of the two measures will be provided in Chapter 8.

The direct reason for clawback and *malus* being unspecified is the scarcity of experience and examples. When the CBRC Guidelines were published in 2010, how to enforce clawback and *malus* was still being discussed by Western banking regulators. In the UK, the policy recommendations made before 2010 were also general principles, rather than specific rules. As a consequence, there was no experience for the CBRC to learn from. When the relevant measures have not been well designed by other national banking regulators, the CBRC is incompetent to provide independent or specific policies or improve its policy-making quality. This limitation has a negative impact on the implementation of these advanced and modern regulatory measures.

7.4.3 Performance Metrics and Assessment

7.4.3.1 Performance Metrics

In order to direct bankers to focus on financial stability and the public interest, the FSB has suggested that performance metrics in bankers' remuneration shall be attached to not only profitability-based factors but also stability-oriented ones, especially risk control and management.⁴⁴ As stated, excessive risk-taking has never been a real problem in the Chinese banking sector. On the contrary, bankers were required to maintain the stability of the financial system, and the macroeconomic and political environment. However, these stability-oriented incentives were traditionally exercised through the administrative and politicised approach, with the state playing a controlling and intrusive role. Under this approach, Chinese bankers were usually less attentive to business efficiency and profitability. The incentives for Chinese bankers should also maintain a balance between efficiency and stability. Nevertheless, contrary to Western bankers, they need to be encouraged to focus more on business efficiency and profitability.

Therefore, the CBRC and the MOF have enacted the rules on performance metrics, which contain both profit-based and stability-based indicators. These rules constitute the current system of performance metrics. The details are shown in Table 7.1.

According to the CBRC Guidelines, banks are required to evaluate bankers' performance from three aspects: economic efficiency, risk control and social responsibility. The CBRC has designated the specific metrics for evaluating the achievements in risk control and social

⁴⁴ The FSB, *Principles for Sound Compensation Practices*, Principle 4-7

responsibility⁴⁵ and complied with the MOF standards on the metrics of economic efficiency.

In January 2009, the MOF enacted the Interim Regulatory Measures for the Performance Assessment in State-owned and State-controlled Financial Institutions (金融类国有及国有控股企业绩效评价暂行办法, hereafter the ‘MOF Performance Assessment Measures’) (No.3, January 2009), aiming at introducing standardised and scientific methods to assess the performance of financial institutions.⁴⁶ Originally, the system in the MOF Performance Assessment Measures is not for the assessment of bankers’ performance. It is for the evaluation of each institution’s financial situation. Nevertheless, the MOF Measures have referred to the system to assess bankers’ performance.

As shown in Table 7.1, the system contains four types of performance metrics: operating income growth, profitability, assets quality and debt-paying ability.⁴⁷ All of the four types are financial indicators. Operating income growth and profitability are about economic efficiency, while assets quality and debt-paying ability are about risk management and sustainability. For each type, the MOF has specified the specific metrics and the corresponding weightings.

Table 7.1 The System of Performance Metrics in the CBRC Guidelines and the MOF Measures

CBRC	
Type	Metrics
Economic efficiency	Referring to the MOF rules
Risk control	Including but not limited to: CAR, NPL ratio, provisioning coverage ratio, leverage ratio, and so on.
Social responsibility	Including but not limited to: regulatory compliance, the assessment of regulators, moral compliance, and so on.

MOF					
Type	Metric	Weighting (%)	Type	Metric	Weighting (%)
Operating income growth	Hedging and proliferating ratio of state-owned assets	10	Assets quality	NPL ratio	10
	Profit increasing ratio	10		provisioning coverage ratio	5
	Economic profit ratio	5			
Profitability	ROE	15	Debt-paying ability	CAR	15
	Return on Assets	10		Core CAR	15
	Cost-benefit ratio	5			

⁴⁵ *The CBRC Guidelines*, Article 19

⁴⁶ *The MOF Performance Assessment Measures*, Article 1

⁴⁷ *The MOF Performance Assessment Measures*, Appendix II: The Table of Metrics and Marking (附件二: 指标及结果评分表)

7.4.3.2 Performance Assessment

The CBRC and the MOF have also issued the methodology for the assessment of bankers' performance and the calculation of their performance-based remuneration. The CBRC has enacted a scheme to decide the entire scale of all bankers' performance-based remuneration according to the achievements in risk control. According to this scheme, among the metrics of risk control listed in Article 19 (2) of the CBRC Guidelines, if one of these metrics has not been achieved in the past financial year, the amounts of performance-based remuneration cannot be increased. If two not achieved, banks must decrease the amounts of performance-based remuneration. The range of decline is decided by banks. If three not achieved, the amounts of performance-based remuneration in the current financial year shall be decreased. Moreover, the amounts in next financial year shall not be increased.⁴⁸ Obviously, in order to monitor and control banks' risk-taking activities, the CBRC has directly aligned banks' risk profiles with bankers' variable remuneration.

The MOF's rules shown in Table 7.1 also acts as a rating system, which is for the MOF to evaluate every bank's achievements in these metrics. Usually, every bank will get an aggregate score from the MOF, which is the outcome by adding up the scores of each individual metric.⁴⁹ Based on the aggregate score, the MOF can add an increment if the bank has made dramatic achievements in business development or corporate governance. However, if the bank induced significant losses, an extra deduction would be made by the MOF.⁵⁰ According to the final scores, the MOF will allocate all of the state-owned and state-related banks to the five rating levels, from A to E.⁵¹ Table 7.2 itemises the score ranges of each rating level and the corresponding assessments.

The rating level of each individual bank is used to calculate its bankers' remuneration. The MOF Measures lay down the formula for banks to decide performance-based remuneration:⁵²

$$\text{Performance-based Remuneration} =$$

$$\text{Basic Salary} \times \text{Remuneration Multiple} \times \text{Assessment Coefficient}$$

The remuneration multiple (绩效年薪倍数) is decided by a bank's final score and its rating level. Table 7.2 shows the figures of remuneration multiple commensurate with each level. Clearly, the figure of the remuneration multiple depends on a bank's overall performance, which is uniformly calculated by the MOF. The assessment coefficient (考核浮动系数) depends on a bank's internal evaluation of the performance of each individual banker.

⁴⁸ *The CBRC Guidelines*, Article 20

⁴⁹ *The MOF Performance Assessment Measures*, Article 18

⁵⁰ *The MOF Performance Assessment Measures*, Article 19 and 20

⁵¹ *The MOF Performance Assessment Measures*, Article 22 and 23

⁵² *The MOF Measures*, Article 14

Banks can develop their own standards, while the MOF requires that the assessment coefficient must be kept in between 0.5 to 1.⁵³

Table 7.2 The MOF Rating Mechanism for Calculating Bankers' Performance-based Remuneration

Final score	Rating level	Assessment	The multiple to calculate remuneration
100-85	A	Excellent (优)	2-3
84-70	B	Good (良)	1.5-2
69-50	C	Satisfactory (中)	1-1.5
49-40	D	Barely Passed (低)	0-1
0-39	E	Failed (差)	0

The system of performance metrics and assessment in the regulatory framework is highly compatible with the international principles of banking regulation and the regulatory practices in developed financial markets. If the rules can be efficiently implemented, it will, on the one hand, encourage bankers to increase banks' profits and compete with others, and on the other hand, promote banks' prudential risk-taking and sustainability.

7.5 Comments on the Current Regulatory Framework

In order to 'make banks into real banks', the modernisation and marketisation reform of bankers' remuneration is a crucial step. Clearly, the CBRC and the MOF have made great efforts to establish a modern and professional regulatory framework to guide banks to reform their remuneration and incentive systems.

The regulatory framework of bankers' remuneration is established on the international standards and the post-crisis experience of developed financial markets. Many modern and advanced regulatory measures have been introduced to this framework. In particular, the CBRC drafted the Guidelines by referring to the FSB's standards and other jurisdictions' regulations. After the GFC, the fundamental principles of the regulation of bankers' remuneration are maintaining financial stability and protecting the public interest. In particular, the regulation should aim at intensifying the pay sensitivity to prudential risk management and long-term incentives. The key measures taken by Western regulators to achieve these regulatory goals include enhancing the role and independence of remuneration committee, long-term deferral, clawback and *malus*, bankers' bonus cap and risk-adjusted performance metrics. It is clear that the CBRC Guidelines are based on the aforementioned principles and have introduced the majority of these measures, though the detailed stipulations are different. In addition, the MOF Measures have also designed a system of performance metrics and assessment based on profitability and risk control.

The current regulatory framework is a significant advancement. It shows that the regulation of bankers' remuneration in China has been keeping pace with the international standards

⁵³ *The MOF Measures*, Article 1

and the regulations in developed financial markets. Nevertheless, the Chinese regulatory approach is still very special. In general, the way of the CBRC and the MOF to push forward the regulatory measures is far more intrusive than their Western counterparts, which shows the typical features of the traditional administrative and politicised approach.

In the UK, the EU bankers' bonus cap has encountered strong resistance. One of the reasons is that capping bankers' remuneration would lead to undue governmental interference and limit banks' discretion and market autonomy. In striking contrast, the Chinese banking regulators have imposed compulsory requirements on the variable-fixed remuneration ratio, and the amounts of basic salary and total remuneration, which enable them to tightly control both the level and structure of bankers' remuneration. The MOF's unified formula to calculate bankers' basic salaries and its temporary cap on bankers' total remuneration in 2008 have directly replaced the role of the market. More seriously, the CCP's requirement to reduce the remuneration levels of SOCBs by 30% is a strong embodiment that political intervention remains a significant impact on bankers' remuneration. Due to these actions, banks' autonomy is restricted and the market mechanism is paralysed.

Moreover, the MOF's injunction on the adoption of equity-based remuneration would impair banks' initiatives to learn from other markets' experience and explore more efficient incentive methods. In terms of the performance metrics and assessment, the rules in the MOF Measures are very similar to the practices of UK banks.⁵⁴ However, the difference is that, in the UK, the specific metrics and assessment systems are designed by banks on a discretionary basis. The UK Remuneration Code only provides generic guidance.⁵⁵ On the contrary, the MOF has designed a unified and standardised system with all of the details. The system is binding on all SOCBs and state-related banks and highly influential on all the other banks. Namely, all banks should comply with the same standards to assess their bankers' performance and decide their remuneration. As a consequence, banks are left with little leeway to make adjustments.

The strong regulatory interference would not mitigate but consolidate the administrative and politicised approach, which has long been the dominant model of the interaction between the government and banks. If the regulators arrange every step through compulsory commands, banks will lose the sense of autonomy and innovation, and completely follow the regulators' instructions. As a result, these intrusive actions depart from the original objective of the regulatory reform of bankers' remuneration in China, which is towards modernisation and marketisation.

In short, the regulatory framework of bankers' remuneration in China has been progressively developed, with a lot of modern and market-based measures adopted.

⁵⁴ For the practices of UK banks, please refer to Appendix E.

⁵⁵ Please refer to Subsection 4.4.3.

However, the approach to enacting and implementing these measures is based on the intrusive role of the regulators. As a result, the framework has preserved the convention of political intervention. The contradiction between modern and traditional approaches demonstrates that the regulatory reform of bankers' remuneration in China is still at the transitional stage, rather than fully accomplished.

7.6 Conclusion

This chapter has provided an overall and integrated analysis of the regulatory framework of bankers' remuneration in China, which has been established in the contexts of the regulatory tightening of bankers' remuneration at the international level and the necessity to push forward the modernisation and marketisation reform of the Chinese banking system at the domestic level. It gives answers to the question: what actions have been taken by the Chinese regulators recently to reform bankers' remuneration?

In 2010, based on the FSB standards and the regulatory experience of developed financial markets, the CBRC issued the Guidelines for bankers' remuneration, with a series of modern and market-based regulatory measures adopted. Simultaneously, more detailed requirements have been enacted through the MOF Measures. These two regulatory documents, as the pillars, have formed the first formal and professional regulatory framework of bankers' remuneration in China.

In terms of the decision-making power of bankers' remuneration, the CBRC favours to put the BOD at the core and to impose the responsibility of protecting stakeholders' interests on the BOD. The purpose is to avoid the problems of excessive risk-taking and short-termism. The CBRC's regulatory philosophy is compatible with the widely accepted principles of banking regulation at the international level, which are learned from the GFC.

In terms of regulating bankers' remuneration level, components and structure, and incentive mechanism, the CBRC also closely follows the international standards and Western experience. The Guidelines have introduced bankers' bonus cap, deferral, clawback and *malus*, and risk-adjusted performance metrics and assessment. Moreover, the MOF Measures have also enacted the caps on bankers' remuneration and developed a unified and standardised system of performance metrics and assessment.

Despite the significant advancements, the current regulatory framework has largely preserved the conventions of the administrative and politicised approach. The caps on bankers' remuneration level, the injunction on the application of equity-based remuneration and the specified system of performance metrics and assessment demonstrate that the regulators still play a very intrusive role in deciding bankers' remuneration, whereas banks' autonomy and discretion are significantly limited. Therefore, the function of market mechanism has not been enhanced yet.

In order to establish an efficient and benign market environment for bankers' remuneration, both market mechanism and regulatory mechanism are needed. Moreover, the way how the two mechanisms interact and cooperate with each other is essential. The market should play a fundamental role in deciding bankers' remuneration. At the same time, the regulation should be reasonable and appropriate to correct market deficiencies. Therefore, neither insufficient nor excessive regulatory intervention will be conducive to a well-functioning remuneration system. In the UK, the regulation of bankers' remuneration was absent before the GFC. Thus, the reform is to enhance the role of regulation. Whereas in China, the problem is that the government has been excessively intrusive. Therefore, the reform is to promote the marketisation of bankers' remuneration and shift the role of the government from the controller to the real market regulator. Obviously, the Chinese banking regulators have made many efforts to cultivate the market. However, at the transitional period, the role and actions of the regulators are still perplexing and even self-contradictory. The regulators, on the one hand, are ambitious to push forward the reform of bankers' remuneration, whereas on the other hand, they cannot completely get rid of the intrusive approach.

All in all, the regulatory framework of bankers' remuneration in China is not perfect. In order to solve the current problems, further actions are needed. Moreover, the framework would be confronted with more problems in the process of enforcement. In order to better and more comprehensively understand the effects and drawbacks of the current regulatory framework, it is necessary to examine the remuneration practices of Chinese banks.

Chapter 8

The Practice of Bankers' Remuneration and the Evaluation of the Chinese Regulatory Framework

8.1 Introduction

Before the GFC, many major Chinese banks had completed the shareholding reforms and turned into listed corporate groups. Nevertheless, bank corporate governance was still based on the traditional administrative and politicised approach. As a key aspect of corporate governance, the modernisation and marketisation reform of bankers' remuneration has become an essential step, in order to push forward and deepen the transitional banking reform and develop banks' businesses in the international financial markets.

The problem of bankers' remuneration in China was inherently embedded in the transitional nature of its financial system and economy, while not materially related to the GFC. Nevertheless, the remuneration failures in developed financial markets have warned the Chinese regulators about the necessity and importance of a professional and efficient regulatory framework. Moreover, the post-crisis solutions taken by the international and Western regulators have provided the experience for China. The regulatory reform of bankers' remuneration in China was launched and implemented in the same period of the reforms in the West, and many of the principles and measures are similar.

The regulatory framework in China has been given a high expectation to ameliorate the practice of bankers' remuneration and cultivate good corporate governance in banks. With reference to the international standards and Western experience, the rules in the regulatory books are progressive and integrated. However, it is always a common concern among Chinese legal scholars that the enforcement of the rules of law is in low efficiency.¹ In Chinese companies, particularly in SOEs, it is very often not the rules of law, but alternative shadow and informal institutions that are followed in practice.²

¹ It is generally acknowledged that in some developing countries and countries in the transition from central planning to liberal market economy, the laws exist only on paper and would not be known or respected by the public or enforced by the state. The problem can also be observed in China's legal and regulatory practice. see Cheryl W. Gary, 'Reforming Legal Systems in Developing and Transition Countries' (1997) 34 (3) *Finance & Development* 14, 14; Erik Berglöf and Stijn Claessens, 'Enforcement and Good Corporate Governance in Developing Countries and Transition Economies' (2006) 21 (1) *The World Bank Research Observer* 123, 123-4; Jiangyu Wang, 'The Political Logic of Corporate Governance in China's State-owned Enterprises' (2014) 47 *Cornell International Law Journal* 631, 651; Tang Xin, 'Protecting Minority Shareholders in China: A Task for Both Legislation and Enforcement' in Curtis Milhaupt *et al*, *Transforming Corporate Governance in East Asia* (1st edn, Routledge 2008) 141, 142; Donald Clarke, 'Law Without Order in Chinese Corporate Governance Institutions' (2010) 30 *Northwestern Journal of International Law and Business* 131, 138; Hui Cai, 'Bonding, Law Enforcement and Corporate Governance in China' (2007) 13 (1) *Stanford Journal of Law, Business and Finance* 82, 118 & 120

² Jiangyu Wang, 'The Political Logic of Corporate Governance in China's State-owned Enterprises' (ibid) 651; Saul Estrin and Martha Prevezer, 'The Role of Informal Institutions in Corporate Governance: Brazil, Russia, India and China Compared' (2011) 28 (1) *Asia Pacific Journal of Management* 41, 52

As a consequence, in order to understand to what extent the regulatory framework has been functional and effective, it is necessary to comprehensively and elaborately scrutinise the practice of bankers' remuneration since the regulation came into force.

For feasibility and significance, this chapter will illustrate the remuneration practices of two major types of Chinese banks: SOCBs and JSCBs, in order to empirically track and analyse the changes in bankers' remuneration level, components and structure, and incentive mechanism. On the one hand, these banks are the largest and most important banks in China. They are always at the cutting edge to carry out reform policies. Thus, their remuneration and incentive systems are representative. On the other hand, for a technical reason, the information disclosure in these banks is more sufficient than SMS banks, which facilitates the access to the data of bankers' remuneration and incentives.

The empirical studies on the remuneration practices of SOCBs and JSCBs are presented in Section 8.2 and 8.3 respectively. Based on the empirical evidence, Section 8.4 will summarise the features of the *de facto* remuneration and incentive systems of major Chinese banks, and construe the effects of the regulation. Section 8.5 is the conclusion.

8.2 The Practice of Bankers' Remuneration and Incentives in SOCBs

The five SOCBs are at the heart of the Chinese banking system. In the official reports of the CBRC and the PBOC, the state-owned character of these banks is deliberately avoided, in order to mitigate the stereotyped understanding that these SOCBs are completely subject to state control and administrative commands. Instead, they are described as 'large commercial banks' (大型商业银行). Nevertheless, the fact is that the state owns these banks' majority equities. It is still the controlling shareholder of ICBC, BOC, CCB and ABC, and the largest shareholder of BCM. Table 8.1 shows the percentages of state ownership in the five banks by the end of 2016.

Table 8.1 State Ownership in Chinese SOCBs by 2016³

	ICBC	BOC	ABC	CCB	BCM
Direct ownership	69.31%	64.02%	82.26%	57.11%	30.95%
Total ownership	71.34%	67.57%	84.52%	60.19%	38.97%

Among more than 4,000 banking institutions in China, SOCBs are at the top five positions and dominate 57.78% of the credit market.⁴ Domestically, SOCBs are the main force to

³ The figures are calculated by the author in line with the information of shareholdings published in these banks' annual reports in 2016. The direct state ownership refers to the equities that are directly owned by the agency bodies of the state, including the MOF, the CHI Ltd. and the National Council for Social Security Fund (全国社会保障基金理事会). In these banks, there are also a small quantity of equities owned by SOEs. The state can indirectly control these equities. Therefore, the total state ownership is the aggregation of the direct and indirect ownerships.

⁴ The figure is calculated by the author in accordance with the PBOC statistical data on credit funds, see PBOC, 'Sources and Uses of Credit Funds of Financial Institutions: 2016 (金融机构信贷收支统计 2016)

facilitate economic growth, technical innovation and social development. At the international level, they have been increasingly important to the development of the global financial industry.

Due to the importance of Chinese SOCBs and the special state ownership which distinguishes them from other G-SIBs, a specific and independent examination of their remuneration and incentive systems is necessary. The empirical analysis is based on the information and data disclosed in banks' official documents, including annual reports, supplementary reports and board announcements.

8.2.1 The Level of Bankers' Remuneration

In total, there are 398 records of bankers' remuneration level collected from banks' official reports published from 2007 to 2015.⁵ In order to provide a comprehensive landscape about the total amounts earned by bankers at different positions and the gaps among their earnings, the records are divided into three groups: the 'chairmen and presidents' group, the 'other board members' group and the 'senior management' group. The maximum, average and minimum remuneration amounts of each group are calculated.

It is necessary to explain that in the original data, the remuneration levels of several bankers were dramatically higher than the amounts earned by majority bankers. Specifically, the average remuneration level of majority bankers was less than RMB 2 million. In contrast, these bankers' remuneration was from RMB 3 to 11 million. By scrutinising the backgrounds of these bankers, it has been found that all of them were foreign bankers or had been working in overseas banks before joined SOCBs.

As explained in Chapter 7, the MOF Measures and the Performance Assessment Measures are special regulatory documents which are only binding on SOCBs. For those bankers recruited from overseas markets, SOCBs do not need to comply with the regulation. Their remuneration and incentives can be decided by the pricing mechanism in overseas financial markets or by negotiating with these overseas bankers.⁶

Generally, the economic and social organisations in China are categorised into two types, which are known as the 'inside system' (体制内) and the 'outside system' (体制外). The 'inside system' is comprised of public organs at all levels, including the central and local governments, CCP committees, courts, procuratorate offices, police bureaus, and all kinds of economic and social organisations that are owned or controlled by the government, such

(PBOC website) <http://www.pbc.gov.cn/diaochatongjisi/116219/116319/index.html> accessed 23 December 2017

⁵ The original data, the process and criteria of data collection and the calculation method are provided in Appendix G.

⁶ *The MOF Measures*, Article 30

as SOEs, public hospitals, public universities and charities. The remainder of the society, which is operated by private entities, is the ‘outside system’.

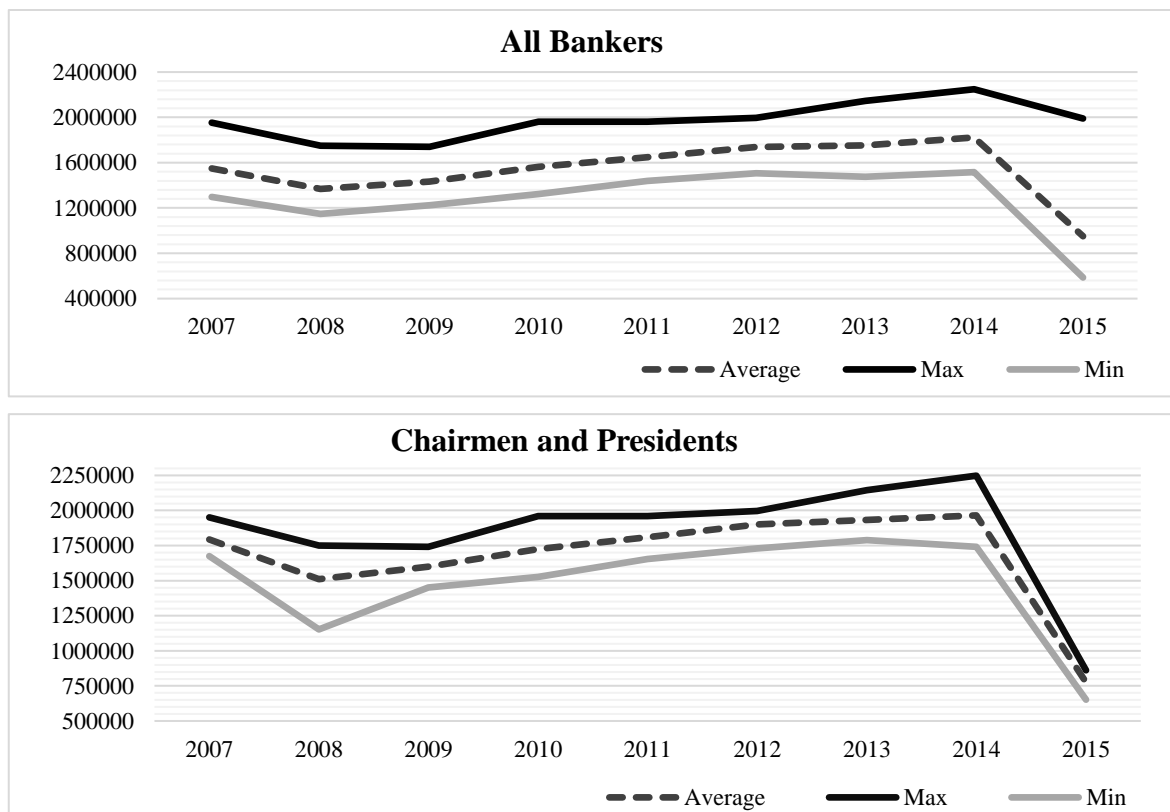
Obviously, these overseas bankers who earned much higher remuneration were from the ‘outside system’, while the majority bankers who developed their careers only within the SOCBs belonged to the ‘inside system’. The remuneration and incentive mechanism of the ‘inside system’ is the mainstream. In order to make sure the statistical outcome can objectively reflect the mainstream, the records of the overseas bankers are excluded. Their cases will be analysed independently.

8.2.1.1 The Mainstream: The Remuneration Level of Bankers in the ‘Inside System’

The yearly remuneration level from 2007 to 2015 and the evolutionary trend in this period are shown in Figure 8.1. The changing range in each year is described in Table 8.2.

Generally speaking, bankers’ remuneration of SOCBs grew mildly and steadily from 2007 to 2014, before it suddenly plummeted in 2015. Up to 2014, the average remuneration level of all bankers ranged from RMB 1.37 to 1.82 million. The increase rate was 4.7% per annum.

Figure 8.1 The Remuneration Levels of Chinese SOCBs from 2007 to 2015 (Unit: RMB)



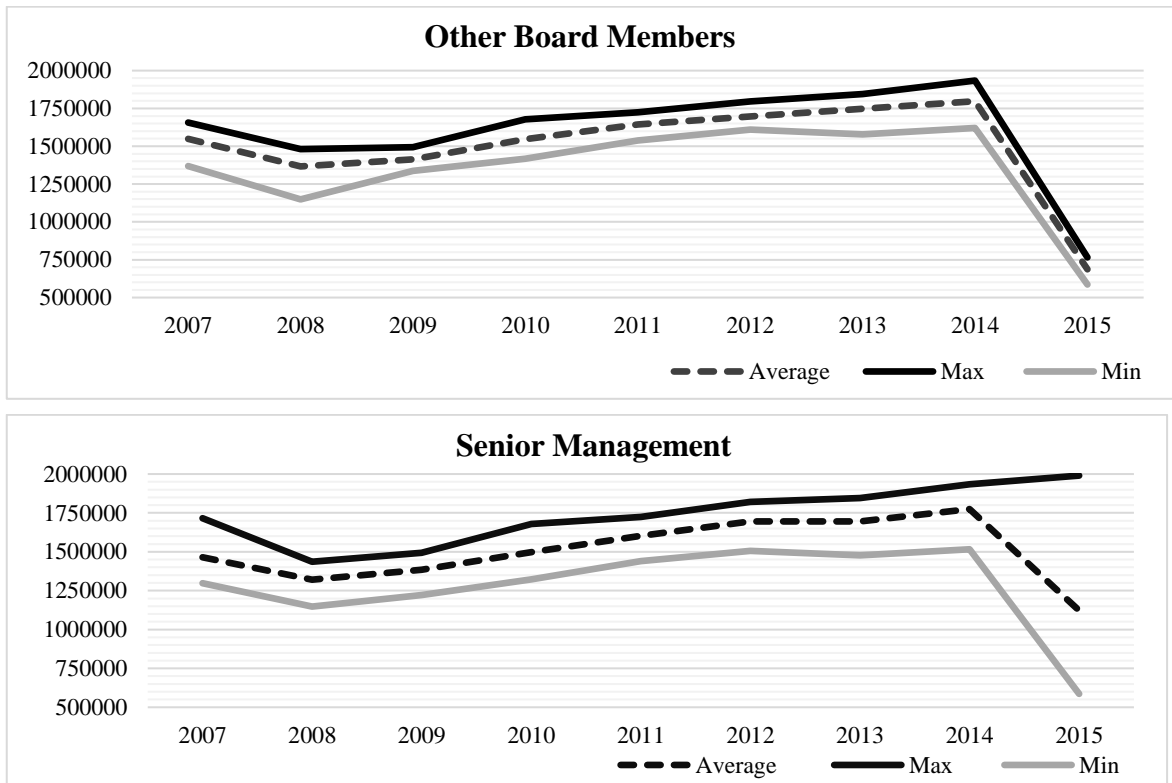


Table 8.2 The Annual Increase/Decrease Rates of Bankers' Remuneration Levels of Chinese SOCBs from 2007 to 2015

Year	2008	2009	2010	2011	2012	2013	2014	2015
Rate	-11.61%	4.70%	9.03%	5.41%	5.55%	0.82%	3.95%	-47.84%

Low Remuneration Level

The remuneration levels of chairmen and presidents were the highest. In Chinese banks, the chairman plays the leading role in the BOD and is the top power in the decision-making process. The president is the leader of the senior management and usually one of the vice chairmen of the BOD. Conventionally, the chairman and president of a bank are known as the 'first chair' and the 'second chair' (二把手). It is reasonable that bankers at the most important positions are also at the top of the remuneration hierarchy. In addition, executive directors play a more important role in banks' decision-making. Therefore, their remuneration was higher than the remuneration of senior managers. Normally, the remuneration of the secretary of the BOD was the lowest among all bankers.

The highest record was around RMB 2.24 million, which was offered to the chairman of CCB in 2014. This figure, in comparison with the amounts earned by Western counterparts, was significantly small. HSBC is a UK bank which is equivalent to Chinese SOCBs in terms of assets and world ranking. In 2014, the average remuneration of HSBC's four executive directors was GBP 7,567,000, and the maximum amount was GBP 12,545,000. Based on

the currency exchange rate at that time,⁷ on average executive directors' remuneration in HSBC was 39.6 times of that in Chinese SOCBs.⁸ If comparing the maximum amounts, the most 'valuable' executive director of HSBC earned 55.8 times of the CCB chairman's remuneration.

Besides, the remuneration levels of SOCBs were also lower than other Chinese banks. In 2014, the highest remuneration level among JSCBs' bankers was RMB 8,352,700, which was three times of the CCB chairman's remuneration. However, in terms of assets scale, market share and international influence, JSCBs are far inferior to SOCBs.

The extremely low level of bankers' remuneration of SOCBs implies two issues about the incentive mechanism. First, bankers in SOCBs were awarded significantly less than their counterparts in foreign banks and other Chinese banks. However, SOCBs are world-leading banks and have been developing rapidly in recent years. As a corollary, these bankers have excellent skills and experience in banking and financial industries. Compared to working in foreign or private banks which can offer far more competitive remuneration packages, why would they rather stay in SOCBs and be poorly remunerated? If remuneration was the primary incentive, these bankers' choices were not reasonable. Therefore, it is possible that the *de facto* incentive mechanism has not relied primarily on pecuniary benefits.

Second, SOCBs have made remarkable achievements and been growing very fast during and after the GFC. From 2011 to 2014, the total assets of SOCBs increased by 279.08%, and the average annual increase rate was approximately 34.89%.⁹ However, the trends in Figure 8.1 indicate that the total level of bankers' remuneration did not increase along with SOCBs' business growth. It is conjectural that bankers' remuneration packages were not compatible with their contributions or their banks' performance. In other words, the pay-to-performance sensitivity would be very low.

These two conjectures will be tested in Subsection 8.2.3, which will focus on the practical incentive mechanisms of SOCBs.

Stable Remuneration Gaps

In each chart of Figure 8.1, the three curves that represent the maximum, average and minimum amounts are parallel with each other. Throughout the period, the remuneration gaps among bankers were stabilised within a certain range. Figure 8.2 shows that every year

⁷ In 2014, the exchange rate between sterling and Chinese yuan was approximately 10:1. The information is available at: 'Current and Historical Rate Tables' (*Xe website*) <http://www.xe.com/currencytables/> accessed 24 December 2017

⁸ Based on the 10:1 exchange rate (see *ibid*), GBP 7,567,000 amounts to RMB 75,670,000. The average remuneration of the BOD members in the five SOCBs was RMB 1,909,177. Therefore, the former was 39.6 times of the latter.

⁹ The figure is calculated with the data collected from the CBRC, 'The Total Assets and Total Liabilities of Banking Institutions: 2011 to 2014' (2011 至 2014 银行业金融机构资产负债情况表) (*CBRC website*) <http://www.cbrc.gov.cn/chinese/home/docViewPage/110009¤t=2> accessed 19 December 2016

the ratio between the average and the maximum was about 80%, and the ratio between the minimum and the maximum was about 70%. The regularity of the ratios clearly indicates that SOCBs intentionally kept the remuneration gaps stable across this period and controlled it narrow among bankers.

In order to keep the ratios stable and narrow, banks must have applied a uniform standard to allocate the amounts of total remuneration in accordance with bankers' positions, rather than their individual performance.

According to the regulation, when deciding bankers' remuneration, SOCBs should comply with three stipulations: the formula for basic salary, the formula for performance-based remuneration and the 3:1 cap of the variable-fixed ratio.¹⁰ In Chapter 7, it has been discussed that the majority of the coefficients and parameters in the two formulas should be given by the MOF. Nonetheless, the distributive coefficient in the formula for basic salary and the assessment coefficient in the formula for performance-based remuneration are subject to banks' discretion. Banks are also free to decide the variable-fixed ratio within 3:1.

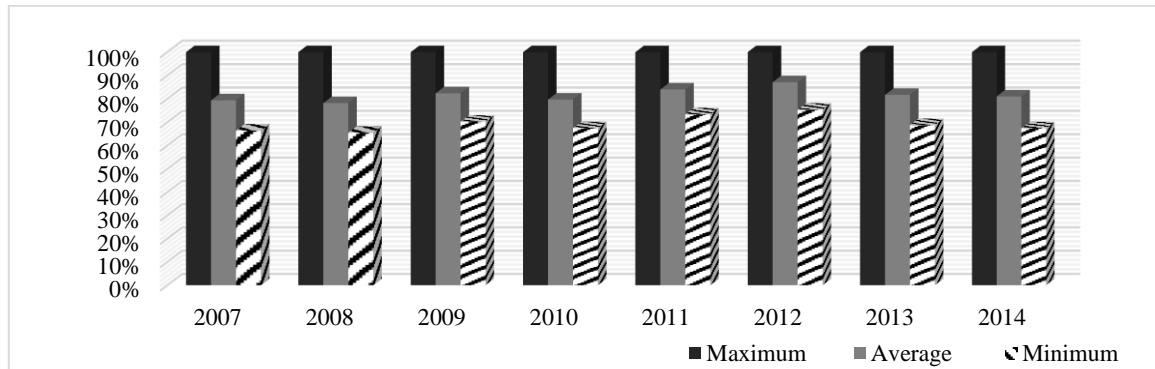
The distributive coefficient is primarily based on bankers' positions in the managerial hierarchy. From chairman to the secretary of the BOD, it should decrease. Bankers' individual performance is not taken into consideration for basic salary. Therefore, the ratios among the maximum, average and minimum levels of fixed remuneration should be stable in every year. In contrast, the assessment coefficient should be decided in accordance with bankers' individual performance. Normally, different bankers have different responsibilities and competencies. As a corollary, their performance should be different. Therefore, bankers' assessment coefficients should also be different from each other, and the amounts of performance-based remuneration must be varying. Despite the regularity in fixed remuneration, the varying performance-based remuneration should make the total remuneration levels irregular. That is to say, if bankers' performance-based remuneration had been a real reflection of their individual performance, the levels of their performance-based remuneration and total remuneration would have been different from each other and varying across years. As a consequence, the phenomenon that the gaps of total remuneration among bankers were maintained stable and regular throughout an eight-year period would not have taken place.

However, the fact was reverse: the gaps were stable and regular. Therefore, it is highly reasonable to make the hypothesis that within SOCBs, there has been a remuneration hierarchy which conforms to the managerial hierarchy of bankers, and has been applied to decide bankers' total remuneration. As a result, bankers' positions in the managerial hierarchy were the determinant factor, implying that performance-based remuneration was

¹⁰ For the details of the formulas and the ratio cap, please refer to Section 7.4.

not based on bankers' individual performance. In next subsection, this conjecture will be further tested through the examination of bankers' remuneration components and structure.

Figure 8.2 The Ratios Between Maximum, Average and Minimum Remuneration in Chinese SOCBs from 2007 to 2014



Remuneration Reduction and Cap

From 2007 to 2014, the remuneration level kept increasing on a modest and steady basis, apart from the slight fall in 2008. In contrast, in 2015, the level suddenly plummeted. Both of the declines were the consequences of regulatory tightening.

As mentioned in Subsection 7.4.1, in 2008, the MOF emergently required all Chinese banks to control the total level of bankers' remuneration within 90% of the level in 2007. Banks that suffered profit decreasing should further reduce the level by 10%. Namely, it should not be higher than 81% of the level in 2007. Since the five SOCBs still made great achievements during the GFC, the average decrease rate in 2008 should be between -10% and -19%.¹¹ As shown in Table 8.2, in 2008, the average remuneration level decreased by 11.61%, which demonstrates that the emergent remuneration cap was rigidly implemented by SOCBs.

The sharp decrease in 2015 should be attributed to the unpublished cap, which was proposed by the CCP Central Committee in 2014 and then drawn up by the MOF and the MHRSS. It requires SOCBs to reduce the total amount of bankers' remuneration by 30% and cap the level 'within eight times of the average salary of all CCEs' employees in last year'.

As mentioned before, there was no official announcement about whether the cap has been implemented or not. Nevertheless, in 2015, the average remuneration level of SOCBs dropped by 47.84%, which can strongly prove that the mandatory reduction policy has been enforced. According to the data provided by the National Bureau of Statistics of the PRC (国家统计局, NBS), in 2014, the average salary in state-owned financial institutions was

¹¹ The increase or decrease rate is the ratio between the gap of the two years' remuneration levels and the remuneration level in previous year. For instance, the rate in 2008 is:

$$\frac{\text{remuneration level of 2008} - \text{remuneration level of 2007}}{\text{remuneration level of 2007}}$$

RMB 94,943.¹² Eight times of this number is RMB 759,544. In 2015, the total remuneration levels of SOCBs' bankers were lower than RMB 759,544, which can prove that the rule of 'within eight times of the average salary of all CCEs' employees in last year' has also been applied.¹³

Nevertheless, not all of the SOCBs' bankers suffered from substantial pay reduction in 2015. As shown in Figure 8.1, the remuneration levels of chairmen, presidents and other board members plummeted. As for senior management, the average and minimum levels declined dramatically, whereas the maximum level slightly increased. It can be learned that the remuneration reduction policy has been applied to all board members and the majority of senior managers, whereas some other managers have been exempted. The original data in Appendix G provides clear and robust proof that the policy has been applied to executive directors and senior managers above the position of vice president. However, it was not mandatory for senior managers below the position of vice president, such as chief financial officer (CFO), chief risk officer (CRO), chief information officer (CIO), auditor general and the secretary of the BOD.¹⁴ Figure 8.3 shows the ratio between the remuneration levels in 2015 and 2014 of each banker, who had worked at the same position in these two years. Clearly, the remuneration of lower-level bankers exceeded the remuneration of top bankers.

Different from the emergent policy in 2008, the mandatory remuneration cap in 2015 was not due to any economic reason. In 2015, the businesses of SOCBs continued to boom. There were no financial losses or corporate scandals caused by bankers' wrong decisions. Therefore, the cap was neither a response to the downturn in the financial market nor a punishment for any specific failure in corporate governance. In fact, the purpose to impose the remuneration cap was political-based rather than market-oriented.

As analysed in Subsection 7.4.1, the cap was proposed by the CCP Central Committee and implemented by the government. It enables the authorities to determine bankers' remuneration through a straightforward and intrusive way. The cap is only binding on the top leaders in SOCBs. However, the leading bankers are at the heart of a SOCB's decision-making process, and they are the most important human resources in the state-owned banking sector. Obviously, the authorities still want to keep the country's core financial cadres under their control, through which they can powerfully make decisions for SOCBs' operations and the allocation of state-owned financial capital. This remuneration cap completely adheres to the ossified administrative and politicised approach, while running

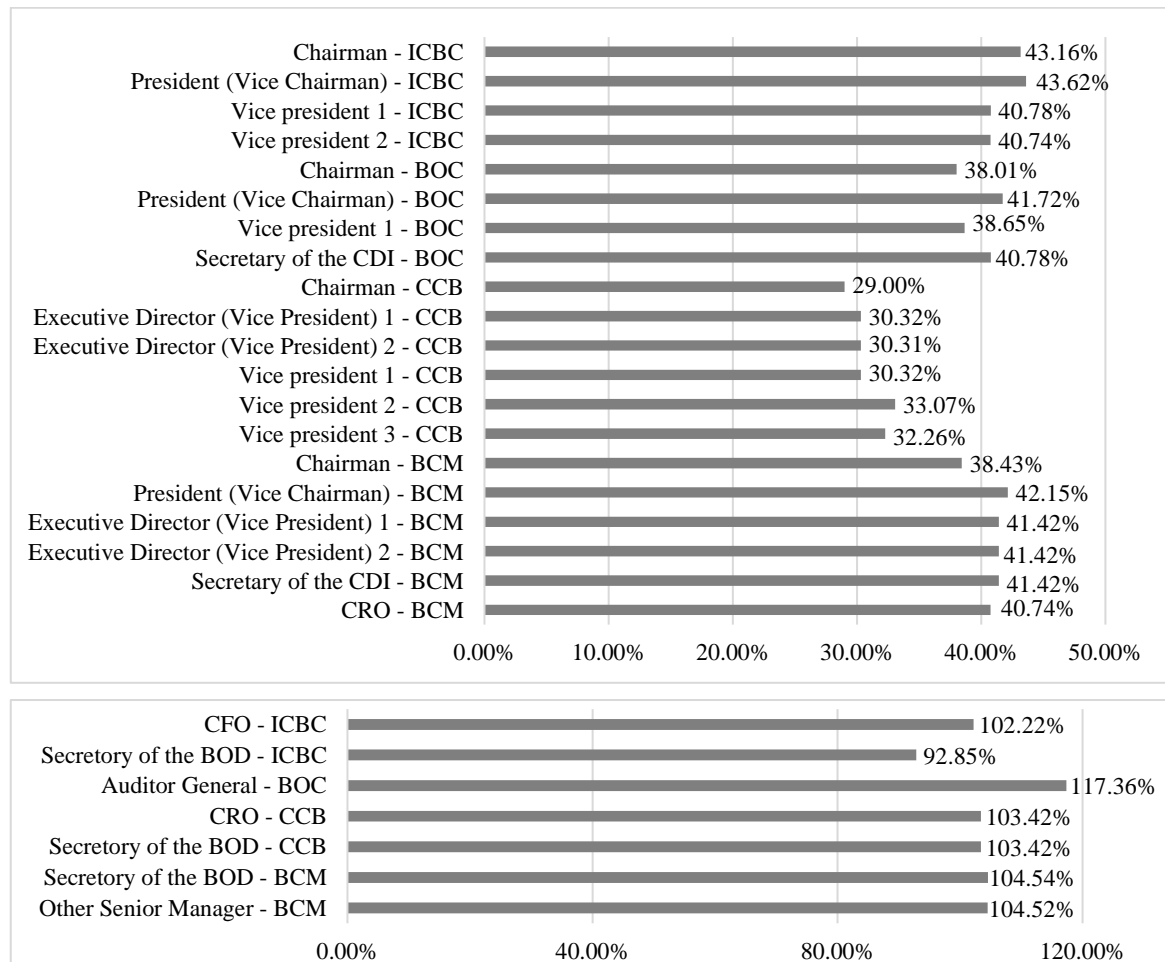
¹² There is no access to the average salary of all CCEs' employees in 2014, thus, it cannot be precisely verified whether the rule that bankers' remuneration should not be higher than eight times of last year's average salary of all CCEs' employees has been complied or not. However, the average salary of the employees in state-owned financial institutions can be used to make a rough estimation. See the data at NBS, 'The Average Salary of the Employees in State-owned Financial Institutions' (金融业国有单位就业人员平均工资) (*NBS website*) <http://data.stats.gov.cn/easyquery.htm?cn=C01> accessed 15 September 2017

¹³ Please refer to the data in Appendix G.3.

¹⁴ Please refer to the data in Appendix G.3.

counter to the market discipline. In the process of modernising and marketising bankers' remuneration and bank corporate governance, it is a retrogressive action.

Figure 8.3 The 2015/2014 Ratios of Bankers' Remuneration in Chinese SOCBs¹⁵



8.2.1.2 The Exception: the Remuneration Level of Bankers from the 'Outside System'

The five SOCBs have a long history as traditional SOEs in the era of the planned economy. Thus, all bank staff were cultivated and trained within the 'inside system'. After the shareholding reforms, in order to introduce modern corporate governance mechanism and enhance the communication with the international financial markets, some SOCBs started to appoint a handful of financial elites from overseas markets.

Table 8.3 shows the amounts of these overseas bankers' remuneration and Figure 8.4 shows the remuneration gaps between overseas and traditional bankers. The remuneration packages of overseas bankers were based on the pricing mechanism in the international

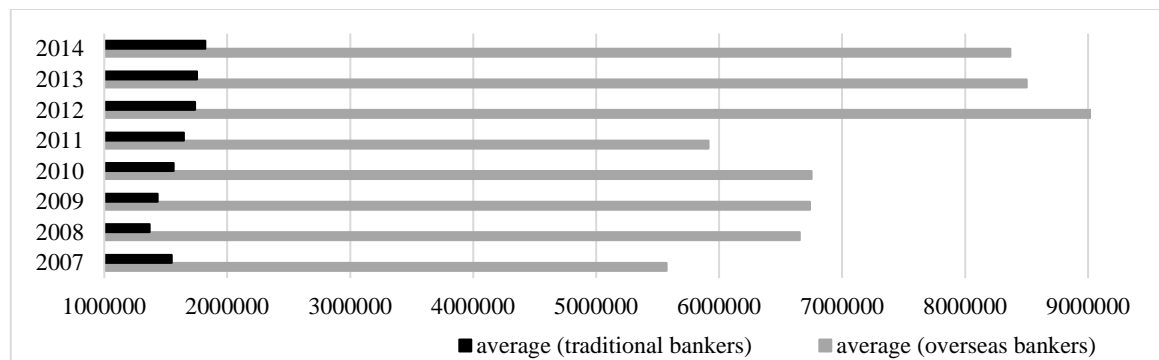
¹⁵ Secretary of the CDI (纪委书记) is a very special position in SOCBs. It is short for the secretary of the Commission for Discipline Inspection. The function and responsibilities of this position are explained in Appendix G.1.

financial employment markets and through contractual negotiations. As a consequence, they were paid several times higher than traditional bankers.

Table 8.3 The Remuneration Levels of the Overseas Bankers in Chinese SOCBs (Unit: RMB)

Banker	Bank and position	Nationality and career history	Remuneration level		
			2007	2008	2009
Zhan Weijian	BOC CRO	British; Deutsche Bank; Standard Chartered Bank; Bankers Trust Company	2007	2008	2009
			9,866,000	11,811,000	11,005,700
			2010	2011	2012
			1,1019,000	8,957,000	9,050,000
			2013	2014	
			8,501,800	8,367,700	
Huang Dingjian	BOC Audit General	Singaporean; Development Bank of Singapore	2007	2008	2009
			3,042,000	4,424,000	4,447,800
			2010	2011	
			4,471,000	2,870,000	
Yang Zhiwei	BOC Secretary of the BOD	Chinese (HK) BOC HK	2007		
			3,813,000		
Mao Yumin	CCB Investment manager	Chinese (Mainland); Cathay Pacific UK; Cathay Pacific HK; CCB HK	2008	2009	2010
			3,730,000	4,765,787	4,761,445

Figure 8.4 The Remuneration Ratios Between Overseas Bankers and Traditional Bankers in Chinese SOCBs from 2007 to 2014



Overseas bankers have more experience in applying and developing modern and market-based methods for remuneration and incentives. Their appointments should have encouraged SOCBs to apply the market-based pricing mechanism to a wider extent and increase the remuneration levels of traditional bankers. However, in practice, the participation of the overseas bankers was very limited. First of all, the number of overseas bankers was very small and their tenures were very short. Furthermore, their positions in SOCBs were below the position of vice president. Usually, overseas bankers were only in charge of a single business unit. Thus, they were excluded from the central decision-making process. These SOCBs have been very cautious about the function and influence of overseas bankers on their corporate governance and remuneration practices. Instead of extending the remuneration and incentive mechanism for overseas bankers to traditional bankers, these SOCBs have applied two separated mechanisms for the two types of bankers. It

demonstrates that the reform of bankers' remuneration has faced with many difficulties in SOCBs' practices, particularly from the traditional management and incentive approach adopted in the 'inside system'. The influence of this approach has been deep and far-reaching and created the institutional barriers to the modernisation and marketisation reform.

Based on the examination and analysis of bankers' remuneration levels of SOCBs, there are four findings. First, bankers' total remuneration levels were significantly lower than those of their counterparts in overseas banks or other Chinese banks. It implies that economic interests are not the major form of incentives. Alternatively, bankers in SOCBs have been primarily incentivised through other approaches. Second, the average level of bankers' remuneration increased very steadily and mildly, which was not compatible with the development of SOCBs' businesses. It is conjectural that performance-based remuneration has not been effectively implemented and the pay-to-performance sensitivity has been low. Third, the two regulatory requirements to reduce and cap bankers' remuneration enacted in 2008 and 2014 have been rigidly enforced by SOCBs. These two requirements were intrusive, rather than market-based. They indicate that the authorities still retain powerful control over the core financial cadres and financial capital. Fourth, appointing overseas bankers, with the purpose of pushing forward the modernisation and marketisation of bankers' remuneration, was ineffective. There are significant institutional barriers in the traditional administrative and politicised approach.

All of the statements and conjectures made above will be further enhanced or tested in the following subsections.

8.2.2 The Components and Structure of Bankers' Remuneration

8.2.2.1 The Components of Bankers' Remuneration

When SOCBs were traditional SOEs, bankers were paid in the same way as governmental officials and civil servants. As a result, fixed remuneration was the primary type of bankers' remuneration. After the shareholding reforms and IPOs, performance-based remuneration became gradually prevailing. Nevertheless, both fixed and performance-based remuneration have been paid in cash only. Compared to the diverse types and complicated designs of the equity-based remuneration schemes adopted by Western banks, the components of bankers' remuneration in SOCBs have been very simple.

Due to the remuneration failures in developed financial markets, in 2008 the MOF emergently required banks to suspend their equity-based remuneration plans. This injunction is also an instructive action. Although the purpose was to avoid repeating the problems in the West, it completely replaced the market mechanism with the administrative order.

In SOCBs, the injunction has been rigidly complied. From 2008 to 2016, the five SOCBs have consecutively announced in their annual reports that they did not implement any

equity-based remuneration plans. The only exception is BCM's pilot programme. From 2014, all of the directors and senior managers in BCM have started to hold a great number of the bank's ordinary shares. For instance, the current chairman Niu Ximing gained 210,000 shares in 2014 and 520,000 shares in 2015.¹⁶ In June 2015, BCM formally announced that it had been permitted to implement the pilot programme of equity-based remuneration.¹⁷

There is no official announcement to annul the injunction. Nevertheless, if without the permission of the government, BCM could not take the ice-breaking action and disclose the details to the public. In history, BCM has always been the pioneer in China's banking reform. Therefore, BCM's pilot programme signals that the prohibition will be gradually removed in the near future to accelerate the reform of bankers' remuneration.

In short, in SOCBs' practices, the only two components of bankers' remuneration are fixed remuneration and performance-based remuneration, both in cash. Due to the injunction, the development of equity-based remuneration has been stagnant.

8.2.2.2 The Structure of Bankers' Remuneration

In 2010, the CBRC enacted the Chinese version of 'bankers' bonus cap', which limits the ratio between variable and fixed remuneration to 3:1. It has also introduced the deferral policy which requires banks to postpone at least 40% of variable remuneration in a three-year period. For bankers at main positions, the minimum percentage of deferral is 50%.¹⁸ The two measures would have an impact on the structure of bankers' remuneration.

In order to reveal bankers' remuneration structures of SOCBs, the data of bankers' variable remuneration and deferred payments has been collected, and the percentages of variable remuneration and deferred payments in total remuneration have been calculated.¹⁹

The data of performance-based remuneration is available from 2009 to 2014.²⁰ According to Figure 8.5, on average variable remuneration was around 60% of total remuneration. Namely, the variable-fixed ratio was around 3:2, smaller than the 3:1 cap. The deferred payments approximately accounted for 30% of total remuneration and 50% of variable remuneration. Therefore, after the implementation of the regulatory framework, bankers'

¹⁶ BCM Annual Reports 2014, 81; BCM Annual Reports 2015, 92

¹⁷ Jun Yuan, 'BCM Is Leading the Pilot Reform; Equity-based Remuneration Is Highly Expected' (交通银行带头试点改革, 股权激励最受期待) *Sina Finance* (Shanghai, 16 June 2015) <http://finance.sina.com.cn/stock/s/20150617/084122453241.shtml> accessed 20 September 2017

¹⁸ For the details of deferral, please refer to Subsection 7.4.2.

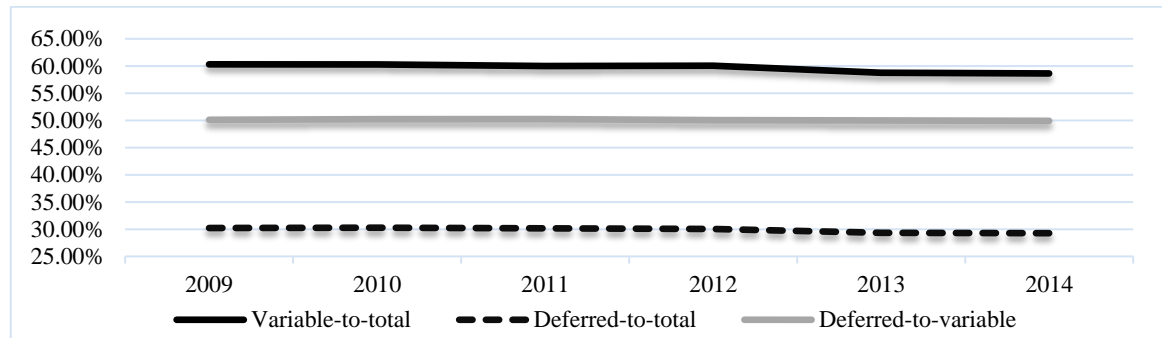
¹⁹ The original data, the process and criteria of data collection and the calculation method are provided in Appendix H.

²⁰ The bonus cap and the deferral policy were enacted in 2010. From then on banks started to disclose the details of bankers' remuneration structures. The information disclosed in 2010 was about the remuneration practice in 2009. Therefore, the information of bankers' remuneration structures is available from 2009. However, since 2015, SOCBs have stopped disclosing the detailed amounts of performance-based remuneration and deferred payments. As a result, the information is only available from 2009 to 2014.

remuneration was made up of 40% fixed remuneration, 30% annual bonuses and 30% three-year incentives.

The horizontal tendencies of the three lines in Figure 8.5 demonstrate that the ratios were maintained at the same levels throughout the period. Every year, SOCBs applied the same ratios to decide the amounts of performance-based remuneration and deferred payments.

Figure 8.5 The General Structure of Bankers' Remuneration of Chinese SOCBs from 2009 to 2014 (Average Proportions)



Moreover, for every banker, the proportion of performance-based remuneration in total remuneration was very approximate with each other, and so was the proportion of deferred payments. In Figure 8.6, every chart shows the proportions of performance-based remuneration in all bankers' remuneration packages in a specific year. In each chart, every black point on the circle represents the proportion of performance-based remuneration in every banker's total remuneration. Figure 8.7 shows the proportions of delayed payments in the same way.

For almost every banker, the performance-based remuneration was around 60% of total remuneration, apart from one person whose performance-based remuneration was only 28% of the total.²¹ Similarly, almost every banker had half of their variable remuneration, namely 30% of total remuneration delayed in a three-year period. The only exception was the same banker and the deferral rate was 40%.²² The exceptional case can be regarded as an outlier and its impact on the overall situation can be ignored. Therefore, it can be concluded that, throughout the six-year period and across the five SOCBs, a 'one-size-fits-all' pattern of remuneration structure was applied to every banker.

²¹ The banker was Liu Yanfen, the audit general of BOC in 2013 and 2014. There is no specified reason why her performance-based remuneration was much lesser than others.

²² In Liu Yanfen's remuneration package, 40% of her variable remuneration was deferred. Since her variable remuneration only made 28% of the total remuneration, the deferred payment was only 12% of the total remuneration.

Figure 8.6 The Proportions of Performance-based Remuneration in Total Remuneration in Chinese SOCBs from 2009 to 2014 (of Each Banker)

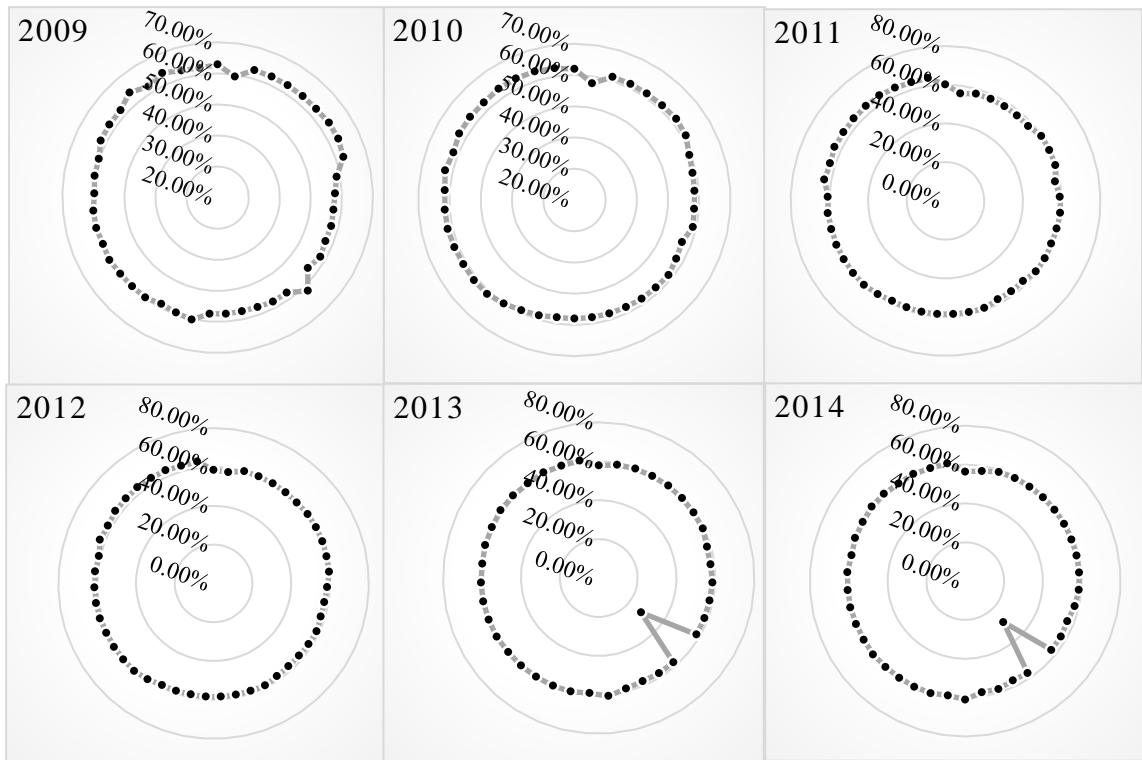
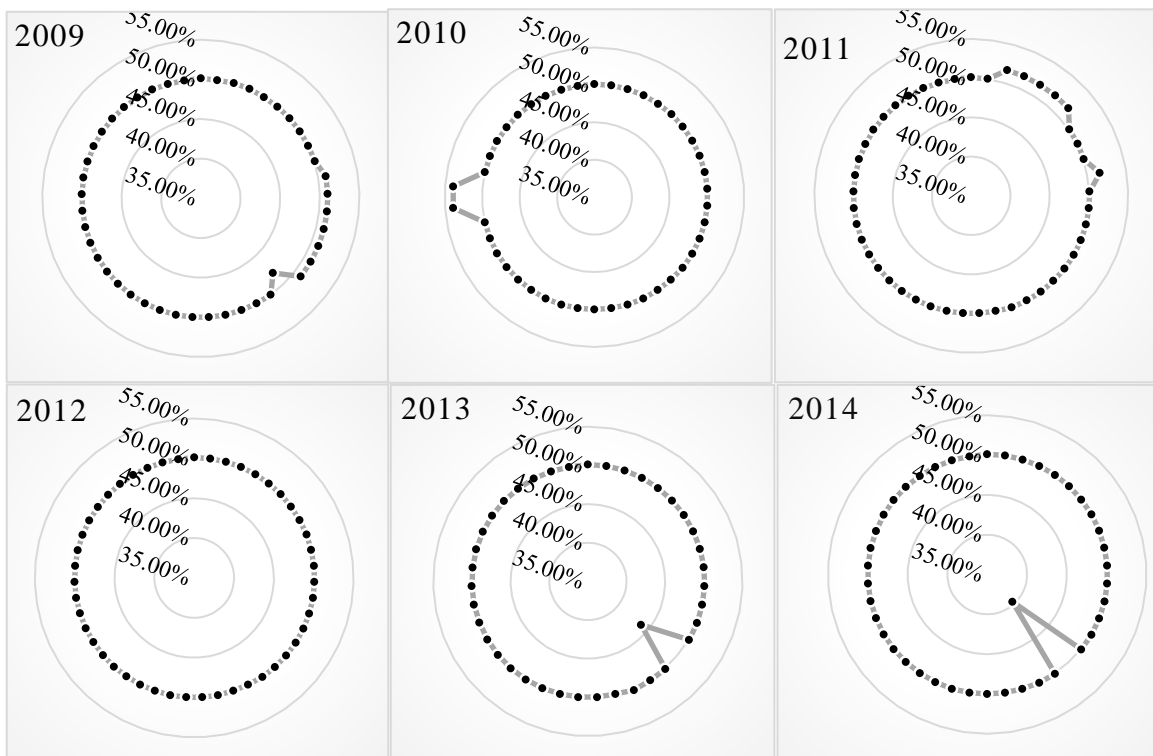


Figure 8.7 The Proportions of Deferred Payments in Total Remuneration in Chinese SOCBs from 2009 to 2014 (of Each Banker)



According to the discussion in last subsection, the mild increase rate of bankers' total remuneration was not compatible with the rapid growth or speedy expansion of SOCBs. Therefore, it is conjectural that performance-based remuneration was neither based on bankers' individual performance nor the banks' overall performance. In other words, it is highly possible that the pay-to-performance sensitivity in SOCBs has been very low. Furthermore, from the very stable and narrow gaps of remuneration levels, it is also inferable that the total amounts of bankers' remuneration have been decided in accordance with a uniform standard, which is based on bankers' positions in the managerial hierarchy, rather than their performance. The high similarity between bankers' remuneration structures and the regularity across these six years can further consolidate this conjecture.

As discussed, in the MOF's formula for variable remuneration, the assessment coefficient is decided by banks in accordance with each banker's individual achievements or contributions. In other words, banks should assess bankers' performance on an individual basis and apply the outcomes to the formula to decide their variable remuneration.

Normally, bankers must have differences in their expertise, capacities, experience and responsibilities, which will lead to the diversities in their individual achievements and contributions. Had individual achievements and contributions been used as the major determinant of the assessment coefficient, the proportions of performance-based remuneration among different bankers must have been different. Moreover, normally, the achievements and contributions of an individual banker would vary from year to year. The bankers' remuneration amounts should also be changing across these years. However, the observed facts were reversed, which prove that performance-based remuneration was not decided by bankers' individual performance.

The implementation of deferral arrangements was also on a 'one-size-fits-all' basis. The highly similar and regular ratios of deferral indicate that SOCBs did not take into consideration each banker's role and the impact on risk-taking activities.

Why is the 'one-size-fits-all' approach inferior to an individual-based approach? An important reason is the 'free rider' problem in collective activities. If bankers know that their remuneration is not decided by their own achievements or contributions, they will tend to make fewer efforts, while expecting others to contribute more. As a consequence, the function of performance-based remuneration and deferral policy will be impaired.

In addition, the structures of bankers' remuneration also verify that the amounts of performance-based remuneration were irrelevant to banks' overall performance. The remuneration multiple in the MOF's formula for performance-based remuneration is decided by the MOF according to banks' overall performance. There is a standardised system enacted in the MOF Performance Assessment Measures, which includes all the

indicators that are used to evaluate banks' overall performance.²³ Normally, these indicators, such as EP, ROE, NPL ratio, CAR, and so on, are dynamic. As a corollary, it was impossible that the assessments of a bank's performance in different years remained unchanged and the assessment of every bank was the same with each other.

However, the observed facts were still opposite. First, in the same year, the average proportion of performance-based remuneration in each bank was very similar to each other (cross-bank horizontal comparison at fixed time point). Second, the annual average proportion of the same bank maintained at the same level (vertical comparison along the timeline in a certain bank). Clearly, the facts can prove that bankers' performance-based remuneration was not determined in line with banks' overall performance.

It is evident that the amounts of performance-based remuneration were neither based on bankers' individual performance nor banks' overall performance. Namely, the so-called performance-based remuneration was not really performance-based. In the practices of SOCBs, the level and structure of bankers' remuneration were decided on a 'one-size-fits-all' basis. As a corollary, the new measures in the regulatory framework to enhance the function of performance-based remuneration and improve the pay-to-performance sensitivity have not been productive. The measures have become only meaningful on a symbolic and formalistic basis: making sure the regulation has been complied on the surface. However, in practice, the important functions of performance-based remuneration and deferral were ignored by SOCBs.

Besides, the CBRC has introduced clawback and *malus* in the regulatory book. However, the CBRC Guidelines do not provide specific instructions about how to implement the two measures. The practical evidence shows that none of the SOCBs has implemented them. As a consequence, the two regulatory measures are completely in vain.

To conclude, the characteristics of the remuneration components and structure of SOCBs can be summarised as below. First, fixed remuneration and variable remuneration were the only two components, and cash was the only form. Due to the MOF's injunction, the development of equity-based remuneration has been stagnant. It demonstrates that the intrusive approach which favours administrative and political control remains powerful. Second, bankers' performance-based remuneration was based on neither bankers' individual performance nor banks' overall performance. It demonstrates that the incentive effect of performance-based remuneration was poor and the pay-to-performance sensitivity remained at a very low level.

As a consequence, in the remuneration practices of SOCBs, the regulatory measures based on the international standards and Western experience have not been effectively

²³ Please refer to Table 7.1.

implemented. The objective to promote the modernisation and marketisation of bankers' remuneration has not been realised.

8.2.3 Incentive Mechanism

By analysing the remuneration level and structure, it is clearly shown that bankers' remuneration of SOCBs was not decided by bankers' individual performance or banks' overall performance. Moreover, the total remuneration levels were far lower than those of Western banks and non-state-owned banks in China. Poorly remunerated with pecuniary benefits, bankers in SOCBs have still been motivated to make efforts for their banks' development. Thus, it is conjectural that pecuniary benefits in remuneration packages were not the primary type of incentives for bankers. Instead, SOCBs have been applying an alternative way to manage and incentivise their bankers.

When SOCBs were traditional SOEs, bankers were managed and incentivised in accordance with the *Nomenklatura* System. Therefore, bankers' careers and remuneration were entirely organised through the administrative and politicised approach.

Theoretically, institutional changes through a gradualist reform will not be completed in a short time by a one-stop action. Therefore, the traditional approach would still be functional after the modern and professional regulatory framework was established. Therefore, it is conjectural that the alternative way which SOCBs have applied to manage and incentive bankers is the traditional administrative and politicised approach. To test the conjecture, it is necessary to examine how the *Nomenklatura* System has been operating in SOCBs since the completion of their shareholding reforms and IPOs.

According to the *Nomenklatura* System, instead of providing competitive pecuniary rewards for bankers' achievements and contributions, the government and SOCBs incentivise bankers with the opportunities to climb to higher ranks in the bureaucratic hierarchy and more important positions in the CCP system. In Chapter 6, based on the career trajectories of the top bankers who worked in the five SOCBs before the shareholding reforms and IPOs, it has been found that all of the bankers rotated among different leading positions in governmental departments, SOCBs or other state-owned financial institutions before their presidencies in SOCBs. The experience as SOCBs' presidents and the achievements at the positions became crucial for these bankers to secure higher and more important positions in the bureaucratic system.

After the shareholding reforms and IPOs, SOCBs have turned into modern corporate groups and have established the BOD and senior management. As mentioned before, the chairman of the BOD who plays the leading role in the decision-making process is the 'first chair' of a bank. President is the leader in senior management, and one of the vice chairmen of the BOD. In practice, president is the 'second chair'.

Usually, chairmen and presidents are already at the highest positions in SOCBs and among the core financial cadres in the COD's list. As a result, promoting to higher positions in the *Nomenklatura* System can only be realised by transferring to the government or the CCP system. Therefore, the career trajectories of these chairmen and presidents after their tenures in SOCBs can reflect to what extent the administrative and politicised approach has been maintained to incentivise bankers.

The career trajectories of SOCBs' chairmen and presidents are listed in Table 8.4. In total, there are 22 records, including 14 previous bankers and 8 incumbent bankers until 2017.

Table 8.4 The Career Trajectories of Chairmen and Presidents in Chinese SOCBs (Post-shareholding Reform)²⁴

Bank, banker, position and tenure ²⁵		Brief career trajectory before SOCBs	Political post during the tenure in SOCB	Reason for termination	Brief career trajectory after SOCBs (including political post)
ICBC	Jiang Jianqing Chairman 2005-2016 ²⁶	1. The president of the ICBC subsidiary in Shanghai 2. The president of Bank of Shanghai (上海银行) 3. The ICBC vice president (the vice secretary of the CCP committee)	The substitute member of the 16th, 17th and 18th CCP Central Committees	Retirement	1. The chairman of China-Central and Eastern Europe Financial Holding Company (中国-中东欧金融控股有限公司) ²⁷ and the chairman of SINO-CEEF Capital Management Company Limited (世福资本管理有限公司) ²⁸
	Yang Kaisheng President 2005-2016	1. The president of a city-level subsidiary of ICBC 2. The ICBC vice president 3. The CEO of China Huarong Assets Management Company (华融资产管理公司) ²⁹	None	Retirement	The guest consultant of CBRC

²⁴ The information of bankers' careers is collected from their biographies published in banks' annual reports and the Index of China's Leaders and Cadres, as well as their profiles at Wikipedia and Baidu Baike.

²⁵ Conventionally, all the chairmen were/are also the secretaries of the CCP committees in these SOCBs and all the presidents were/are the vice secretaries of the CCP committees.

²⁶ Jiang became the 'first chair' of ICBC since 2000, before the bank's shareholding reform. At that time, he was the ICBC president. After ICBC turned into a shareholding company, he became the chairman and was still the 'first chair'.

²⁷ This company is wholly-owned by ICBC, so it is closely connected to the state-owned financial sector. See Yu Wu, 'ICBC Invested 1 Billion Euros to Establish China-Central and Eastern Europe Financial Holding Company' (工行投资 10 亿欧元设立中国——中东欧金融控股公司) *Xinhua Online* (Beijing, 6 November 2016) http://news.xinhuanet.com/world/2016-11/06/c_1119859179.htm accessed 22 September 2017

²⁸ This company is affiliated to ICBC Asia, an overseas branch of ICBC incorporated in Hong Kong.

²⁹ During Yang's tenure, Huarong was a wholly state-owned investment company. It turned into a shareholding company in 2012.

	Yi Huiman Chairman 2016-	1. The president of the ICBC subsidiary in Beijing (the secretary of the CCP committee) 2. The ICBC vice president 3. The ICBC president and vice chairman (the vice secretary of the CCP committee)	The substitute member of the 19th (2017-2022) CCP Central Committee	NA	NA
	Gu Shu President 2016-	1. The president of a provincial subsidiary of ICBC (the secretary of the CCP committee) 2. The ICBC vice president	None	NA	NA
BOC	Xiao Gang Chairman 2004-2013 ³⁰	The PBOC vice governor	The substitute member of the 17th CCP Central Committee	Rotation and promotion	1. The CSRC governor (the secretary of the CCP committee) 2. The member of the 18th CCP Central Committee
	Li Lihui President 2004-2014	1. The vice president of a provincial subsidiary of ICBC 1. The ICBC vice president 2. The vice governor of Hainan (海南) Province	None	Retirement	The manager of the Blockchain Team in the National Internet Finance Association of China (中国互联网金融协会)
	Tian Guoli Chairman 2013-2017	See Tian's information in the volume of BOC			
	Chen Siqing Chairman 2017-	1. The president of a provincial subsidiary of BOC 2. The BOC vice president 3. The BOC president and vice chairman (the vice secretary of the CCP committee)	The substitute member of the 19th CCP Central Committee	NA	NA
CCB	Guo Shuqing Chairman 2005-2011	1. The senior manager of the Economic System Reform Office in the State Council (国务院)	The substitute member of the 17th CCP Central Committee	Rotation and promotion	1. The CSRC governor (the secretary of the CCP committee) 2. The vice governor and interim governor of Shandong

³⁰ Xiao Gang was the BOC president from 2003 to 2004 before the bank transformed into a shareholding company.

	<p>务院经济体制改革办公室)³¹</p> <p>2. The vice governor of Guizhou (贵州) Province</p> <p>3. The PBOC vice governor</p> <p>4. The chairman of CHI.Ltd</p>			<p>(山东) Province and the vice secretary of the CCP provincial committee in Shandong; then promoted to the governor of Shandong Province</p> <p>3. The member of the 18th and 19th CCP Central Committees</p> <p>4. The CBRC governor (the secretary of the CCP Committee) and the member of the PBOC Monetary Policy committee (concurrent)</p>
Zhang Jianguo President 2006-2015	<p>1. The vice president of a provincial subsidiary of ICBC</p> <p>2. The BCM vice president and then promoted to the president and vice chairman (the vice secretary of the CCP committee)</p>	None	Retirement	Unknown
Wang Hongzhang Chairman 2012-2017	<p>1. The governor of a city-level subsidiary of PBOC</p> <p>2. The secretary of the CDI in PBOC</p>	<p>1. The member of the 17th CCDI</p> <p>2. The substitute member of the 18th CCP Central Committee</p>	Retirement	Unknown
Tian Guoli Chairman 2017-	<p>1. The CCB senior manager</p> <p>2. The chairman of China Cinda Assets Management Company (信达资产管理公司)³²</p> <p>3. The vice chairman of CITIC Group and the chairman of CITIC Bank (concurrent)</p> <p>4. The BOC chairman (the secretary of the CCP Committee)</p>	The substitute member of the 19th CCP Central Committee	NA	NA
Wang Zuji President 2015-	<p>1. The vice governor of Jilin (吉林) Province</p> <p>2. The CIRC vice governor</p>	None	NA	NA

³¹ The Economic System Reform Office was annulled in 2003.

³² During Tian's tenure, Cinda was a wholly state-owned investment company. It turned into a shareholding company in 2009.

ABC	Xiang Junbo Xiang Chairman 2009-2011 ³³	1. The vice governor of the National Audit Office of the PRC (中华人民共和国审计署) ³⁴ 2. The PBOC vice governor	The substitute member of the 17th CCP Central Committee	Rotation and promotion	1. The CIRC governor (the secretary of the CCP committee) ³⁵ 2. The member of the 18th CCP Central Committee
	Jiang Chaoliang Chairman 2011-2014	1. The governor of a city-level subsidiary of PBOC (the secretary of the CCP committee) 2. The vice governor of Hubei (湖北) Province 3. The BCM chairman (the secretary of the CCP committee) 4. The CDB president and vice chairman (the vice secretary of the CCP committee)	The substitute member of the 18th CCP Central Committee	Rotation and promotion	1. The governor of Jilin Province and the vice secretary of the CCP provincial committee in Jilin 2. The secretary of the CCP provincial committee in Hubei 3. The member of the 19th CCP Central Committee
	Liu Shiyu Chairman 2014-2016	The PBOC vice governor	None	Rotation and promotion	1. The CSRC governor (the secretary of the CCP committee) and the member of the PBOC Monetary Policy Committee (concurrent) 2. The member of the 19th CCP Central Committee
	Zhang Yun President 2009-2015	1. The president of a provincial subsidiary of ABC 2. The ABC vice president	None	Dismissal	Unknown
	Zhou Mubing Chairman 2016-	1. The president of a provincial subsidiary of ICBC (the secretary of the CCP committee) 2. The vice mayor of Chongqing (重庆) (a provincial municipality) 3. The CBRC vice governor (the vice	None	NA	NA

³³ Xiang was the ABC president before it was restructured as a shareholding company in 2009.

³⁴ The National Audit Office is a ministerial body in the State Council.

³⁵ In September 2017, the CCDI announced that Xiang has been expelled from the position of the CIRC governor and deprived of the CCP membership due to the violations of law and the CCP disciplines. See the announcement at CCDI, 'The Former CIRC President Xiang Junbo Deprived of the CCP Membership and Discharged of the Public Employment Due to Serious Violations of Disciplines' (中国保险监督管理委员会原党委书记、主席项俊波严重违纪被开除党籍和公职) (*The CCDI website*, 23 September 2017) http://www.ccdi.gov.cn/toutiao/201709/t20170923_126025.html accessed 9 January 2018

		secretary of the CCP committee)			
	Zhao Huan President 2016-	1. The president of the CCB subsidiary in Shanghai 2. The CCB vice president 3. The president of Everbright Bank and the member of the CCP committee of China Everbright Group (concurrent)	The substitute member of the 19th CCP Central Committee	NA	NA
BCM	Jiang Chaoliang Chairman 2004-2008	See Jiang information in the volume of ABC			
	Zhang Jianguo President 2004-2006	See Zhang information in the volume of CCB			
	Hu Huaibang Chairman 2008-2013	1. The governor of a city-level subsidiary of PBOC 2. The secretary of the CDI in CBRC 3. The chief supervisor of China Investment Corporation (中国投资有限责任公司) ³⁶ (the vice secretary of the CCP committee)	The substitute member of the 18th CCP Central Committee	Rotation and promotion	The CDB chairman
	Li Jun President 2006-2009	The BCM vice president and executive director	None	Rotation and promotion	The BOC chief supervisor
	Niu Ximing Chairman 2016-	1. The president of the ICBC subsidiary in Beijing 2. The ICBC vice president and executive director 3. The BCM president (the vice secretary of the CCP committee)	None	NA	NA
	Peng Chun	1. The president of a provincial level subsidiary of BCM	None	NA	NA

³⁶ China Investment Corporation is a wholly state-owned company which is established by the State Council and specialised in the investments on state assets.

	President 2009-	2. The BCM vice president and executive director			
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Bankers' pre-SOCB career trajectories suggest that the 'inside system' has been the only source of the chairmen and presidents in SOCBs.³⁷ Specifically, bankers usually have three different types of career experience in the 'inside system'. The first type is in the state-owned financial sector, including SOCBs and other state-owned financial institutions. The second type is in the financial regulatory bodies of the State Council (the central government), such as the PBOC, CBRC, CSRC, CIRC, and so on. The third type is in local governments. Some bankers have experience in more than one of the three sectors. Therefore, in terms of an individual banker's pre-SOCB career trajectory, there are seven possibilities:

Type A: the state-owned financial sector

Type B: the financial regulatory bodies

Type C: the local governments

Type AB: the state-owned financial sector and the financial regulatory bodies

Type AC: the state-owned financial sector and the local governments

Type BC: the financial regulatory bodies and the local governments

Type ABC: the state-owned financial sector, the financial regulatory bodies and the local governments

Figure 8.8 shows the statistical outcomes of bankers' pre-SOCB career trajectories based on the above typology. 12 bankers (55%) developed their careers only within the state-owned financial sector before promoted to the chairman or president of SOCBs, which is represented by Type A. Apart from bankers in Type A, all the other 10 bankers (45%) have the experience in the governmental sector: the financial regulatory bodies or local governments. That is to say, 45% of the chairmen and presidents of SOCBs worked previously as the country's governmental officials. Therefore, governmental officials and employees of financial SOEs are the two sources of top bankers of SOCBs.

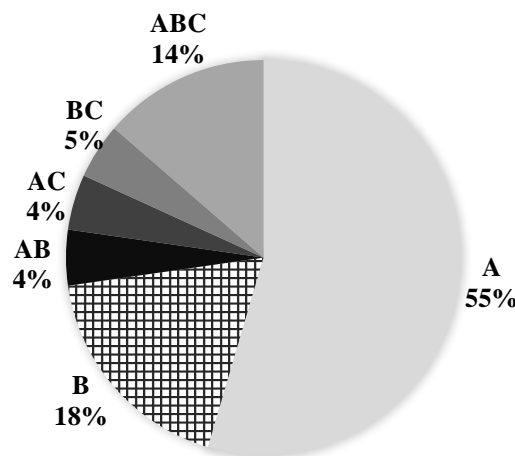
As high as 77% of the bankers (Type A, AB, AC and ABC) have the experience in the state-owned financial sector, which means that entrepreneurship and professionalism have been

³⁷ Tian Guoli, the incumbent chairman of CCB was ever the chairman of CITIC Bank. The incumbent president of ABC - Zhao Huan was ever the president of Everbright Bank. CITIC Bank and Everbright Bank are JSCBs. Based on the official classification, these two banks are not in the state-owned financial sector. However, their positions in the two banks were based on their capacities in the boards and the senior management systems of CITIC Group and China Everbright Group (as elaborated in Table 8.4), which are the majority shareholders of CITIC Bank and Everbright Bank respectively. The two financial holding groups are CCFIs. In this sense, their positions were still within the state-owned financial sector.

emphasised as important elements for the selection of top bankers. Nevertheless, political affiliation and loyalty have always been more important than entrepreneurship and professionalism. As mentioned before, after the shareholding reforms and IPOs, SOCBs started to recruit some financial elites from overseas markets. Nevertheless, their positions were all below vice president. Figure 8.8 also shows that, among the chairmen and presidents, none of the bankers has any previous experience in private or overseas financial industries. Generally speaking, overseas bankers are more experienced in terms of making strategies for the development in the international markets and implementing modern corporate governance mechanisms. However, their participation and influence in the decision-making process were limited by their positions. If entrepreneurship and professionalism had been prioritised, these overseas bankers should have been allowed to play a more important role.

Instead of professionalism and entrepreneurship, the experience in the ‘inside system’, which represents a banker’s knowledge about the nation’s politics and the network in the bureaucratic system must be primarily satisfied, despite that the banker had no previous experience about how to operate and manage a bank. For instance, Xiao Gang, the former chairman of BOC and Liu Shiyu, the former chairman of ABC, both of them transferred to SOCBs from the position of the PBOC’s vice governor, while without previous industrial experience.

Figure 8.8 The Types of Chairmen’s and Presidents’ Career Trajectories Before SOCBs’ Tenures



These bankers’ pre-SOCB career trajectories are not directly evidential for the operation of political incentives in SOCBs. Nevertheless, the analysis is still significant. It indicates that the personnel of SOCBs remains within the bureaucratic system and intertwined with the personnel of the government and the CCP. Particularly, by emphasising the significance of political affiliation and loyalty, the government can still control the selection of SOCBs’ chairmen and presidents, which maintains the political intervention in SOCBs’ decision-making processes. Moreover, in this context, the communication and exchange of financial elites between the ‘inside system’ and the ‘outside system’ remain limited, which has a

negative impact on the modernisation and marketisation of bankers' remuneration and bank corporate governance.

Bankers' career development in the bureaucratic system during and after their tenures in SOCBs can directly reflect the role and operation of political incentives. Conventionally, the 'first chairs' in governmental departments or large CCEs can be included in the CCP's core policy-making organs, especially the Central Committee. In SOCBs, chairmen have the opportunities to become the substitute members of the CCP Central Committee. In Table 8.4, among the 14 chairmen, 10 (71.43%) had/have the posts in the CCP Central Committee. Besides, the current ABC president has also been selected as one of the substitute members of the CCP Central Committee. In total, 11 of the 22 bankers (50%) had/have concurrent political posts during their tenures in SOCBs.

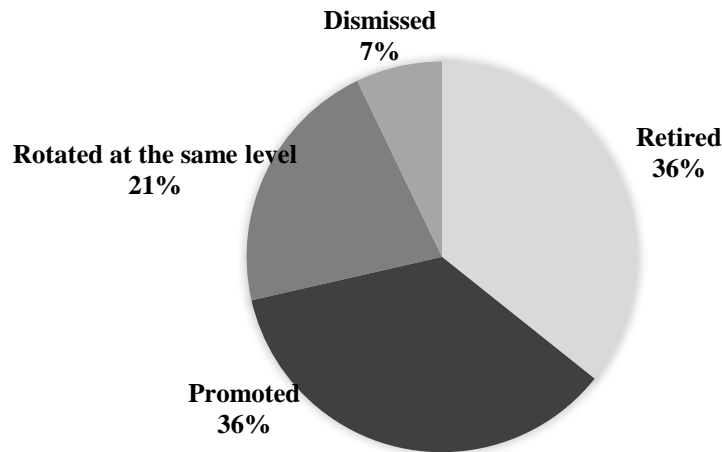
Before becoming SOCBs' chairmen or presidents, usually, these bankers worked at the vice leading positions in CCFIs, financial regulatory bodies or local governments. As explained, SOCBs' top bankers are at the deputy ministerial level in the bureaucratic hierarchy. If transferring from the vice leading positions in CCFIs, regulatory bodies or provincial governments, the administrative level would remain the same. However, at those vice leading positions, they were not qualified to enter the CCP Central Committee. Only by transferring to the positions of the chairmen or presidents of SOCBs, can they have the opportunities to participate the policy-making process of the CCP. Therefore, these bankers' concurrent political posts in the CCP Central Committee during their tenures in SOCBs are substantial promotions in the CCP system.

More importantly, these bankers can secure more promising careers in the government or the CCP system afterwards. Figure 8.9 shows the directions of the post-SOCB career trajectories of the 14 previous chairmen and presidents.³⁸

Among them, apart from one who was dismissed due to illegal conduct and five who retired due to age, the other eight bankers all stayed in the 'inside system' and the majority of them have been immediately promoted to upper positions in the bureaucratic hierarchy: becoming the leading officials in the central government's financial departments or provincial governments. Besides, those chairmen who held concurrent posts in the CCP Central Committee during their tenures in SOCBs, if they did not retire, have all maintained their seats and promoted from substitute members to formal members.

³⁸ Tian Guoli, the current CCB chairman, has transferred from the position of the BOC chairman. This was a lateral transfer. Since Tian already worked as a chairman in SOCBs, he is categorised as a previous banker not a current one.

Figure 8.9 The Types of Chairmen's and Presidents' Career Trajectories After SOCBs' Tenures



Xiao Gang and Liu Shiyu are the aforementioned two bankers who had no industrial experience, while transferring from the position of the PBOC vice governor to the chairmen of SOCBs. After their tenures in SOCBs, both of them were promoted to the position of the CSRC governor.³⁹ In terms of the administrative level in the bureaucratic hierarchy, both the vice governor of the PBOC and the chairmen of SOCBs are at the deputy ministerial level. The CSRC governor is at the chief ministerial level. Obviously, after their tenures in SOCBs, Xiao and Liu have rotated back to the governmental system and achieved political promotions. In their cases, working in SOCBs was to obtain industrial experience and skills and improve the records of their contributions to the development of the Chinese financial industry. The ultimate purpose was to enhance their qualifications for higher positions in the bureaucratic hierarchy and lay the foundation for further development of their political careers.

Moreover, some other bankers have been more successfully promoted. Guo Shuqing, the previous chairman of CCB, was first promoted to the CSRC governor, from where he rotated to the governor of Shandong Province and concurrently acted as one of the vice secretaries of the CCP provincial committee in Shandong. In China, this position is the 'second chair' in a provincial government.⁴⁰ Simultaneously, Guo was promoted from a

³⁹ Xiao and Liu worked in SOCBs and the CSRC in different periods. Xiao worked as the BOC chairman from 2004 to 2013 and the CSRC governor from 2013 to 2016. Liu was at the position of the ABC chairman from 2014 to 2016 and in 2016 Liu took over the position of the CSRC governor from Xiao.

⁴⁰ In China, the governor of a province is not the 'first chair', whereas the secretary of the CCP provincial committee, namely the top leader of the Party system in that province is. The governor is the top leader of the administrative system of a province and conventionally is one of the vice secretaries of the CCP provincial committee. The governor usually ranks the second in a province's leading group. This is different from the relation between the administrative leader and the CCP leader in the ministries of the State Council or in SOEs. For instance, in the PBOC, the governor, as the top administrative leader concurrently acts as the secretary of the CCP committee in the PBOC. Nevertheless, in terms of the administrative levels, both a provincial governor and the secretary of a CCP provincial committee are at the chief ministerial/provincial level.

substitute member to a formal member of the CCP Central Committee. In early 2017, Guo has rotated back to the financial regulatory sector to act as the CBRC governor.⁴¹

Another similar case is Jiang Chaoliang, the previous chairman of ABC. Different from Guo, after his tenure as the ABC chairman, Jiang completely left the financial industry and started his political career in local governments. He first worked as the governor of Jilin Province and concurrently acted as one of the vice secretaries of the CCP provincial committee in Jilin. Similar to the experience of Guo, Jiang was also promoted from a substitute member to a formal member of the CCP Central Committee. Afterwards, he got further promoted to the secretary of the CCP provincial committee in Hubei, which is the ‘first chair’ leader in that province.

The two provinces where Guo and Jiang has governed/is governing, Shandong and Hubei, ranked the third and the seventh among China’s 32 provinces and provincial municipalities⁴² in terms of the GDP in 2016.⁴³ These two provinces are economically important areas in China. The qualifications to take such an important position in Chinese politics particularly benefited from the experience as the ‘first chairs’ in SOCBs. On the one hand, the long-term chairmanship in SOCBs has made the bankers political-minded, which is the foundation to be politically trustable by the authorities. On the other hand, the experience of managing large state-owned financial enterprises has made them knowledgeable in economic development and skilled in personnel management.

For Guo and Jiang, the ‘first chair’ or ‘second chair’ in a Chinese provincial government or a ministerial organ of the State Council signifies not only a powerful political position but also the promising opportunities of further developing their political careers. Both of them have developed from national financial elites into political elites. This kind of promotion routine is completely the same as those of the top bankers who had worked as the presidents of SOCBs before the shareholding reforms and IPOs. It typically demonstrates that political promotion: the opportunity to become the core politicians in this country remains the predominant mechanism to incentivise the top bankers in SOCBs.

These cases of political promotion happened after the five SOCBs turned into internationalised and listed banking groups and after the regulatory framework of bankers’ remuneration was established. Despite the SOCBs’ great achievements in business development, the practices of bankers’ remuneration and incentives have still been based

⁴¹ ‘China Said to Name Reformer Guo as Head of Banking Regulator’ *Bloomberg* (Guangzhou, 24 February 2017) <https://www.bloomberg.com/news/articles/2017-02-24/china-said-to-name-guo-shuqing-as-head-of-banking-regulator-izj84vbf> accessed 24 September 2017

⁴² This number excludes the two special administrative regions Hong Kong and Macao, as well as Taiwan province.

⁴³ ‘The GDP Ranking by Province in 2016’ (2016 各省份 GDP 排行) *Sina Finance* (Beijing, 7 February 2017) <http://finance.sina.com.cn/china/gncj/2017-02-07/doc-ifyaexzn9124761.shtml> accessed 24 December 2017

on the traditional *Nomenklatura* System. As a consequence, the government can still impose strict control over the senior personnel of SOCBs and thereby substantially intervene in banks' decision-making and internal governance.

From the perspective of these bankers, political promotion is the most fundamental and important motivation to serve for SOCBs. As the trade-off, small remuneration packages are acceptable. In essence, these top bankers of SOCBs are still political bureaucrats. In their eyes, the pecuniary benefits in remuneration packages are inferior to the opportunities of political promotion.

The predominant role of political incentives also demonstrates that the regulatory framework established by the CBRC and the MOF to push forward the modernisation and marketisation of bankers' remuneration, has been unproductive and inefficient so far.

To sum up, based on the empirical data and information of bankers' remuneration and career trajectories, this section has examined the remuneration levels, components and structures, and incentive mechanisms of Chinese SOCBs. The major findings and conclusions are summarised below.

First, the levels of bankers' total remuneration in SOCBs were far lower than those of their counterparts in developed financial markets. SOCBs ever recruited bankers from overseas markets and offered them the equivalent remuneration packages to those offered by Western banks. However, the number of overseas bankers was very small and they were not offered top positions in SOCBs. Therefore, their contributions to the modernisation and marketisation of bankers' remuneration and bank corporate governance were very limited.

Second, the components of bankers' remuneration were still very simple. Equity-based remuneration has not been introduced to the majority of the SOCBs. Performance-based remuneration and deferral policy were applied to all bankers through a 'one-size-fits-all' approach, rather than based on bankers' individual performance or their individual responsibilities and the impact on banks' risk profiles. As a result, all bankers' remuneration structures were the same, and the remuneration gaps were controlled to be very stable and narrow across years. Moreover, bankers' remuneration was not based on banks' overall performance, either. It indicates that the regulatory measures to promote the role of performance-based remuneration in pursuing banks' development and sustainability have only been formalistically implemented, rather than materially effective.

Third, the incentive mechanisms of SOCBs have still been based on the traditional administrative and politicised approach. Specifically, the personnel of SOCBs remains within the national bureaucratic system. The *Nomenklatura* System remains predominant in managing and incentivising bankers, and political promotion is still the most important type of incentives. Therefore, the long-lasting control of the government over SOCBs' top bankers has impeded the modernisation and marketisation of bankers' remuneration.

Last but not least, the efforts of the Chinese banking regulators to reform bankers' remuneration have not been successful so far. Specifically, only those mandatory actions which facilitate direct governmental control, such as the remuneration caps and the injunction on equity-based remuneration, have been rigidly followed. In striking contrast, the regulatory measures based on the international standards and Western experience, such as performance-based remuneration and assessment, deferral, and clawback and *malus*, have been playing a very weak card.

8.3 The Practice of Bankers' Remuneration and Incentives in JSCBs

In comparison with SOCBs, JSCBs are less competitive in many aspects, such as the scale of assets and market share. However, JSCBs have relatively dispersive ownership structures. Shareholders of JSCBs include large SOE groups, local governments, overseas and private institutional investors and the state. Usually, the state is not a controlling shareholder. Thus, JSCBs are less trapped by policy burdens and state control. They can be more active to make attempts to reform and improve their corporate governance mechanisms. Moreover, majority JSCBs accomplished their shareholding reforms and IPOs earlier than SOCBs.⁴⁴ These JSCBs have had more opportunities of, and been more open to learning the experience of modern corporate governance. Thus, with less state control but more participation of multiple market players, bankers' remuneration of JSCBs would be different from SOCBs.

JSCBs form an important part of the Chinese banking sector. Therefore, in order to comprehensively understand bankers' remuneration in China, it is necessary to examine the practices of JSCBs.

In this section, based on the empirical data and information, bankers' remuneration and incentive systems of JSCBs will be described and analysed. In total, there are twelve JSCBs, and nine of them are listed companies. Due to the inaccessibility to the information of bankers' remuneration of the three unlisted JSCBs, the empirical study will focus on the nine listed JSCBs.⁴⁵

8.3.1 The Level of Bankers' Remuneration

Generally, the ownership structures of JSCBs are less concentrated. However, among different JSCBs, the ownership structures are various. Some JSCBs are owned by dispersive private capital, whereas some others are primarily controlled by large state-owned financial groups or have the state or local governments as the largest shareholder (not the majority). The ownership structure would have a substantial impact on the institutions and culture of

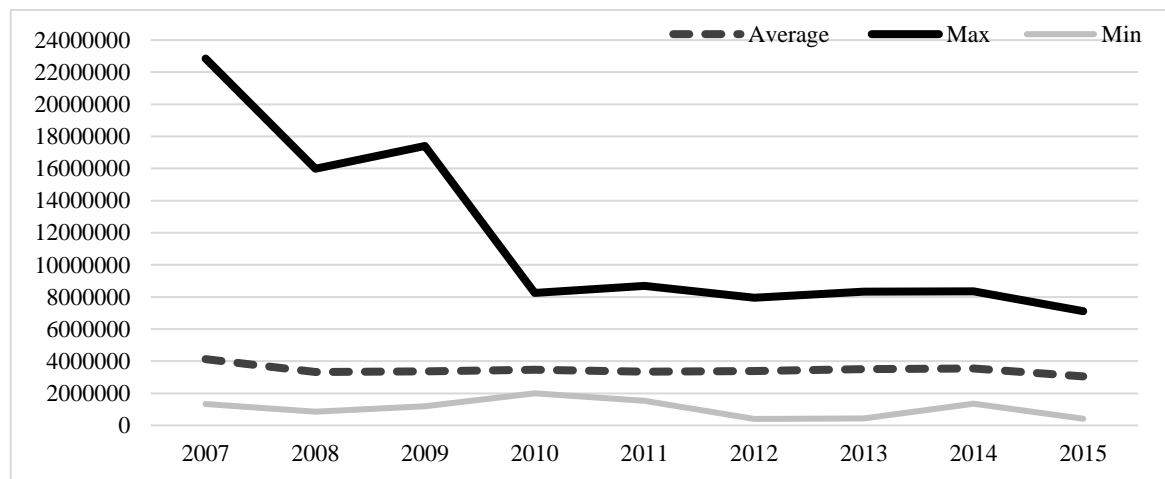
⁴⁴ For the details about JSCBs' shareholding reforms and IPOs, please refer to Table 6.3.

⁴⁵ The criteria and process of data collection and the methodology of data calculation are compatible with those used for the study of SOCBs. For the details and the original data, please refer to Appendix I.

corporate governance. In China, state ownership often brings the administrative and political institutions and the Chinese official culture into corporate governance,⁴⁶ whereas private institutional investors will tend to promote the application of modern corporate governance mechanisms and emphasise competition and efficiency.⁴⁷ Therefore, it is hypothetical that among JSCBs there would be internal diversities in bankers' remuneration practice.

In total, 595 records of bankers' remuneration in JSCBs have been collected. Figure 8.10 shows the overall status of bankers' remuneration levels of the nine JSCBs. On average, from 2007 to 2015, the remuneration level maintained steadily at about RMB 3.5 million. The maximum amount plummeted from RMB 23 to 15 million in 2008 and further dropped down to RMB 8 million in 2010. Since then, it stabilised in between RMB 7 to 8 million. The minimum amount fluctuated in between RMB 0.4 to 2 million.

Figure 8.10 The Overall Status of the Remuneration Level of Chinese JSCBs from 2007 to 2015 (Unit: RMB)



In fact, bankers' remuneration levels of JSCBs were very different from each other. According to the differences in remuneration level, the nine banks are divided into the 'top group', the 'middle group' and the 'bottom group'.

8.3.1.1 The Remuneration Level of the 'Top Group'

The 'top group' includes Minsheng Bank and Ping An Bank. Bankers' remuneration levels of these two banks are provided in Figure 8.11.

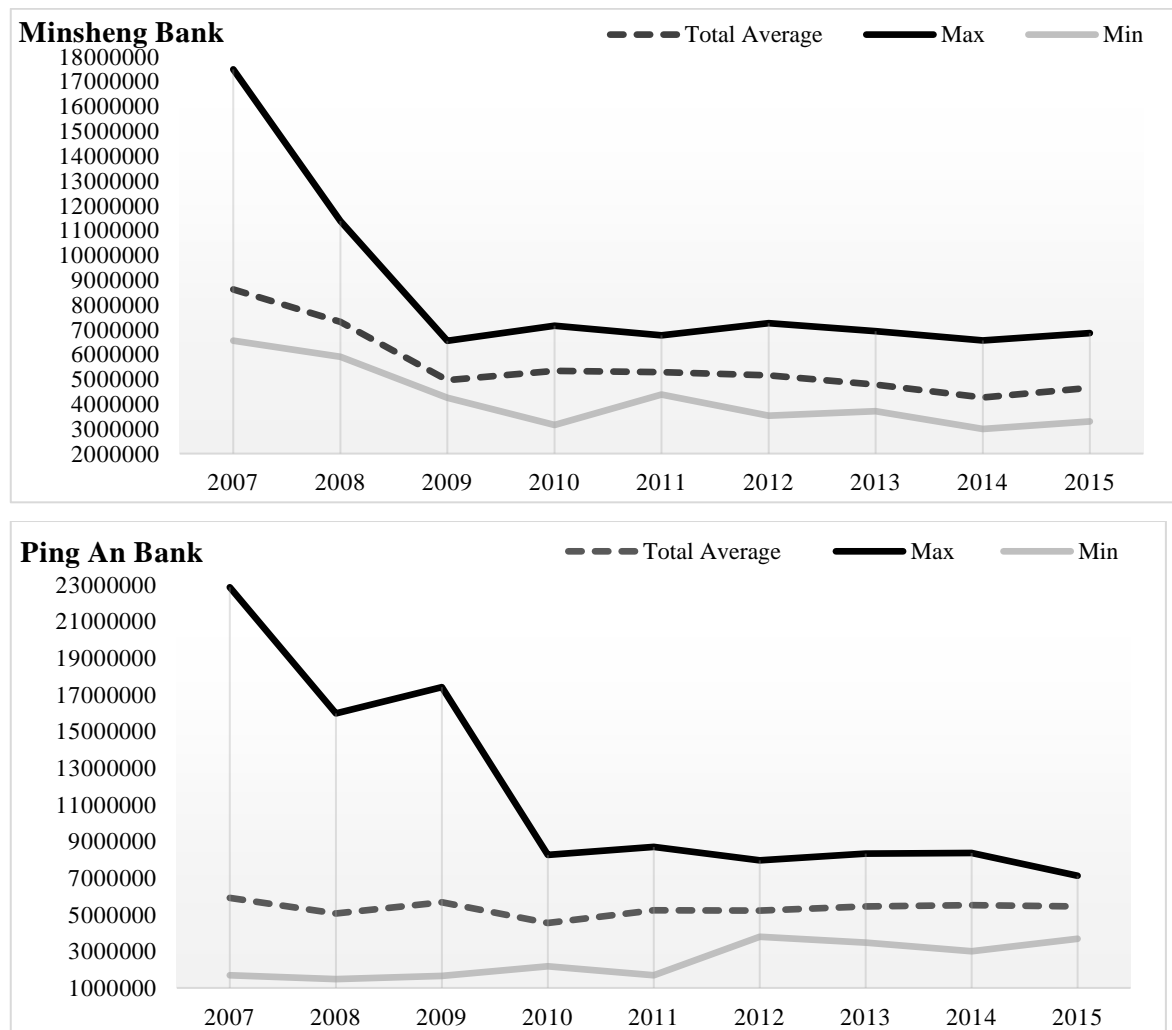
From 2007 to 2009, the maximum remuneration levels of the two JSCBs were more than RMB 10 million. Specifically, the chairman of Ping An Bank was awarded RMB 23 million, which was the highest record. In these three years, the total remuneration of the highest paid banker was approximately ten times of the remuneration earned by the chairmen and

⁴⁶ Donald Clarke, 'Law Without Order in Chinese Corporate Governance Institutions' (n1) 136

⁴⁷ Michael N.T.Tan, *Corporate Governance and Banking in China* (Routledge 2013) 86

presidents of SOCBs. Since 2010, the maximum remuneration declined to RMB 7 to 8 million. Nevertheless, it was still five times of the remuneration of SOCBs' top bankers. On average, the remuneration levels of these two banks maintained above RMB 5 million, which were more than three times of the average levels of SOCBs. In addition, the bottom levels of the two JSCBs were also much higher than SOCBs.

Figure 8.11 The Remuneration Levels of the 'Top Group' of Chinese JSCBs from 2007 to 2015 (Unit: RMB)



The remuneration packages offered by Ping An Bank and Minsheng Bank were far more competitive than SOCBs and other JSCBs. In some years, the total amounts were almost equivalent to the average level in developed financial markets. For instance, the chairman's remuneration in Ping An Bank from 2007 to 2009 ranged from RMB 16 to 23 million, which amounted to GBP 1.3 to 1.8 million.⁴⁸ During this period, the average remuneration level of the UK 'Big Four' was slightly higher than GBP 2 million. Due to the bank failures, many bankers in RBS and Lloyds were paid less than GBP 1.3 million.

⁴⁸ In 2007, 2008 and 2009, the exchange rate from sterling to Chinese yuan was 15:1, 12:1 and 10:1 respectively. For the sources of the exchange rates, please refer to footnote 7 in this chapter.

The two JSCBs appointed overseas bankers to act as their chairmen and presidents. The American banker Frank N. Newman was the chairman of Ping An Bank from 2006 to 2010. The British banker Richard Jackson was the president of Ping An Bank from 2010 to 2012. The former president of Minsheng Bank Eddie Wang transferred from the Hong Kong financial market. Obviously, the remuneration amounts paid to these bankers were based on the pricing mechanism in the Western financial employment markets.

Moreover, appointing overseas bankers to the leading positions encouraged the two JSCBs to apply the market-based pricing mechanism to domestic bankers. Therefore, the amounts offered to domestic chairmen and presidents were at the same levels of overseas bankers. For both domestic and overseas bankers, the two banks have used competitive remuneration packages to attract and incentivise them. The high remuneration levels indicate that in Ping An and Minsheng pecuniary benefits have been emphasised.

From 2009 to 2010, the maximum remuneration levels sharply decreased, which was due to the two banks' financial distresses after the GFC. Table 8.5 shows some important indicators of the two JSCBs' profitability and sustainability. In 2008, Ping An Bank suffered a severe downturn. In particular, the net profit and ROE dramatically dropped. The EPS and ROE of Minsheng Bank also slightly slowed down. Obviously, the sharp decline of bankers' remuneration followed the banks' financial distresses.⁴⁹ It is also evidential that both of the two banks announced in their annual reports in 2008 that due to the hostile financial environment, all bankers' remuneration would be reduced.⁵⁰ In addition, the MOF in 2008 required all Chinese banks to axe bankers' remuneration. Therefore, the decline of remuneration was also a consequence of regulatory compliance.

Table 8.5 The Financial Performance of Minsheng Bank and Ping An Bank from 2007 to 2010⁵¹

Bank / Year	Total assets (million RMB)	Net profit (million RMB)	EPS (RMB)	ROE (%)	CET-1 ratio (%)	NPL ratio (%)
Minsheng 2007	918,837	6,335	3.47	18.23	5.90	1.24
Minsheng 2008	1,054,350	7,885	2.86	15.23	7.00	1.21
Minsheng 2009	1,426,392	12,104	3.95	20.19	8.92	0.84
Minsheng 2010	1,823,737	17,581	3.90	18.29	8.07	0.69
Ping An 2007	352,539	2,650	5.67	33.41	5.77	5.64
Ping An 2008	474,440	614	5.28	4.32	5.27	0.68
Ping An 2009	587,800	5,031	6.59	26.59	5.52	0.68
Ping An 2010	727,600	6,284	9.62	23.22	7.10	0.58

After 2008, the two JSCBs recovered from the downturn and started to develop quickly. In contrast, the maximum remuneration amounts did not return to the level before 2008, which

⁴⁹ Usually, the changes in remuneration reflect bankers' or banks' performance in previous years. As a result, the decline of remuneration level was hysteretic than the occurrence of the GFC.

⁵⁰ Ping An Bank Annual Report 2008, 29; Minsheng Bank Annual Report 2008, 43

⁵¹ The data is collected from these two banks' annual reports from 2007 to 2010.

could not be explained by the two banks' achievements in 2009 and 2010. The banks did not give clear interpretations, either. A possible reason is that the high remuneration levels and the remuneration gap between the two JSCBs and other banks raised public concern.⁵² Through mass media, the public challenged the reasonability of bankers' remuneration, which particularly targeted the highest remuneration packages in Minsheng and Ping An. In 2008, a top media company in China launched an online survey to collect public opinions on the remuneration paid to Mingsheng Bank's chairman. Up to September 2017, there have been 84% voters deemed that the remuneration was too high and 67% thought the chairman was overpaid.⁵³ Confronted with the challenge from the public, the banks had to control the remuneration amounts paid to their top bankers. Nevertheless, the remuneration levels of Minsheng and Ping An still maintained the highest in the Chinese banking sector. In 2015, the remuneration cap was implemented by the MOF and the MHRSS in line with the decision of the CCP. However, different from SOCBs where bankers' remuneration was axed by 60%, Minsheng and Ping An did not enforce the cap.

Clearly, in the two banks, the changes made to the total amounts of bankers' remuneration were mainly the responses to market situations and public opinions, rather than the adherence to state control. It demonstrates that the two banks have emphasised the function of bankers' remuneration in promoting banks' business development and maintaining banks' reputation among customers.

In fact, Minsheng and Ping An are the only two JSCBs which are largely owned by private investors. The state holds very small stakes in these two banks. Minsheng's shares are held by private companies, investment funds and individual investors in a decentralised way, without any state ownership.⁵⁴ The major shareholder of Ping An Bank is Ping An Insurance Group: a large listed and private corporation, whereas the state ownership is only 1.26%.⁵⁵ As private-based JSCBs, they are less restricted by state intervention and control. On the one hand, many of the compulsory requirements to control bankers' remuneration are not binding on non-SOCBs. Thus, the two JSCBs are not responsible for complying with them. On the other hand, their *de facto* corporate governance systems are less intervened by political or administrative forces, which to a large extent releases the institutional and conventional barriers to the adoption of market-based remuneration and incentive methods.

⁵² 'The Sky High Remuneration in Chinese Banks Has Raised the Concern Among Top Policy Makers' (国内银行高管天价薪酬引发决策高层关注) *Netease* (Shanghai, 8 April 2008) <http://news.163.com/08/0408/02/48VLJFSV0001124J.html> accessed 29 September 2017

⁵³ 'Sina Survey: Minsheng Bank' (*Sina Finance*, 12 May 2008) <http://survey.news.sina.com.cn/voterresult.php?pid=24126> accessed 29 September 2017

⁵⁴ Minsheng Bank Annual Report 2016, 74

⁵⁵ Ping An Bank Annual Report 2016, 61

In general, the remuneration levels of the two private-based JSCBs were the highest in the Chinese banking sector. The two banks have tried to offer globally competitive remuneration packages. Therefore, it is conjectural that pecuniary benefits have been used as the major type of incentives. Moreover, the remuneration systems have been more marketised and less affiliated to the administrative and politicised approach. This conjecture will be further tested by probing into the remuneration structures and incentive mechanisms of the two banks.

8.3.1.2 The Remuneration Level of the ‘Middle Group’

There are two JSCBs in the ‘middle group’: Merchants Bank and CITIC Bank. Figure 8.12 shows the remuneration levels of these two banks. Generally, the maximum amounts kept above RMB 5 million, the average levels stabilised at RMB 3.1 to 4.6 million and the minimum levels were usually between RMB 2 to 3 million. The remuneration packages offered by Merchants and CITIC were not as competitive as those of the ‘top group’ and lower than the average level in developed financial markets. Nevertheless, they were much higher than those of SOCBs. Even the minimum remuneration levels of Merchants and CITIC were usually higher than the maximum levels of SOCBs.

Due to the inaccessibility to the data, bankers’ remuneration of CITIC Bank after 2012 is unknown. Up to 2012, following a mild decrease in 2008, the remuneration level of CITIC Bank maintained steady. Similarly, in Merchants Bank, after a slight decline during the GFC, bankers’ remuneration kept at a stable level from 2008 to 2015.

Figure 8.12 The Remuneration Levels of the ‘Middle Group’ of Chinese JSCBs from 2007 to 2015 (Unit: RMB)

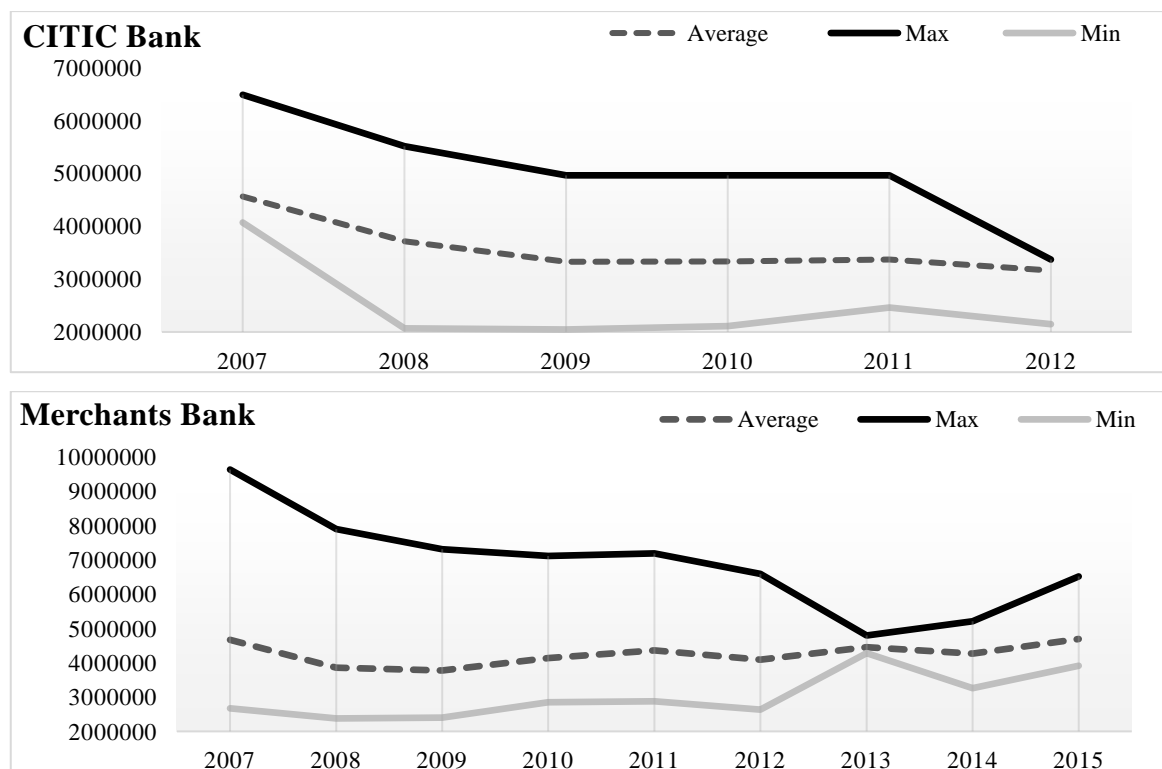


Table 8.6 shows the two banks' financial performance. Different from Minsheng and Ping An, neither Merchants nor CITIC was seriously trapped in the GFC. Apart from the slight declines in CET-1 ratio, the two banks made substantial improvements in assets scale, profitability, shareholder return and risk control. Thus, the declines of bankers' remuneration in 2008 were not due to the two banks' financial performance. The CITIC Bank announced in its annual report that 'despite the great progress in bank's business, our bankers' remuneration has been axed by 15%'.⁵⁶ Obviously, the decline was a voluntary action in the context of the depressed macro-financial environment. It was also to comply with the MOF's mandatory policy of remuneration reduction in 2008.

Table 8.6 The Financial Performance of CITIC Bank and Merchants Bank in 2008⁵⁷

Bank /Year	Total assets (million RMB)	Net profit (million RMB)	EPS (RMB)	ROE (%)	CET-1 ratio (%)	NPL ratio (%)
CITIC 2007	1,011,236	84,136	2.16	12.70	13.14	1.48
CITIC 2008	1,187,837	95,343	2.44	14.84	12.32	1.36
Merchants 2007	1,310,964	15,243	4.62	24.76	8.78	1.54
Merchants 2008	1,571,797	21,077	5.41	27.41	6.56	1.11

CITIC and Merchants are closely connected with the state-owned financial sector through shareholdings. Originally, the two banks were sponsored by the large SOE groups: CITIC Group and China Merchants Group. After the shareholding reforms, their ownership structures have been diversified. However, the two SOE groups still retain substantial stakes.

Table 8.7 The SOE Shareholders in CITIC Bank and Merchants Bank in 2016⁵⁸

Bank	Numbers of SOE shareholders	Total proportion	The largest shareholder	Proportion
CITIC	6	72.54%	CITIC Group	65.37%
Merchants	7	40.34%	Merchants Group	13.04%

Table 8.7 shows the stakes currently owned by the two SOE groups. CITIC Group is the controlling shareholder of CITIC Bank, and China Merchants Group is the largest shareholder of Merchants Bank. In this context, the two banks' corporate governance could be largely influenced by the groups through the arrangements of top personnel. Usually, in CITIC Bank and Merchants Bank, the banks' chairmen are acted by the chairmen or vice chairmen at the group level. The banks also share the common NEDs with their parent corporations. As a result, the corporate governance mechanisms and decision-making processes are not completely independent from the parent corporations.⁵⁹ Institutions, cultures and policies at the group level have a material impact on the subsidiary banks.

⁵⁶ CITIC Bank Annual Report 2008, 114

⁵⁷ The data is collected from the annual reports of CITIC Bank and Merchants Bank in 2007 and 2008.

⁵⁸ Merchants Bank Annual Report 2016, 91-2; CITIC Bank Annual Report 2016, 122

⁵⁹ Masahiko Aoki, 'Controlling Insider Control: Corporate Governance Issues in the Transition' (对内部人控制的控制: 转轨经济中的公司治理结构的若干问题) in Masahiko Aoki and Yingyi Qian (eds), *Corporate Governance in Transitional Economies: Inside Control and the Role of Banks* (转轨经济中的公司治理结构——内部人控制和银行的作用) (China Economic Publishing 1995)17, 38

Moreover, CITIC Group and Merchants Group are CCEs. They are directly managed by the central government. Therefore, through the parent groups, the political and administrative power would have an indirect impact on these two JSCBs.

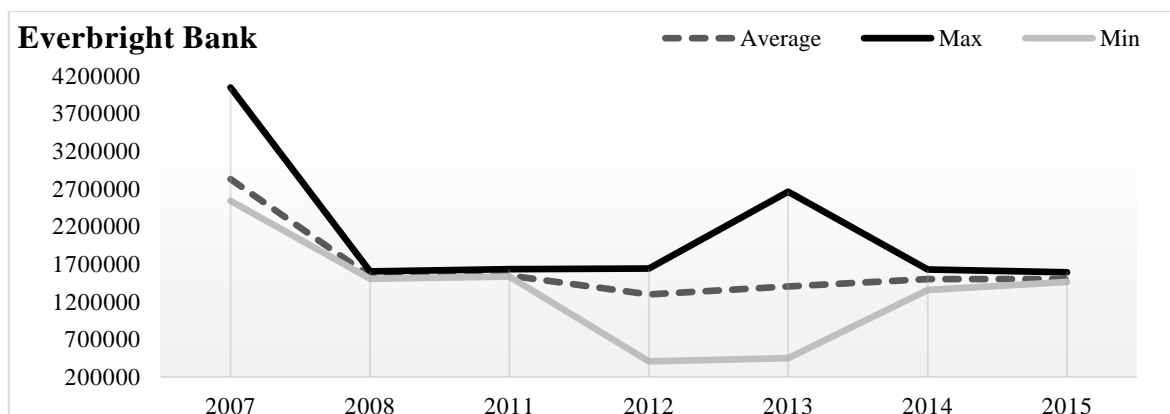
Nonetheless, in comparison with SOCBs, these JSCBs still have more discretion and flexibility. For instance, SOCBs must obey the mandatory remuneration cap made in 2015, so must the CITIC Group and Merchants Group. However, the two subsidiary banks are not bounded by it. According to the data in Figure 8.12, the remuneration level of Merchants Bank did not decrease in 2015, which demonstrates that the bank did not apply the cap.

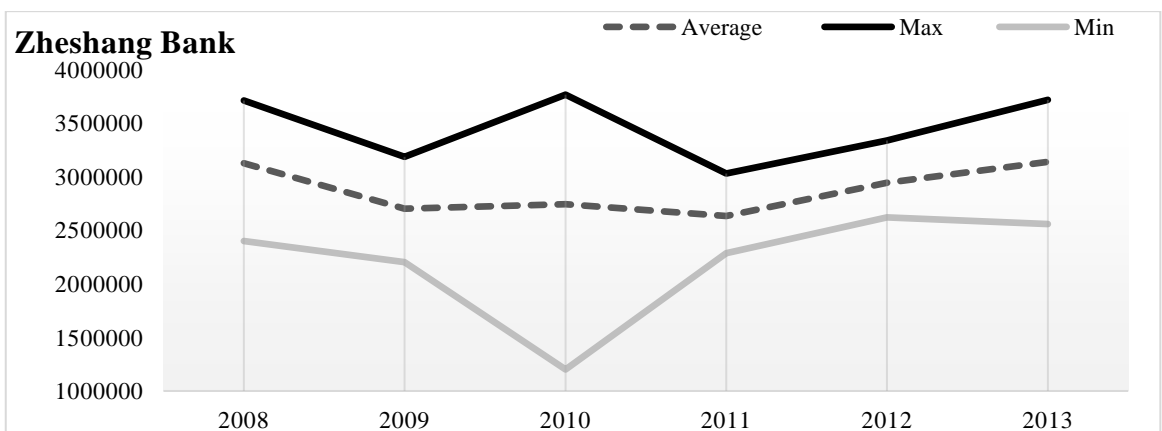
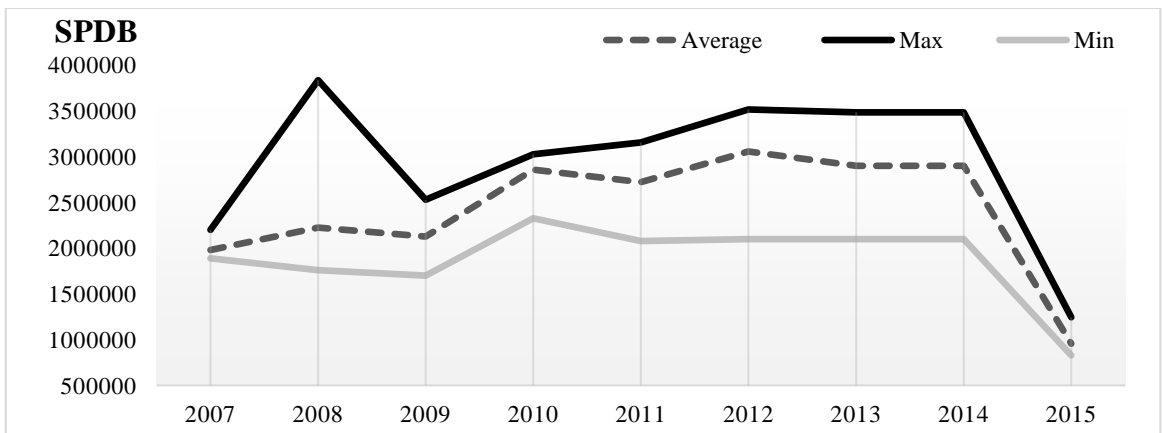
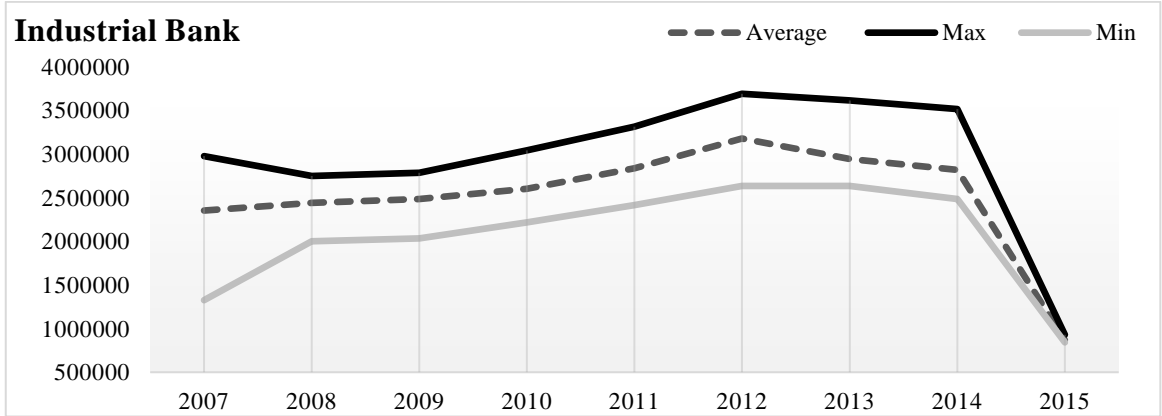
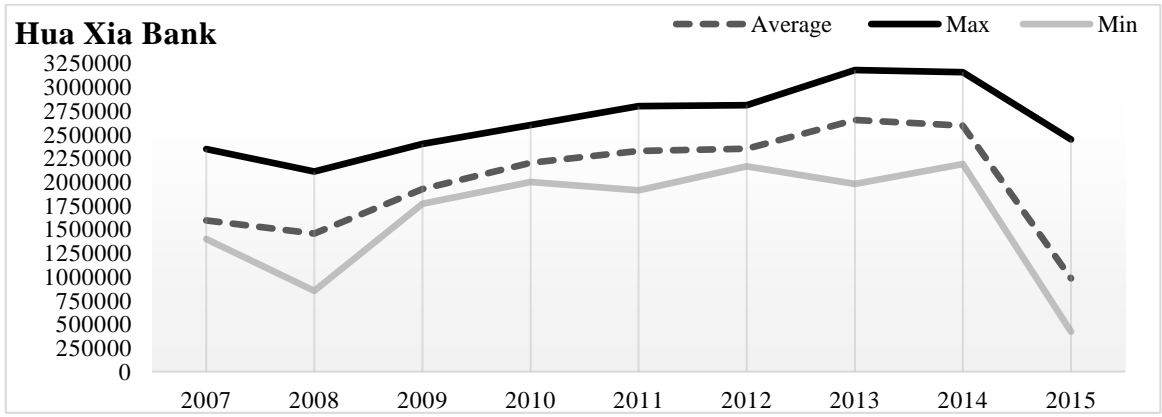
To summarise, the remuneration levels of the JSCBs in the ‘middle group’ were more competitive than SOCBs and the majority of JSCBs, though inferior to the two private-based JSCBs and Western banks. The two banks have tried to maintain the competitiveness of remuneration packages and to limit the impact of governmental intervention and state control. Pecuniary benefits have also been used as an important type of incentives in these two banks. However, the banks are the subsidiaries of large SOE groups, which means that the state can indirectly influence bankers’ remuneration and incentives. Therefore, it is possible that in these two JSCBs political incentives have to some degree been preserved. This issue will be further scrutinised in the next two subsections.

8.3.1.3 The Remuneration Level of the ‘Bottom Group’

The other five JSCBs are categorised as the ‘bottom group’ because bankers’ remuneration levels of these banks were much lower than the other four JSCBs. In general, their total remuneration levels and the evolutionary tendencies were very close to those of SOCBs. The detailed information is shown in Figure 8.13.

Figure 8.13 The Remuneration Levels of the ‘Bottom Group’ of Chinese JSCBs from 2007 to 2015 (Unit: RMB)





First, from 2007 to 2014, the maximum remuneration amounts of the five JSCBs ranged from RMB 2 to 4 million, the average levels were between RMB 1.5 to 3 million and the minimum amounts were usually below RMB 2 million.

Second, in each of the five banks, the remuneration gaps between the maximum, the average and the minimum amounts were narrow. For example, in some years, the gaps between the highest and lowest remuneration amounts of Everbright Bank were controlled within RMB 0.1 million. In addition, throughout the period, the gaps were stabilised at the same level. These two features were also observed in SOCBs. Therefore, it can be inferred that these JSCBs have also applied a ‘one-size-fits-all’ standard to decide bankers’ total remuneration.

Third, these JSCBs dramatically reduced bankers’ remuneration in 2015. Apart from Zheshang Bank, whose data was not disclosed in 2014 and 2015, the tendencies of other banks are evidential. In Hua Xia Bank, Industrial Bank and SPDB, the average remuneration sharply declined by nearly 70%, down to less than RMB 0.9 million. Same with SOCBs, the reduction was to comply with the remuneration cap in 2015. Besides, in terms of the targeted bankers, in SOCBs, the cap was only applied to bankers at the top positions, whereas lower level bankers were exempted. The actions of these JSCBs were consistent with those of SOCBs. For instance, in Hua Xia Bank, the board members’ remuneration was significantly axed from RMB 3.1 to 0.4 million, and the remuneration of president and vice presidents was also axed from RMB 2.4 to 0.4 million. In contrast, the lower level bankers, such as the secretary of the BOD, still received the same amounts as they did in 2014.

As shown in Table 8.8, the state or SOEs have substantial stakes in these JSCBs. In terms of the relationship with the state or SOEs, the five banks can be divided into two types. One type is called the ‘large SOE’ style, which includes Everbright Bank and Hua Xia Bank. These two banks were first sponsored by large SOEs as the subsidiary banks. After the shareholding reforms, the original sponsors have still been the largest shareholders. This type of ownership structure is similar to those of the two JSCBs in the ‘middle group’: CITIC and Merchants. Nevertheless, the state holds much more shares in Everbright and Hua Xia. Therefore, compared to CITIC and Merchants, the impact of state control can be deeper and more straightforward in Everbright and Hua Xia.

Another type is the ‘local government’ style, which means that the banks were originally established as local commercial banks by local governments, together with the support of local SOEs. SPDB in Shanghai, Industrial Bank in Fujian Province and Zheshang Bank in Zhejiang Province belong to this type. Due to the historical connections, these banks have been intertwined with the local governments and subject to the policies for local economic and financial development. As a consequence, corporate governance in these three banks cannot be completely independent from the local governments.

Table 8.8 The State and SOE Shareholders in Everbright Bank, Hua Xia Bank, Industrial Bank, SPDB and Zheshang Bank in 2016⁶⁰

Bank	State ownership		SOE ownership		Largest shareholder		
	Number	Proportion	Number	Proportion	Name	Type	Proportion
Everbright	1	23.31%	7	42.15%	Everbright Group	SOE	28.52%
Hua Xia	1	1.3%	7	66.28%	Shougang Corporation	SOE	20.28%
Industrial	1	18.22%	7	23.71%	Fujian provincial government ⁶¹	State	18.22%
SPDB	1	1.42%	6	51.32%	Shanghai International Group (上海国际集团)	SOE	19.53%
Zheshang	0	0	3	25.04%	Zhejiang Provincial Financial Holdings (浙江金融控股有限公司)	SOE	14.79%

To summarise, in the five JSCBs in the ‘bottom group’, the remuneration amounts were equivalent to those of SOCBs. The changing tendencies from 2007 to 2015 were also similar to those of SOCBs. Different from the JSCBs in the ‘top group’ and the ‘middle group’, these banks have rigidly complied with the MOF’s mandatory policies to cap bankers’ remuneration. The historical affiliation with the government and the state-owned sector has a profound influence on the personnel management, remuneration and incentive mechanisms of these JSCBs. Due to the high similarity with SOCBs in remuneration level, it is conjectural that these JSCBs have also complied with the administrative and politicised approach to incentivise bankers. In order to test this conjecture, the examination of remuneration structure and incentive mechanism will be undertaken in next subsections.

8.3.2 The Components and Structure of Bankers’ Remuneration

In JSCBs, fixed and performance-based remuneration are the two major components of bankers’ remuneration. However, in these banks’ annual reports, the specific amounts of every component were not disclosed, making it impossible to calculate the exact proportions. As a result, the thesis cannot provide quantitative evidence of the remuneration structures of JSCBs. Nevertheless, some JSCBs have provided the details of their performance-based remuneration schemes and deferral arrangements.

Table 8.9 shows the performance-based remuneration schemes adopted by JSCBs, and their implementation of deferral, clawback and *malus*.

⁶⁰ The data is collected from the annual reports of these JSCBs in 2016. Shareholders acting in concert have been counted as one shareholder.

⁶¹ The actual holder is the Finance Department of Fujian government.

Table 8.9 The Remuneration Components and Structures of Chinese JSCBs from 2007 to 2015

Bank	Performance-based remuneration		Deferral		Clawback and <i>malus</i>
Minsheng	Performance-based remuneration system and Special Contribution Rewards: assessments of risk control, management and profitability	2004-	1-year deferral on performance-based remuneration and Special Contribution Rewards	2004-2011	NA
			3-year deferral (CBRC)	2011-	
Ping An	Market-oriented assessment system: rewards linked with performance and contributions	2005-	3-year deferral (voluntary)	2006-2011	NA
			3-year deferral (CBRC)	2011-	
CITIC	NA		3-year deferral (CBRC)	2011-	NA
Merchants	H Share SARs	2007-	3-year deferral (CBRC)	2011-	NA
Everbright	NA		3-year deferral (CBRC)	2011-	NA
Hua Xia	NA		1-year deferral on performance-based remuneration (voluntary)	2007-2011	NA
			3-year deferral (CBRC)	2011-	
Industrial	NA		3-year deferral on Annual Risk Funding Scheme (voluntary)	2008-	NA
			3-year deferral (CBRC)	2011-	
SPDS	NA		3-year deferral (CBRC)	2011-	NA
Zheshang	NA		2-year deferral (voluntary)	2007-2011	NA
			3-year deferral (CBRC)	2011-	

8.3.2.1 The Components of Bankers' Remuneration

As explained before, SOCBs have been required to suspend the plans of equity-based remuneration since 2008. Although the injunction is not explicitly binding on non-SOCBs, it still demonstrates the regulators' conservative attitude towards equity-based remuneration. As a result, other banks have also been discouraged. Among the nine listed JSCBs, by the end of 2016, there has not been any equity-based remuneration scheme, apart from the H Share SARs adopted by Merchants Bank since 2007. Merchants Bank is simultaneously listed in Mainland China and Hong Kong. The SARs scheme is only applied to its shares traded at HKSE.

Generally, cash-based fixed and variable remuneration are the major ingredients of bankers' remuneration of JSCBs. Equity-based remuneration and other types of advanced remuneration incentives remain underdeveloped.

8.3.2.2 Performance-based Remuneration Schemes

According to Table 8.9, three JSCBs have applied explicit performance-based remuneration schemes and specified the details of the systems of performance metrics and assessment.

Before the regulatory framework was established in 2010, the two private-based JSCBs: Ping An and Minsheng had already introduced market-oriented remuneration schemes.

In Ping An, the primary principle of the performance-based remuneration scheme is complying with the market discipline. Bankers' remuneration should be decided by the pricing mechanism in the financial employment market, and the level should be maintained within the top quarter among all the competitors. Moreover, the awards for every banker should be based on their individual performance. The assessments of bankers' performance are classified into three levels: fully competent, basically competent and incompetent. Bankers receive the three types of assessments will be correspondingly awarded 100%, 75% and 0% of the originally scheduled amounts of awards.⁶²

In Minsheng Bank, performance-based remuneration has been applied since 2004. It is comprised of the normal performance-based remuneration and the Special Contribution Rewards. The amounts of performance-based remuneration are subject to bankers' individual achievements in three dimensions: 40% for risk control, 10% for management and governance and 50% for profitability. If bankers' achievements in all of the three dimensions have been far more excellent than the required quotas, bankers are entitled to the Special Contribution Rewards.⁶³

Apart from Ping An and Minsheng, all of the other seven JSCBs have substantial relations with the government and the state-owned sector. Among these state-related JSCBs, there have also been some actions to apply modern and market-based remuneration methods, such as the SARs scheme in Merchants Bank. SARs refer to a scheme of equity-based remuneration which authorises executives the rights to obtain a quantity of cash, the value of which is equivalent to the appreciation on a specified number of company shares over a specified period. However, different from stock options, executives do not need to buy or hold the shares. After the specified period lapses, if bankers' performance has fulfilled the conditions and the share price has increased, bankers will be awarded the corresponding appreciation.⁶⁴ The awards in a SARs scheme are directly paid in cash. Thus, no matter before or after the rights are vested, executives are not entitled to any actual ownership.

It seems that a SARs scheme aligns bankers' remuneration with share price, which would encourage bankers to take excessive risks to drive up the share price. In fact, the design of

⁶² Ping An Bank, 'The Resolution of Ping An Bank on Directors' Remuneration' (平安银行股份有限公司关于董事报酬的议案) in the documents for the first interim shareholder meeting in 2015. http://resources.pingan.com/app_upload/file/bank/91d5aa26659c4af8b10c9b5d6c819490.pdf accessed 10 January 2018

⁶³ Minsheng Bank, 'The Management Methods of Minsheng Bank for Bankers' Annual Remuneration' (民生银行高级管理人员年薪制管理办法) (2003) <http://www.cninfo.com.cn/finalpage/2003-12-09/13121295.PDF> accessed 22 February 2017, Article 6

⁶⁴ 'Understanding Stock Appreciation Rights' (Morgan Stanley) <http://www.morganstanley.com/spc/knowledge/managing-equity/understanding-your-awards/understanding-stock-appreciation-rights.html> accessed 23 February 2017

Merchants' SARs scheme has perfectly avoided this potential problem. The scheme is a long-term incentive strategy, which lasts for six years in total. The first two years are the lockup period, during which the rights cannot be exercised. From the third to the sixth year, in each year bankers are limited to exercise at most 25% of the whole package of SARs.⁶⁵ Therefore, this arrangement is able to align bankers' pecuniary benefits with the bank's performance in the long run.

In the Chinese banking sector where most of the banks have not introduced any equity-based remuneration or long-term incentives, this SARs scheme is of great foresight. In 2007, the formal regulation had not been promulgated, and banks had not been required to apply the three-year deferral policy. Even in the UK, at that time, the lengths of most LTIPs were only three years, and most of them did not include any restriction on the percentage of the options or shares that could be exercised in each year. Therefore, the design of the SARs scheme is advanced. It demonstrates that Merchants Bank has been not only active to apply market-based incentives but also watchful of the material impact of bankers' remuneration on the bank's long-term interests.

Furthermore, the scheme disproves the necessity and reasonability to suspend the application of equity-based remuneration. The problem of bankers' remuneration in Western banks was not in the form of equity-based remuneration *per se*. It was essentially due to the neglect of long-term stability and risk control in the incentive mechanism of equity-based remuneration. Obviously, Merchants Bank has managed to absorb the merits of equity-based remuneration, and at the same time taken precautionary actions against short-termism and excessive risk-taking.

8.3.2.3 The Arrangements of Deferral, Clawback and *Malus*

The CBRC has enacted the rules of deferral, clawback and *malus* with reference to the international standards and Western experience. However, the regulator has not given elaboration about how to implement clawback and *malus*, making it impossible to be effective in practice. Same with SOCBs, none of the nine JSCBs has practically applied clawback and *malus* to bankers' remuneration.

As for deferral, these banks have complied with the rules and applied the three-year deferral policy to performance-based remuneration. Moreover, before the regulation was enacted, some JSCBs had voluntarily adopted deferral.

In Ping An Bank, deferral was applied since 2006. A substantial portion of bankers' performance-based remuneration should be deferred into a three-year period, and the vesting of the delayed rewards relies on bankers' performance. Among different bankers, the specific deferral ratios were various. Taking the delayed rewards allocated in 2007 (paid

⁶⁵ Merchants Bank Annual Report 2007, 49

in 2010) as an example, 30% to 47% of bankers' total remuneration was delayed.⁶⁶ Obviously, the various ratios in Ping An were different from the highly similar ratios among SOCBs' bankers. It demonstrates that the deferral arrangements have been applied by considering bankers' individual responsibilities and the impact on the bank's risk-taking.

In Minsheng Bank, the deferral policy has been applied in conjunction with its performance-based remuneration scheme. From 2004 to 2011, 50% of bankers' performance-based remuneration should be subject to a one-year deferral. After 2011, to comply with the CBRC Guidelines, the deferral period has been extended to three years.

In 2008, Industrial Bank introduced the Annual Risk Funds scheme which is essentially a deferral policy. Bankers' remuneration should be partially delayed into a three-year period and the amounts paid to bankers at the end of the third year should be decided by their achievements in risk control.

Industrial bank disclosed the amounts paid to bankers under the Annual Risk Funds scheme from 2008 to 2014. In 2008 and 2009, the deferral ratios were about 20% and since 2010 the ratios increased to more than 30%. In comparison with Ping An and Minsheng, the deferral ratios of Industrial Bank were lower. However, they were close to the ratios of SOCBs. Besides, the ratio applied to every individual banker's remuneration package was very similar to each other. Therefore, same with SOCBs, the deferral policy of Industrial Bank was also carried out on a 'one-size-fits-all' basis, without considering bankers' individual responsibilities and impact. As a consequence, the effect of the scheme on risk control would be limited.

Table 8.10 The Proportions of Industrial Bank Annual Risk Funds in Bankers' Total Remuneration from 2008 to 2014 (Unit: %)⁶⁷

Position	2008	2009	2010	2011	2012	2013	2014
Chairman	21.09	20.83	35.03	35.03	31.30	30.87	28.75
President (Executive Director)	21.13	20.69	35.08	35.08	31.29	30.84	28.71
Executive Director (Vice President) 1	21.29	20.92	35.69	35.69	32.49	31.63	30.46
Executive Director (Vice President) 2	21.98	21.60	36.38	36.38	32.91	31.68	30.09
Vice President 1			37.74	37.74	32.08	32.07	31.51
Vice President 2			37.82	37.82	32.13	32.10	30.95
Vice President 3					29.27	32.03	30.88
Vice President 4					30.05	32.01	30.45
Vice President 5					30.79		29.59
Secretary of the BOD	22.50	22.15	37.25	37.25	31.68	31.19	30.61
Average	21.60	21.24	36.43	36.43	31.40	31.60	30.20

Apart from Industrial Bank, other JSCBs in the 'bottom group' have had very few attempts to push forward the reform of bankers' remuneration. They did not disclose the details of

⁶⁶ Ping An Bank Annual Report 2010, 71

⁶⁷ The data is collected from the annual reports of Industrial Bank from 2008 to 2014.

the deferral policies, either. Usually, JSCBs which offered lower remuneration levels to their bankers have also been reluctant to apply modern and market-based remuneration methods. In these banks, no matter the remuneration levels or the remuneration structures were similar to those of SOCBs. That is to say, these banks have still adhered to the administrative and politicised approach.

To conclude, in terms of performance-based remuneration and deferral, the practices of the nine JSCB have been different from each other. The two private-based JSCBs have more than ten years' experience in practising systemic and integrated performance-based remuneration schemes and robust deferral arrangements. They have introduced market-oriented systems to align bankers' remuneration with banks' profitability and prudential risk-taking. However, among the state-related JSCBs, the majority of them have not started the marketisation and modernisation reform of bankers' remuneration. In particular, most of the banks that kept the total remuneration levels equivalent to those of SOCBs have not adopted any formal or explicit performance-based remuneration schemes.

The practices of bankers' remuneration in JSCBs are complex. In general, banks with private backgrounds are much more motivated and progressive in terms of developing market-oriented remuneration and incentive mechanisms. In contrast, the processes in the majority of the state-related banks have still been stagnant. Clearly, the findings in remuneration components and structure are consistent with the findings in remuneration level. The banks which have been offering competitive remuneration packages have also applied market-based remuneration incentive mechanisms, including the two private-based banks and Merchants Bank. It further demonstrates that in these banks pecuniary incentives are important to attract excellent financial elites and promote the banks' sustainability. On the contrary, those banks that have maintained bankers' remuneration at low levels and kept pace with SOCBs to comply with the remuneration caps, have been more reluctant and conservative on the reform of bankers' remuneration.

As stated, private-based JSCBs are less institutionally or conventionally constrained by state control. As a result, they are more motivated to adopt market-based remuneration and incentive mechanisms to pursue better corporate governance and higher financial efficiency. In striking contrast, the remuneration and incentive systems of state-related JSCBs have been significantly influenced by the administrative and politicised approach. Nevertheless, in comparison with SOCBs, some state-related JSCBs have been more discretionary and flexible. Merchants Bank is just a good example of breaking through the traditional institutional barriers to push forward the marketisation and modernisation of bankers' remuneration.

8.3.3 Incentive Mechanism

According to previous analysis, bankers' total remuneration levels of Ping An Bank, Minsheng Bank and Merchants Bank were the highest among all JSCBs.⁶⁸ Offering competitive remuneration packages is an important method adopted by these banks to retain their bankers. Aligning pecuniary benefits with banks' development and sustainability is also an important method to incentivise bankers and improve the efficiency of corporate governance. However, many other JSCBs have not adopted market-based remuneration and incentive mechanisms, and the total remuneration was controlled at low levels. In these JSCBs, political incentives would still be predominant. In order to reveal the incentive mechanisms of different JSCBs, it is necessary to examine bankers' career trajectories.

The empirical study on the career trajectories of JSCBs' bankers is based on the same criteria and methodology for the study on the career trajectories of SOCBs' bankers. In total, there are 42 records of the career trajectories of JSCBs' chairmen and presidents, including 24 previous bankers and 18 incumbent bankers. The details are shown in Table 8.11.

Table 8.11 The Career Trajectories of Chairmen and Presidents in Chinese JSCBs⁶⁹

Bank, banker, position and tenure		Brief career trajectory before JSCBs	Political post during tenure in JSCBs	Reason for termination	Brief career trajectory after JSCBs (including political post)
CITIC	Kong Dan Chairman ⁷⁰ 2006-2012	1. The member of the National Economic Commission (国家经济委员会) ⁷¹ in the State Council 2. The vice chairman and president of China Everbright Group 3. The vice chairman and president of CITIC Group	None	Retirement	The director of CITIC Foundation for Reform and Development Studies (中信改革发展研究基金会) ⁷²
	Chen Xiaoxian	1. The vice governor of the PBOC subsidiary in Beijing	None	Retirement	Unknown

⁶⁸ Merchants Bank is in the 'middle group', however, its remuneration level was slightly higher than the other bank in this group - CITIC Bank. More importantly, it is the only JSCB that has adopted equity-based remuneration.

⁶⁹ The information of bankers' careers is collected from their biographies published in banks' annual reports and the Index of China's Leaders and Cadres, as well as their profiles at Wikipedia and Baidu Baike.

⁷⁰ In CITIC Bank, the chairman is usually not an executive member of the BOD and not paid by the bank. The reason is that CITIC Bank is a subsidiary in CITIC Group. Conventionally the chairman of the group is also the chairman of the bank and is paid in accordance with his position as the group's chairman. As the group's chairman, the person cannot ensure the daily management for the bank. As a result, he is regarded as a non-executive director. Nevertheless, the bank is affiliated with the group, thus, it is reasonable to deem that the chairman, as the top leader of the whole group, still has substantial influence on the business and governance of the bank. Merchants Bank (within Merchants Group) and Everbright Bank (within Everbright Group) are in the same situation.

⁷¹ The National Economic Commission was abrogated in 2003.

⁷² The foundation is a non-government organisation (NGO) which focuses on academic research in financial development. It is a subsidiary of CITIC Group.

	President 2004-2012	2. The executive director and vice president of Merchants Bank			
	Zhu Xiaohuang President 2012-2014	1. The president of a provincial subsidiary of CCB 2. the vice president and CFO of CCB	None	Rotation	The chief supervisor of CITIC Group
	Chang Zhenming Chairman 2013-2015	1.The vice president of CITIC Bank 2. The executive director and vice president of CITIC Group 3. The vice chairman and president of CCB (the vice secretary of the CCP committee) 4. The vice chairman and president of CITIC Bank	None	Rotation	The chairman of CITIC Group (the secretary of the CCP committee)
	Li Qingping Chairman 2015-	1. The president of a provincial subsidiary of ABC 2. The ABC senior manager 3. The president of CITIC Bank	None	NA	NA
	Sun Deshun President 2015-	1. The member in PBOC 2. The vice president of the ICBC subsidiary in Beijing 3. The president of the BCM subsidiary in Beijing (the secretary of the CCP committee)	None	NA	NA
Everbright	Wang Mingquan Chairman 2002-2007	1. The vice governor of a city-level subsidiary of PBOC 2. The vice mayor of Wuhan (武汉) ⁷³ 3. The vice chairman and president of BCM (the secretary of the CCP committee)	The substitute member of the 16th CCP Central Committee	Retirement	The independent director of Changjiang Securities Company (长江证券) ⁷⁴
	Guo You President 2004-2014	1. The manager of the Department for the Management of Foreign Financial Institutions in PBOC 2. The vice president of Everbright Bank	None	Rotation	The CCB chief supervisor
	Zhao Huan President 2014-2016	1. The president of the CCB subsidiary in Shanghai 2. The CCB vice president	None	Rotation	1. The vice chairman and president of ABC (the vice secretary of the CCP committee) 2. The substitute member of the 19th

⁷³ Wuhan is the capital city of Hubei Province.

⁷⁴ Changjiang Securities Company is a joint-stock listed company.

					CCP Central committee
	Tang Shuangning Chairman 2007-	1. The president of a city-level subsidiary of PBOC 2. The manager of the Monetary policy Department and the Supervision Department in PBOC 3. The CBRC vice governor	None	NA	NA
	Zhang Jinliang President 2016-	1. The president of the BOC subsidiary in Beijing 2. The BOC vice president	None	NA	NA
Hua Xia	Liu Haiyan Chairman 2003-2007	1. The chairman of Sinopec Beijing Yanshan Company (北京燕山石化公司) ⁷⁵ (the secretary of the CCP committee) 2. The vice mayor of Beijing and the vice secretary of the CCP municipal committee in Beijing	None	Retirement	Unknown
	Zhai Hongxiang Chairman 2007-2008	1. The governor of the Auditing Bureau of Beijing government 2. The governor of the Financial Department of Beijing government 3. The vice mayor of Beijing and the vice secretary of the CCP municipal committee in Beijing	None	Retirement	Unknown
	Wu Jian Chairman 2008-	1. The BCM vice president 2. The president of Hua Xia Bank	None	NA	NA
	Fan Dazhi President 2008-	1. The executive director and vice president of Beijing State-owned Assets Management Limited (北京国有资产管理有限责任公司) ⁷⁶ 2. The executive director and president of Beijing Securities Limited (北京证券有限责任公司) ⁷⁷ 3. The executive director and vice president of Beijing Capital Group (北京首都创业集团有限公司) ⁷⁸	None	NA	NA

⁷⁵ Sinopec Beijing Yanshan Company is a large SOE in the petroleum industry.

⁷⁶ Beijing State-owned Assets Management Limited is a wholly state-owned enterprise, which is directly organised and supervised by Beijing government.

⁷⁷ Beijing Securities Limited is a state-owned securities firm.

⁷⁸ Beijing Capital Group is a large state-owned investment company.

Industrial	Li Renjie President 2002-2016	1.The president of the Industrial Bank's subsidiary in Shenzhen (深圳) 2.The vice president of Industrial Bank	None	Retirement	The chairman and CEO of Lufax Company (陆金所) ⁷⁹
	Gao Jianping Chairman 2002-	1.The vice president of Industrial Bank 2. The president of Industrial Bank	The member of the CCP provincial committee in Fujian	NA	NA
	Tao Yiping President 2016-	The president of a BOC provincial subsidiary	None	NA	NA
Merchants	Qin Xiao Chairman 2001-2010	1. The president of China International Trust Investment Corporation (中国国际信托投资公司) ⁸⁰ 2. The vice chairman of CITIC Group	None	Retirement	The director of Boyuan Foundation (博源基金会) ⁸¹
	Ma Weihua President 1999-2013	1. Civil servants in the provincial governments of Liaoning (辽宁) and Anhui (安徽) 2. The president of a provincial subsidiary of PBOC	None	Retirement	The director of One Foundation (壹基金) ⁸²
	Fu Yuning Chairman 2010-2013	1. The chairman of China South Mountain Development Company (中国南山开发集团公司) ⁸³ 2. The president and executive director of Merchants Group (the vice secretary of the CCP committee)	None	Rotation	The chairman of China Resources (华润集团) ⁸⁴
	Li Jianhong Chairman 2014-	1. The vice CEO of China Ocean Shipping Group (中国远洋运输集团) ⁸⁵ 2. The executive director and president of Merchants Group (the vice secretary of the CCP committee)	None	NA	NA
	Tian Huiyu President	1. The vice president of Bank of Shanghai	None	NA	NA

⁷⁹ Lufax is short for Shanghai Lujiazui International Financial Asset Exchange Co., Ltd., which is an online Internet finance marketplace founded by Ping An Group.

⁸⁰ China International Trust Investment Corporation was the predecessor of CITIC Group.

⁸¹ Boyuan Foundation is a NGO registered in Hong Kong.

⁸² One Foundation is a NGO registered in Mainland China.

⁸³ China South Mountain Development Company is a SOE.

⁸⁴ China Resources is a CCE.

⁸⁵ China Ocean Shipping Group is CCE.

	2013-	2. The vice president of the CCB subsidiary in Shanghai 3. The presidents of the CCB subsidiaries in Beijing and Shenzhen			
Minsheng	Dong Wenbiao Chairman 2006-2014	1. The chairman of Haitong Securities (海通证券) ⁸⁶ 2. The vice president of Minsheng Bank 3. The president of Minsheng Bank	None	Resignation	The chairman of China Minsheng Investment Company (中国民生投资集团) ⁸⁷
	Eddie Wang (HK citizen) President 2006-2009	1. The CEO of HSBC China 2. The CEO of the HSBC subsidiary in Los Angeles	None	Resignation	The senior consultant for Mckinsey
	Mao Xiaofeng President 2014-2015	The secretary of the BOD and vice president of Minsheng Bank	None	Dismissal	Unknown
	Hong Qi Chairman 2014-	1. The president of a city-level subsidiary of BCM 2. The vice president of Minsheng Bank 3. The president and vice chairman of Minsheng Bank	None	NA	NA
	Zheng Wanchun 2016-	1. The vice president of Huarong Assets Management Company 2. The president of Changcheng Assets Management Company (中国长城资产管理公司) ⁸⁸ 3. The vice president of ICBC	None	NA	NA
	Ping An	Frank Newman (US citizen) Chairman (President) 2006-2010	Directors and senior managers in a variety of American banks, including Citi, Wells Fargo, American Bank, Bankers Trust, and so on.	None	Resignation
	Xiao Suining	1. The president of the BCM subsidiary in Shenzhen	None	Resignation	The Chairman of PAG China ⁸⁹

⁸⁶ Haitong Securities is a large and major securities firm in China. Its shareholding structure is dispersed, without a single shareholder holding more than 5% of the company's common shares. See Haitong Securities Annual Report 2016, 66.

⁸⁷ Minsheng Investment Company is a large private investment company in China.

⁸⁸ During Zheng's tenure, Changcheng was a wholly state-owned investment company. It turned into a shareholding company in 2016.

⁸⁹ PAG is a large private investment company in Asia.

	Chairman 2010-2012	2. The president of Ping An Bank			
	Richard Jackson (UK citizen) President 2010-2012	Senior managers in many subsidiaries of Citi Bank located in different countries, including Hungary, Korea, and so on.	None	Retirement	NEDs of several listed corporations in the UK and Europe
	Sun Jianyi Chairman 2012-	1. The vice CEO of Ping An Group 2. The director and vice chairman of Ping An Bank	None	NA	NA
	Ping Shao President 2012-	1. The president of the Minsheng Bank's subsidiary in Shanghai 2. The vice president of Minsheng Bank	None	NA	NA
SPDB	Jin Yun Chairman 2005-2007	1. The vice president of the ICBC subsidiary in Shanghai 2. The vice chairman and president of SPDB	None	Retirement	Unknown
	Fu Jianhua President 2006-2012	1. The vice president of the CCB subsidiary in Shanghai 2. The chairman and president of Bank of Shanghai	None	Retirement	The chairman of SPD Silicon Valley Bank ⁹⁰
	Zhu Yuchen President 2012-2015	1. The president of Dalian Commodity Exchange (大连商品交易所) ⁹¹ 2. The president of China Financial Futures Exchange (中国金融期货交易所)	None	Resignation	The manager of Ping An Overseas Commodity and Precious Metals Exchanges ⁹²
	Ji Xiaohui Chairman 2007-	1. The president of the ICBC subsidiary in Shanghai 2. The vice secretary general of Shanghai government 3. The vice governor of the Financial Department of Shanghai government 4. The chairman of Shanghai International Group ⁹³ (the secretary of the CCP committee)	The member of the CCP municipal committee in Shanghai	NA	NA
	Liu Xinyi	1. The SPDB vice president and CFO	None	NA	NA

⁹⁰ SPD Silicon Valley Bank is a joint-capital bank invested by SPDB and Silicon Valley Bank in the US.

⁹¹ These futures exchanges or commodity exchanges in China are the same with stock exchanges. They are state-owned and non-profit social entities. Therefore, these exchanges belong to the public sector (the 'inside system').

⁹² Xue Liang, 'Two Financial Giants - Zhu Yuchen and Wang Dingguo Joining Ping An Group' (两金融大佬王开国朱玉辰齐齐加盟平安集团) *STCN* (Shenzhen, 31 October 2016) <http://www.stcn.com/2016/1031/12926813.shtml> accessed 25 February 2016

⁹³ Shanghai International Group is the largest shareholder of SPDB, see Table 8.8. The group is a SOE.

	President 2015-	2. The president of Shanghai Guosheng Group ⁹⁴ (上海国盛集团) (the vice secretary of the CCP committee)			
Zheshang	Zhang Dayang Chairman 2006-2014	1. The secretary of the CCP municipal committee in Zhuji (诸暨) ⁹⁵ 2. The member of the CCP municipal committee in Shaoxing (绍兴) 3. The vice secretary of the CCP municipal committee in Quzhou (衢州) ⁹⁶ and the mayor of Quzhou 4. The chairman and president of Zhejiang Commerce Group (浙江省商业集团) ⁹⁷	None	Retirement	Unknown
	Gong Fangle President 2004-2014	The vice president of the PBOC provincial subsidiary in Zhejiang	None	Resignation	The vice chairman of Caitong Securities Company (财通证券) ⁹⁸
	Shen Renkang Chairman 2014-	1. The vice secretary of the CCP municipal committee in Lishui (丽水) ⁹⁹ and the mayor of Lishui 2. The vice secretary of the CCP municipal committee in Quzhou and the mayor of Quzhou	None	NA	NA
	Liu Xiaochun President 2014-	1. The vice president of the ABC subsidiary in Zhejiang 2. The president of the ABC subsidiary in Hong Kong	None	NA	NA

First of all, in comparison to SOCBs' bankers, the pre-JSCB career trajectories of JSCBs' bankers were more diverse. Many of them have experience in the state-owned financial sector, the financial regulatory bodies of the State Council and local governments. In addition, a few bankers developed their careers in the private financial sector before they transferred to JSCBs.

The typology of bankers' pre-JSCB career trajectories is listed below.

⁹⁴ Shanghai Guosheng Group is a SOE specialised in investment.

⁹⁵ Zhuji is a city in Zhejiang Province.

⁹⁶ Quzhou is a city in Zhejiang Province.

⁹⁷ Zhejiang Commerce Group is a large state-owned corporate group which is organised and supervised by the government of Zhejiang Province.

⁹⁸ Caitong Securities Company is a SOE.

⁹⁹ Lishui is a city in Zhejiang Province.

Type A: the state-owned financial sector (including non-financial SOEs and state-related JSCBs)¹⁰⁰

Type B: the financial regulatory bodies

Type C: the local governments

Type D: the private financial sector

Type AB: the state-owned financial sector and the financial regulatory bodies

Type AC: the state-owned financial sector and the local governments

Type AD: the state-owned financial sector and the private financial sector

Type BC: the financial regulatory bodies and the local governments

Type BD: the financial regulatory bodies and the private financial sector

Type CD: the local governments and the private financial sector

Type ABC: the state-owned financial sector, the financial regulatory bodies and the local governments

Type ABD: the state-owned financial sector, the financial regulatory bodies and the private financial sector

Type ACD: the state-owned financial sector, the local governments and the private financial sector

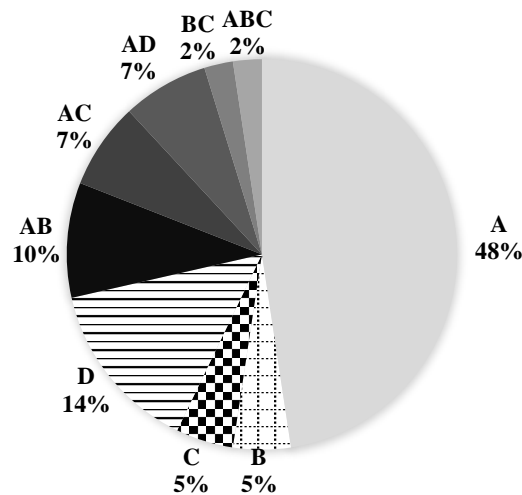
Type BCD: the financial regulatory bodies, the local governments and the private financial sector

The statistical outcomes are shown in Figure 8.14. Type A was the largest source of the chairmen and presidents of JSCBs. Nearly half of the top bankers (48%) served in the state-owned financial sector before their tenures in JSCBs. A number of bankers (19%) rotated between the state-owned financial sector and the government system (Type AB, Type AC and Type ABC). Besides, about 12% bankers directly transferred from local governments or financial regulatory bodies to JSCBs (Type B, Type C and Type BC), without any industrial experience. These types of previous career trajectories were also observed among SOCBs' bankers. However, among these JSCBs' chairmen and presidents, 21% of them have the experience in the private banking sector (Type D and Type AD). In particular, 14% bankers only developed their careers in the private sector (Type D), without any experience in the government or SOEs.

¹⁰⁰ Several bankers worked in non-financial SOEs. However, to make the typology simple, the experience in non-financial SOEs is included in Type A. Besides, working experience in state-related JSCBs is also included in Type A. The reason is that in many cases, when the bankers worked in these state-related JSCBs, the shareholding reforms were not launched. At that time, these banks were fundamentally controlled by SOEs or local governments.

Generally speaking, the ‘inside system’ was the major source of the top bankers of JSCBs. Nevertheless, different from the personnel system of SOCBs which has long been isolated from the ‘outside system’, JSCBs have been more open. In some JSCBs, political affiliation and loyalty was not a compulsory qualification for the leading positions, whereas professionalism and entrepreneurship have been considered crucial.

Figure 8.14 The Types of Chairmen’s and Presidents’ Career Trajectories Before JSCBs’ Tenures



As analysed before, the nine JSCBs have very different shareholding structures. Some of them are completely owned by private capital, while others are intertwined with the government or SOEs. It is hypothetical that bankers with experience in the private banking sector were/are usually recruited by the private-based JSCBs, whereas the state-related JSCBs prefer governmental officials and SOEs’ managers. In order to test this hypothesis, the thesis adopts the Pearson Correlation Test in SPSS to check the correlation between JSCBs’ ownership structures and their bankers’ career trajectories. As shown in Table 8.12, statistically there is a positive correlation between the ownership structures and bankers’ pre-JSCB career trajectories. In fact, according to the information in Table 8.11, it can also be proven that all of the bankers with previous experience in the private banking sector were/are the chairmen or presidents of Ping An and Minsheng. However, the top personnel of the state-related JSCBs has been mainly selected from the ‘inside system’, rather than open to the ‘outside system’.

Table 8.12 The Correlation Between JSCBs’ Ownership Structures and Bankers’ Pre-JSCB Career Trajectories¹⁰¹

		Pre-JSCB career trajectories	JSCB ownership structures
Pre-JSCB career trajectories	Correlation Coefficient	1	1.000*
	Sig. (2-tailed)		.000
		1.000*	1

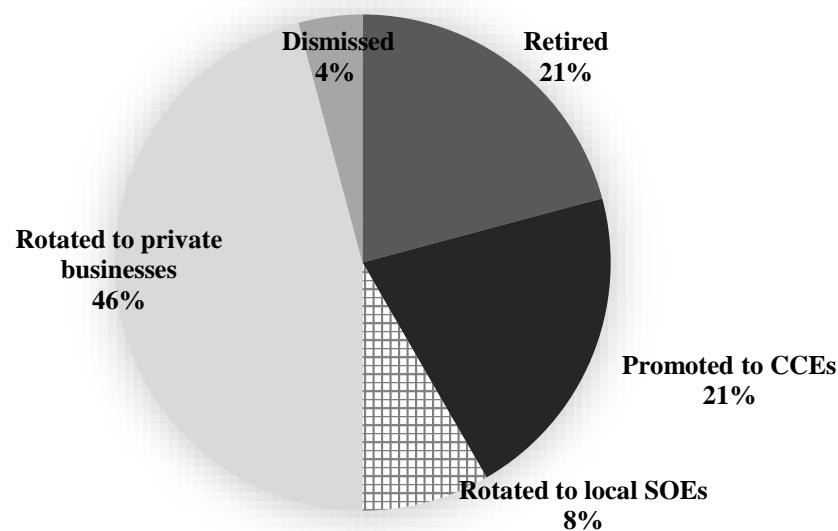
¹⁰¹ The design of the test and the interpretation of the outcome are provided in Appendix J.1.

JSCB ownership structures	Sig. (2-tailed)	.000	
*. Correlation is significant at the 0.01 level (2-tailed).			

Secondly, very few bankers held/hold political posts in the CCP Central Committee during their tenures in JSCBs. State-related JSCB, despite their connections with the state-owned sector, are not directly managed by the central government. In the Chinese banking system, these state-related JSCBs are inferior to SOCBs, and their bankers are usually not included in the core list of the *Nomenklatura* System. Nevertheless, there have been some exceptional cases. The previous chairman of Everbright Bank, Wang Mingquan, was concurrently the substitute member of the 16th CCP Central Committee. In addition, in some JSCBs supported by local governments, bankers largely transformed from local governmental departments. These bankers could be offered important positions in the CCP's local committees during their tenures in these JSCBs. For instance, the current chairman of Industrial Bank is one of the members of the CCP provincial committee in Fujian, and the current chairman of SPDB is included in the CCP municipal committee in Shanghai.

Thirdly, the post-career trajectories of the chairmen and presidents of JSCBs are various. Figure 8.15 shows the five types of career directions after bankers' tenures in JSCBs. Although the majority of the JSCBs mainly selected bankers from the 'inside system', the private financial sector has become the most popular career direction of JSCBs' bankers. Apart from retired or dismissed bankers, 46% bankers chose to work in private businesses after their tenures in JSCBs.¹⁰² Some bankers who previously developed their careers only within the 'inside system', also decided to enter the private financial sector afterwards.

Figure 8.15 The Types of Chairmen's and Presidents' Career Trajectories After JSCBs' Tenures



¹⁰² This percentage includes those bankers who left JSCBs due to retirement, while moving to work in another financial institution.

Only 29% bankers stayed in the ‘inside system’. Usually, they promoted to other CCEs or large local SOEs. Since JSCBs’ bankers are not in the core list of national cadres, it is difficult for them to directly get promoted to the top and leading positions in the bureaucratic system, such as the governors of the PBOC and the CBRC. For them, the first step of political promotion is to get to a leading position in a SOCB or a CCFI. This kind of promotion enables bankers to enter the core bureaucratic system and would pave the way for them to climb to higher positions and become top bureaucrats or politicians.

The statistical outcomes demonstrate that political promotion was not the major type of incentives for JSCBs’ bankers. Nevertheless, it has still been applied in some JSCBs as an effective incentive method. In order to find out in which banks political incentives have still been functional, the correlations between JSCBs’ remuneration levels, their practices of performance-based remuneration and bankers’ post-JSCB career trajectories are tested with the Kendall Test in SPSS.¹⁰³

Table 8.13 shows the outcomes of the correlation tests. Clearly, bankers’ post-JSCB career trajectories are correlative with both JSCBs’ remuneration levels and their practices of performance-based remuneration. Specifically, bankers who stayed in the ‘inside system’ after the tenures in JSCBs or held political posts in the CCP system during the tenures in JSCBs were from those banks with lower remuneration levels and without explicit performance-based remuneration schemes.

Table 8.13 The Correlations Between JSCBs’ Remuneration Levels, JSCBs’ Practices of Performance-based Remuneration and Bankers’ post-JSCB Career Trajectories¹⁰⁴

		Post-JSCB career trajectories	Remuneration levels
Post-JSCB career trajectories	Correlation Coefficient	1	.386***
	Sig. (2-tailed)		.075
Remuneration levels	Correlation Coefficient	.386***	1
	Sig. (2-tailed)	.000	

***. Correlation is significant at the 0.1 level (2-tailed).

		Post-JSCB career trajectories	Performance-based remuneration
Post-JSCB career trajectories	Correlation Coefficient	1	.458**
	Sig. (2-tailed)		.046
Performance-based remuneration	Correlation Coefficient	.458**	1
	Sig. (2-tailed)	.046	

** . Correlation is significant at the 0.05 level (2-tailed).

¹⁰³ The test excludes the cases of the incumbent bankers and the bankers who retired or was dismissed without further career development. As a consequence, there are only 20 available records. Pearson Correlation Test is not suitable for a small sample (less than 30). Thus, Kendall Test, which has a wider application range is applied. For the application of Pearson Correlation Test and Kendall Test, please refer to Cyrus R. Mehta and Nitin R. Patel, ‘Exact Tests’ (SPSS) http://www.sussex.ac.uk/its/pdfs/SPSS_Exact_Tests accessed 23 May 2018

¹⁰⁴ The designs of the tests and the interpretations of the outcomes are provided in Appendix J.2 and J.3.

In the two private-based JSCBs, bankers are usually recruited from the private financial sector, and pecuniary benefits in competitive remuneration packages have been used as the primary incentives. These banks are not substantially affiliated with the government or SOEs, and their bankers are not involved in the ‘inside system’. Traditionally the personnel of these two JSCBs was not managed through administrative and politicised approach. Therefore, the channel to the government system and SOEs was not available and political incentives were not functional. Therefore, the incentive mechanisms in these two JSCBs have been market-based. In terms of remuneration level, the two JSCBs are in the ‘top group’. In terms of incentive mechanism, they can be described as the ‘market group’. The regulators’ compulsory requirements to reduce or cap remuneration level, which were very intrusive and in violation of the market discipline, were rejected by the two JSCBs. On the contrary, some modern measures based on the international standards and Western experience, such as performance-based remuneration and deferral, have been put into their remuneration practices.

Apart from the private-based JSCBs, some state-related JSCBs have also tried to use pecuniary benefits and equity-based remuneration, such as Merchants Bank and CITIC Bank in the ‘middle group’.¹⁰⁵ By tracking bankers’ post-JSCB career trajectories in these two JSCBs, it has been found that some of the previous bankers shifted to the private financial sector, while others stayed in the ‘inside system’ through promoting to the leading positions in CCFIs. Therefore, both economic incentives in remuneration packages and political incentives based on the opportunities to upper positions in the bureaucratic system have been used by these two JSCBs. Clearly, the two banks are typically at a transitional stage from the administrative and politicised approach to the market-based approach. Therefore, they can be described as the ‘quasi-market group’. They have tried to increase remuneration level and improve remuneration structure by introducing market-based methods, in order to get rid of the excessive constraint of state control. For instance, Merchants Bank did not comply with the injunction on equity-based remuneration. In contrast, it has applied the advanced SARs scheme.

In the other five state-related JSCBs, pecuniary benefits have not been applied as the major incentive mechanism. The remuneration levels of these banks were the lowest (the ‘bottom group’) among all listed JSCBs. However, the levels were equivalent to those of SOCBs. Moreover, performance-based remuneration schemes have not been developed in these banks.¹⁰⁶ Bankers all developed their careers within the ‘inside system’ before their tenures

¹⁰⁵ The data of bankers’ remuneration of CITIC Bank from 2012 to 2015 is not available. As a consequence, the remuneration and incentive methods adopted by the bank in these years are unknown. Nevertheless, the bank’s remuneration levels from 2007 to 2012 were higher than the levels of the ‘bottom group’. Therefore, the thesis reckons that CITIC Bank has tried to provide pecuniary incentives.

¹⁰⁶ As stated, Industrial Bank has applied the Annual Risk Funds scheme to link bankers’ remuneration and risk control. Nevertheless, in practice bankers’ risk-adjusted remuneration is decided on a ‘one-size-fits-all’ basis, rather than an individual basis.

in JSCBs. When working in these JSCBs, some bankers were entitled to the political posts in the CCP Central Committee or local committees. Moreover, the majority of the top bankers continued their careers in the ‘inside system’ by promoting to other SOEs after their tenures in JSCBs. For instance, the three recorded previous bankers of Everbright Bank all rotated to SOEs. In particular, two of them worked in SOCBs after their tenures in Everbright, which could be regarded as progressive promotions to the state-owned banking sector. Besides, many bankers in Hua Xia Bank and Zheshang Bank were previously retired officials of local governments or retired managers of large SOE groups. However, after they left the JSCBs, they did not continue to take any other position in the government or SOEs. For them, working in JSCBs was not for further promotions. Nevertheless, the tenures in JSCBs could be regarded as the extension of their political careers which would help maintain their political capital. Bankers working in these JSCBs are usually not the core cadres in the *Nomenklatura* System. Nevertheless, there are opportunities for them to get closer to the core bureaucratic system, which lays the foundation for future political promotion. Therefore, in these JSCBs, political incentives have been prioritised. These JSCBs can be described as the ‘quasi-state group’. These banks have rigidly complied with the compulsory requirements to reduce and cap the level of bankers’ remuneration and the injunction on equity-based remuneration, despite that some of the requirements are not binding on them. In contrast, they have been reluctant to apply performance-based remuneration schemes and other modern and market-based methods.

Table 8.14 A Summary of JSCBs’ Remuneration and Incentive Systems

Remuneration level	Remuneration incentives	Political incentives	Modern regulatory measures	Intrusive regulatory intervention
Top group	Market	None	Complied	Not complied
Middle group	Quasi-market	Minor	Complied	Not complied
Bottom group	Quasi-state	Major	Not all complied	Complied

Table 8.14 summarises the major characteristics of the different kinds of remuneration and incentive systems of the nine JSCBs. To conclude, the remuneration practices of JSCBs are diverse and complex. Some banks have adopted a modern and market-based approach while others still adhere to the ossified administrative and politicised approach. To a large extent, the different approaches are highly relevant to banks’ ownership structures. Specifically, private-based JSCBs prefer the market approach while most of the state-related JSCBs conservatively stay with the traditional way.

8.4 The Features of Bankers’ Remuneration Practice in China

In the last two sections, the practices of bankers’ remuneration and incentives in Chinese SOCBs and JSCBs have been empirically analysed. Based on the empirical evidence, the features of the remuneration practice in the Chinese banking sector are discussed below.

8.4.1 Predominant Political Incentives

As one of the key issues of bank corporate governance, the modernisation and marketisation of bankers' remuneration is a necessary and crucial step to push forward China's transitional banking reform. However, it is also an arduous and complicated task.

Traditionally, the system of allocating, managing and incentivising banks' top personnel was organised through the administrative and politicised approach, which was developed in the era of the planned economy. Banks' personnel was regarded equivalent to civil servants. In particular, top managers were the core financial cadres in the nation's bureaucratic hierarchy and belonged to the *Nomenklatura* System. The *Nomenklatura* System was the incentive mechanism through which the state could incentivise bankers with the opportunities of political promotion.

Low remuneration level, weak pay-to-performance sensitivity, lack of economic incentives, and the essential role of political incentives are the fundamental features of the administrative and politicised approach. Before the Chinese banking regulators launched the reform of bankers' remuneration, this approach was predominant. However, the empirical evidence of the remuneration practices of major Chinese banks demonstrates that even after the regulatory framework has been established, the administrative and politicised approach is still predominant in all SOCBs and the majority of JSCBs.

These banks, especially SOCBs, have made great achievements in their businesses. Bankers have made substantial contributions to banks' development. However, bankers' remuneration has maintained at very low levels, far less than the average level in developed financial markets. Instead of competitive remuneration packages, working in SOCBs can help bankers secure the opportunities to get promoted to important and leading positions in the central government's financial regulatory bodies or provincial governments. Usually, their career trajectories have been a routine from lower positions in the 'inside system' to top bankers of SOCBs, and further to senior positions as the country's core cadres and politicians. This routine is completely the same as the career trajectories of their predecessors who worked in SOCBs before the shareholding reforms.

Therefore, in major Chinese banks, political promotion remains the predominant form of incentives, whereas in practice, the regulatory reform to adopt market-based incentive methods has encountered many difficulties and barriers from the old institutions.

8.4.2 Market Force in the Infancy

Despite the predominance of political incentives in the majority of Chinese banks, the modern and market-based remuneration system has been developing in several JSCBs.

In comparison with SOCBs, JSCBs are in the face of less state control. In terms of ownership structure, usually, the state is not a majority shareholder in JSCBs. In terms of regulation, JSCBs are not in the list of CCFIs and not directly controlled by the central

government. Therefore, some of the compulsory regulatory requirements for SOCBs are not binding on JSCBs. In principle, they have more leeway to make decisions on their own to pay, manage and incentivise bankers.

In particular, the two private-based JSCBs were not traditionally organised through the administrative and politicised approach. Their personnel systems belong to the ‘outside system’ and political incentives were not feasible in these two banks. Therefore, they have been advanced in taking initiatives to offer competitive remuneration packages and adopt modern and market-based incentive methods.

In other JSCBs, due to the affiliation to the government and SOEs, the administrative and politicised approach remains influential on banks’ personnel management. Nevertheless, there is an exceptional case. One of the state-related JSCBs – Merchants Bank, is more foresighted than others. It has taken ice-breaking steps to adopt modern and market-based remuneration methods to shift from political incentives to economic incentives. It is also attentive to the remuneration failures in the developed financial markets and has taken actions to enhance long-term incentives and risk control.

Therefore, it can be concluded that a modern and market-based approach of bankers’ remuneration and incentives has also been developing, though still in the infancy.

8.4.3 Ineffective Regulation

By establishing the professional regulatory framework with reference to the international standards and Western experience, the Chinese banking regulators want to push forward the modernisation and marketisation reform of bankers’ remuneration. However, the practice in Chinese banks exposes the ineffectiveness of the regulatory framework.

First of all, there are flaws within the framework *per se*. One of the flaws is that some of the regulatory measures which encourage banks to adopt modern and market-based remuneration methods are not reasonably or sufficiently designed, making them inefficient or unfeasible in practice. For instance, the CBRC Guidelines do not provide specific instructions about how to apply clawback and *malus*. As a result, the two measures have been completely unenforced. Besides, the length of deferral is three years. However, it is much shorter than a bank’s business cycle. As a consequence, although banks have implemented this policy, it will not be sufficient to encourage bankers to develop a long-term angle. In contrast, in the developed financial markets, regulators have been exploring the methods to enhance banks’ long-term sustainability and risk control through remuneration incentives. They have been progressive in designing and implementing the measures of deferral, clawback and *malus*. Their experience could have been introduced into the Chinese regulatory framework to improve its feasibility and effectiveness.

Another flaw rests with the compulsory requirements to cap bankers’ remuneration and to suspend the application of equity-based remuneration. Although the purpose of these

requirements was to avoid repeating the remuneration failures in the West, they have been too intrusive. These requirements have reinforced state control and political intervention, whereas completely in violation of the market discipline and contradictory with the objective of modernising and marketising bankers' remuneration.

In fact, the long and powerful tradition of the administrative and politicised approach is an essential reason for the ineffective regulation. In a transitional economy and society, social members' thoughts and interests have been deeply shaped by the traditional institutions and conventions, which form the insurmountable bottleneck in the process of institutional reform and innovation. In next chapter, the institutional barriers to the reform of bankers' remuneration in China will be analysed in detail.

8.5 Conclusion

This chapter has empirically examined the remuneration practices in China's major commercial banks from 2007 to 2015. It has summarised the typical features of bankers' remuneration practice and analysed the implementation details and the practical effects of the regulatory framework. The chapter has given answers to the question: how is bankers' remuneration practiced in China and how does the regulation work?

The five SOCBs are the largest and most important banks in China. They are also the top-ranking banks in the World. However, these Chinese SOCBs are typically distinguished from other world-leading banks due to the majority state ownership. Historically, China's banks were completely owned by the state. Thus, the systems of governance and personnel were controlled by administrative and political power. The institutional tradition has a profound impact on the current remuneration practices of SOCBs.

A decade ago, Chinese SOCBs completed their shareholding reforms and IPOs. They successfully developed from traditional SOEs to large and listed banking groups. However, the systems of bankers' remuneration and incentives of SOCBs are still subject to the administrative and politicised approach. Through this approach, bankers are managed as the core cadres in the state's *Nomenklatura* System. Moreover, they are incentivised with the opportunities of political promotion in the bureaucratic hierarchy and the CCP system. The predominance of political incentives has become the major institutional and conventional barrier for Chinese banks and banking regulators to push forward the marketisation and modernisation reform of bankers' remuneration. As a consequence, the remuneration levels of SOCBs have been much lower than the levels of Western and domestic private banks. The so-called performance-based remuneration offered to bankers has been decided by neither bankers' individual performance nor banks' overall performance. The modern and advanced regulatory measures such as deferral, clawback and *malus*, remain unenforced or have been implemented in a formalistical way.

JSCBs are also nationwide and important banks in China. The ownership structures and sponsorship backgrounds of JSCBs are complex. According to the types of ownership structure, the nine listed Chinese JSCBs can be categorised into private-based and state-related banks. The former are owned by dispersive private capital, whereas the government or SOEs usually have stakes in the latter. The two private-based JSCBs are less intertwined with the government and SOEs, and less constrained by the administrative and politicised approach. Therefore, these two banks have provided competitive remuneration packages to attract bankers from all over the world and relied mainly on economic benefits to incentivise bankers. However, the majority of the JSCBs are affiliated to the government and SOEs. Their personnel has been historically intertwined with the bureaucratic system. Therefore, the remuneration and incentives systems have been significantly influenced by the administrative and politicised approach. Similar to SOCBs, most of these state-related JSCBs have maintained the remuneration amounts at low levels. They have not effectively applied performance-based remuneration to incentivise bankers. In these banks, political incentives remain predominant, whereas the marketisation and modernisation reforms of bankers' remuneration have been stagnant. Nevertheless, not all of the state-related JSCBs have been ossified to adhere to the traditional approach. Merchants Bank is the best example of actively promoting the transitional reform in a state-related commercial bank from the administrative and politicised approach to the market-based approach.

In general, the practice of bankers' remuneration and incentives in China is still significantly embedded in the administrative and politicised approach, despite that market-based remuneration system has started to develop in a minor range. The outcomes of the empirical studies demonstrate that the primary objective of the regulatory framework, which is to promote the marketisation and modernisation of bankers' remuneration, has not been fulfilled. The inefficiency of the regulatory framework first results from the defects in itself. The regulators have imposed strict control over bankers' remuneration in an intrusive way, which has completely replaced the role of the market. Moreover, the regulators did not properly design the measures or provide sufficient instructions to banks. More importantly, at the transitional stage, the barriers of the old institutions and conventional norms have strongly impeded the regulation from being effective.

In fact, the path-dependent character of institutions and the restrictions on reforms can be observed in any economies. For instance, the UK's regulatory reform of bankers' remuneration is also highly influenced by the long tradition of the liberal market mechanism. In next chapter, the regulatory approaches in the UK and China will be compared and the different institutional impact of the two financial systems will be discussed.

Part IV
Comparative Analysis

Chapter 9

Market or State: The Comparison of the Regulations of Bankers' Remuneration Between the UK and China

9.1 Introduction

Part II and III have discussed the issues of bankers' remuneration in the UK and China respectively. In particular, the problems of bankers' remuneration in these two economies, the solutions adopted by the UK and Chinese banking regulators and the effects of the two regulatory frameworks in practice, have been analysed.

The discussions in previous chapters give an intuitional sense that the issues of bankers' remuneration in the UK and China are very different from each other. Despite that the two countries' regulators have adopted some similar measures, the basic problems in bankers' remuneration, the regulatory philosophies and the concrete regulatory conduct, as well as the institutional environments for regulatory implementation and compliance, are substantially divergent. In essence, the divergence reveals the different patterns of the relation and interaction between the state and the market in these two countries.

Along with the trend of financial globalisation, the policies of banking regulation in different economies have exhibited a strong tendency of convergence.¹ In particular, the extensive destruction of the GFC has manifested the necessity of international cooperation. The issue of regulating bankers' remuneration and incentives has also been included in the international regulatory framework.

However, among different countries, the legal and institutional origins, and the economic and political environments are divergent, which have a significant impact on the patterns of corporate governance and business cultures.² Thus, even if there are international standards guiding national regulators, it cannot be taken for granted that the regulations of bankers' remuneration in different countries will be operating in the same way. Understanding different regulatory approaches, their particularities and the deep-seated reasons for the particularities, will provide a multiple and comprehensive view of the regulation of bankers' remuneration in the global financial markets.

This chapter attempts to discuss how and why bankers' remuneration practices and regulatory approaches in the UK and China have been different from each other. Section 9.2 compares the problems of bankers' remuneration, the regulatory frameworks and the

¹ Heidi Mandanis Schooner and Michael Taylor, 'Convergence and Competition: The Case of Bank Regulation in Britain and the United States' (1999) 20 (4) *Michigan Journal of International Law* 595, 596; Mark J. Roe, 'Legal Origins, Politics, and Modern Stock Markets' (2006) 120 (2) *Harvard Law Review* 460, 476

² Rafael La Porta *et al.*, 'Investor Protection and Corporate Governance' (2000) 58 (1-2) *Journal of Financial Economics* 3, 24

implementation processes and effects in these two countries. Section 9.3 construes the reasons for the divergence by probing into the two countries' legal and institutional origins, and the economic and political backgrounds. Section 9.4 is the conclusion.

9.2 The Market VS. the State in Regulating Bankers' Remuneration

9.2.1 The Starting Point: Different Problems

Regulation is assumed to be facilitative to improving social welfare and economic efficiency.³ The emergence of the regulations of bankers' remuneration in both the UK and China is to deal with the problem in practice, which would stymie social and economic development. Nevertheless, the specific problems and how the problems would impair social welfare and economic efficiency are heterogeneous. In reality, the problem is the starting point to understand any economic regulation. Only after knowing the specific problem, can the regulator prescribe the suitable solutions. Moreover, for different problems, the prescriptions and their efficacies are different.

9.2.1.1 The UK

The problem of bankers' remuneration in the UK is elaborately analysed in Chapter 3. The problem had been concealed under UK banks' expansionary businesses and thriving share prices until the GFC. It was first brought to the regulators' attention due to the public condemnation on the 'sky high' level of bankers' remuneration. In order to maintain public confidence in the financial market, the UK government started to investigate the problem and found out that the crux was the incentive mechanism in bankers' variable remuneration.

Banking is always an intensively regulated industry. However, before the GFC, bankers' remuneration was completely subject to private autonomy and decided through contracts.⁴ In the market of remuneration, the players included banks' shareholders, the existing directors and managers on behalf of shareholders, and the financial elites with the potential of becoming new bankers. This free market mechanism was hypothesised to be efficient, and efficient remuneration practice was interpreted as bankers offering the best services to maximise shareholders' interests.⁵ Therefore, equity-based remuneration was prevalently adopted as the predominant form of incentives, through which bankers became shareholder-minded and were motivated to create immediate shareholder returns.

However, this interpretation of 'efficiency' was distorted. Usually, value prediction on long-term behaviours is full of uncertainties. In contrast, short-term returns are much more

³ Bronwen Morgan and Karen Yeung, *An Introduction to Law and Regulation: Text and Materials* (CUP 2007) 41

⁴ Kym Maree Sheehan, *The Regulation of Executive Compensation: Greed, Accountability and Say on Pay* (Edward Elgar 2012) 1

⁵ Jay Cullen, *Executive Compensation in Imperfect Financial Markets* (Edward Elgar 2014) 48-9

foreseeable.⁶ For banks' shareholders and shareholder-minded managers, short-term returns were more certainly perceived, whereas the long-term interests of the financial system were irrelevant.

As a consequence, during a long time before the GFC, the function of equity-based remuneration was to encourage bankers to make immediate profits and drive up share prices in the short run. Subject to short-term interests, bankers took high-risk and expansionary strategies, while ignoring the necessity of prudential risk management. Finally, banks became excessively exposed to the risks in the global financial markets and got trapped in the GFC. In a word, the exercise of equity-based remuneration before the GFC impelled bankers to one-sidedly pursue short-term interests at the expense of banks' long-term interests and financial stability.

In essence, the failure of bankers' remuneration in the UK was a failure of the laissez-faire market mechanism.⁷ It demonstrated that the liberal market of bankers' remuneration was imperfect, which has justified that governmental regulation is necessary to rectify market conduct and deal with market inefficiencies and defects.⁸

9.2.1.2 China

The problem of bankers' remuneration in China is entirely different. The problem in the UK was due to the inefficiency of the market mechanism, while in China the crux was the absence of the market mechanism.

In the recent four decades, China has made unprecedented achievements in financial development. Nevertheless, the approach of financial development substantially differs from other major economies, in particular, developed financial markets.

According to the endogenous financial development theories, usually, the emergence and development of a financial market are endogenous. At the stages of early capital accumulation and economic growth, along with the increase of incomes and the thriving of productivity and business, financial intermediaries become more and more necessary for improving the efficiency of information collection, processing and resources allocation.⁹

Differently, in China, when the financial reform started, all economic-social institutions were founded on the ideology of the planned economy. Those endogenous conditions for financial development did not exist. Instead, at the starting point, the state, with strong

⁶ Ibid, 95

⁷ Jay Cullen, *Executive Compensation in Imperfect Financial Markets* (n5) 160

⁸ Richard Posner, 'Theories of Economic Regulation' (1974) 5 (2) *The Bell Journal of Economics and Management Science* 335, 336

⁹ Angelde De La Fuente and JoséMaría Marin, 'Innovation, Bank Monitoring, and Endogenous Financial Development' (1996) 38 (2) *Journal of Monetary Economics* 269, 273; Robert E. Lucas, 'On the Mechanics of Economic Development' (1988) 22 (1) *Journal of Monetary Economics* 3, 39

power and solid intention, was the pivotal impetus for financial development.¹⁰ Therefore, the early development of the Chinese banking system was not a natural or spontaneous consequence of economic growth. On the contrary, it was driven by active state policies. In the trend of economic globalisation, China was a lagging-behind country without a mature market mechanism. Therefore, in order to complete the primitive capital accumulation and facilitate the construction of market infrastructure in a short time, it was indispensable for the state to play a crucial role in information collection, processing and resources allocation.¹¹ In this context, state control over banks' decision-making processes was essential for enhancing the 'top-down' reform. To a large extent, state control over banks' decision-making depended on the control over banks' core personnel, and political incentives and administrative management were necessary. As a consequence, bankers became bureaucrat-minded and were incentivised to prioritise the government's policies to banks' profitability.

State control and political intervention over banks' internal governance could be applied as an expedient at the early stage of the transitional banking reform. However, when the financial market infrastructure has been primarily established, and more and more multi-background players have entered the market, state control and political intervention will become a major constraint against further reforms.¹² In the current stage of China's financial development, after the primitive capital accumulation has accomplished and the financial market infrastructure has been preliminarily established, it has become an endogenous requirement to eliminate unnecessary state control and political intervention in bank corporate governance, and to allow banks to operate on the market mechanism.

The way how executives are remunerated and incentivised determines their performance. Executives' performance is of crucial importance to a firm's development. Therefore, in order to further enhance the transitional banking reform and improve the efficiency of bank corporate governance, the modernisation and marketisation reform of bankers' remuneration is necessary. However, under the strong and excessive state control and political intervention, bankers' remuneration practice in China was still subject to the administrative and politicised approach, which has become the major impediment of the reforms of bankers' remuneration and bank corporate governance.

9.2.1.3 Comparison

Clearly, in both the UK and China, before the regulatory reforms, the problem of bankers' remuneration became a crucial obstacle to the development and sustainability of the

¹⁰ Victor C. Shih, *Factions and Finance in China: Elite Conflict and Inflation* (1st edn, CUP 2009) 8

¹¹ Alexander Gerschenkron, *Economic Backwardness in Historical Perspective: A Book of Essays* (The Belknap Press of Harvard University Press 1962) 20; Robert Wade, *Governing the Market: Economic Theory and the Role of Government in East Asian Industrialisation* (Princeton University Press 2004) 16

¹² Victor C. Shih, *Factions and Finance in China: Elite Conflict and Inflation* (n 10) 8; Ronald I. McKinnon, *Money and Capital in Economic Development* (Brookings Institution 1993) 74-7

banking system. Differently, the problem in the UK was that the market of bankers' remuneration was dysfunctional and governmental regulation was absent, whereas the problem in China has focused on how to establish the market of bankers' remuneration and shift the role of the state from the controller to the real market regulator.

In fact, both of the problems essentially rested with the relationship between the market and the state. In the UK, the market was the sole mechanism to decide bankers' remuneration, without proper state intervention. In China, the state played a predominant role whereas the market was suppressed.

9.2.2 The Process: Different Regulatory Approaches

To deal with the problems, both the UK and Chinese authorities have taken actions to reform bankers' remuneration. In the UK, governmental regulation has been launched to remedy for market inefficiencies and defects. The main purpose of the regulation is to correct market conduct and shift the practice of bankers' remuneration from short-termism and excessive risk-taking to long-term orientation and prudential risk-taking. In China, a regulatory framework has also been established to guide banks to apply modern and advanced remuneration and incentive methods.

After the GFC, the BCBS and the FSB have published general principles and implementation standards to instruct the regulatory reforms of bankers' remuneration at the national level. The international standards have been taken into account by both the UK and Chinese regulators. China has also learned from the Western experience. Therefore, some of the measures have been included in both regulatory frameworks. Nevertheless, the detailed arrangements and stipulations of these measures are very different, which can reflect that their regulatory philosophies and approaches are divergent.

9.2.2.1 The UK

At the ideological level, the principles of bank corporate governance in the UK has shifted from agency theory and shareholder primacy to the maintenance of financial stability and the protection of the public interest. The shift implies that bankers' remuneration practice should be directed towards banks' long-term development, risk control and the public interest.¹³

To this end, first of all, the UK regulators have enhanced the independence and responsibilities of remuneration committee. Specifically, a remuneration committee should be entirely made up of NEDs. It should be in full charge of designing and implementing remuneration policies in accordance with the principles of maintaining financial stability

¹³ HL Selected Committee on Economic Affairs, *Banking Supervision and Regulation* (2nd Report of Session 2008-09, HL Paper 101-I) 47

and protecting the public interest. The measure aims at restricting the power of shareholder-minded bankers from controlling the decision-making of their own remuneration packages. Bankers were subject to short-termism and excessive risk-taking. In order to limit their power over remuneration and incentives, the UK regulators' solution is to enhance the power of external and independent third parties in the market. Nevertheless, the regulators themselves do not directly intervene in the decision-making of bankers' remuneration. It demonstrates that the regulators have regarded themselves as market instructors and supervisors, rather than participants. They believe that the market mechanism should still play the fundamental role. When the market operates inefficiently, their job is to adjust the conduct of market players and guide them to the correct way.

This regulatory philosophy is also embodied in other measures, such as deferral, clawback and *malus*, and risk-adjusted performance metrics and assessment. These measures are of crucial importance to direct banks' remuneration practices to focus on the pursuits of long-term interests and risk control. It is compulsory for banks to implement all of these measures. Therefore, banks' remuneration policies and practices would be substantially changed by these measures. Nevertheless, the regulators do not have the intention to replace banks as the decision makers. Before the GFC, banks decided bankers' remuneration based on the market signals such as share price and profits. These regulatory measures require banks to pay more attention to other market signals which could reflect banks' potential of long-term development and the situations of risk-taking. Therefore, despite a flurry of regulatory measures, the fundamental mechanism is still market-based, and banks still have the discretion and autonomy to determine the level and structure of bankers' remuneration.

Although the regulatory environment for bankers' remuneration has shifted from 'light touch' to tightening, the UK regulators are still precautionous about the potential negative impact of excessive and intrusive intervention on market efficiency. Therefore, they have carried out the regulation at a moderate pace and confined their own power on a reasonable and necessary basis.¹⁴ Moreover, for this reason, the UK regulators strongly opposed to the application of bankers' bonus cap. Apart from the contradiction between the cap and other regulatory measures and the adverse effect on the competitiveness of the UK financial market, the UK regulators have also concerned that bankers' bonus cap would result in direct intrusion in the decision-making of bankers' remuneration and thereby impair market autonomy.

The UK regulators' cautiousness is influenced by the institutional and ideological tradition of the liberal market discipline. It is the fundamental principle and the most important experience of the country's thriving and prosperous economy, no matter in the 19th century

¹⁴ Ian MacNeil, 'The Trajectory of Regulatory Reform in the UK in the Wake of the Financial Crisis' (2010) 11(4) *European Business Organisation Law Review* 483, 499

or in the contemporary era.¹⁵ In next section, the impact of the institutional and ideological tradition on the current regulatory reform will be analysed, through the comparison with China.

9.2.2.2 China

The institutional tradition of banking regulation in China is based on state control and political intervention, rather than the market mechanism. The purpose of the regulation is to eliminate state control and political intervention in bank corporate governance and pave the way for the modernisation and marketisation of bankers' remuneration. Therefore, the Chinese banking regulators have tried to implement modern and market-based measures.

Similar to UK banks, Chinese banks are also required to establish a remuneration committee. However, the requirement on remuneration committee's independence is not as strict as the UK. It is not compulsory for all of the committee members to be independent.¹⁶ In addition, the CBRC Guidelines explicitly stipulate that the BOD takes full charge of the design, implementation and management of bankers' remuneration,¹⁷ which is based on the model of 'director primacy'. At the same time, the CBRC Guidelines have also required banks' BODs to protect the interests of different stakeholders. Namely, the CBRC empowers the BOD to decide bankers' remuneration and give the mission of protecting the public interest to the BOD. However, executive directors materially exercise the power of the BOD, rather than NEDs. Thus, 'director primacy' particularly enhances the predominant role of executive directors. In Chinese banks, executive directors are top bankers. Given that many bankers have been politically affiliated with the government, the emphasis of 'director primacy' would continue to enhance state control, while restraining market autonomy.

Based on the traditional administrative and politicised remuneration system, bankers were bureaucrat-minded and would prioritise state control to the market mechanism. If bureaucrat-minded bankers are still the decision makers of bankers' remuneration, the modernisation and marketisation reform would be reluctant. In this sense, empowering neutral and external NEDs, who are usually acted by entrepreneurs, economists, lawyers and overseas bankers, would make some contributions to the implementation of modern and market-based remuneration methods. However, the preference to banks' executive directors in the decision-making of bankers' remuneration demonstrates that, in terms of

¹⁵ Iain Murray, 'The UK's Return to Socialism' (*Foundation of Economic Education*, 27 April 2015) <https://fee.org/articles/the-uks-return-to-socialism/> accessed 23 October 2017; Andy Beckett, 'How Britain Fell Out of Love with the Free Market' *The Guardian* (London, 4 August 2017) <https://www.theguardian.com/news/2017/aug/04/how-britain-fell-out-of-love-with-the-free-market> accessed 23 October 2017

¹⁶ The CBRC Guidelines do not specify how many members should be independent. The stipulation is that 'the remuneration committee should be relatively independent', which implies that a remuneration committee can be made up of both NEDs and executive directors. *The CBRC Guidelines*, Article 17.

¹⁷ *The CBRC Guidelines*, Article 17

leaving bankers' remuneration to the market, the Chinese banking regulators are still conservative. They still want to take full charge of the reforming process.

In fact, the regulators have made attempts to introduce a number of modern and advanced measures. However, in the process of introducing these measures, the regulators have still played a very intrusive role. For instance, in order to encourage the application of performance-based remuneration, the MOF has enacted very detailed provisions on the types and weightings of metrics, and the assessment system of bankers' performance. As a consequence, performance-based remuneration is primarily decided by the MOF, whereas banks' discretion is very limited. Moreover, in 2008 and 2015, the regulators have reduced and capped bankers' remuneration levels. They have also required banks to suspend the plans of equity-based remuneration. These measures have completely abandoned the market mechanism.

An important intention behind these measures was to avoid the similar mistakes made by Western banks so as to maintain financial stability. The regulators were afraid that the remuneration reform would become so radical that it would cause uncertainty and instability in the financial system. Therefore, it is still necessary for them to retain the power to intervene in bankers' remuneration practice and master the pace of the reform. Obviously, when in the face of the potential problems in market operation, the orthodox philosophy of the Chinese regulators is strictly confining the market or even replacing the market.

There is no doubt that the regulatory reform of bankers' remuneration will redefine the roles of the state and the market and rebalance the power between the two. Ideally, a successful reform can lead to a well-functioning market of bankers' remuneration and a reasonable and supportive regulatory framework. To this end, the reform should try to turn market players into real decision makers, while the regulators should act as instructors and supervisors. However, the very detailed and intrusive measures demonstrate that the approach taken by the Chinese regulators to carry out the reform of bankers' remuneration has departed from the original purpose.

The regulatory dilemma, 'giving power to the market results in disorder, whereas enhancing state control leads to reform failure',¹⁸ has been a long-term puzzle throughout China's economic and financial reform. In terms of the reform of bankers' remuneration, the regulators are afraid of market disorder. If the market is out of control after the state power over bankers' remuneration has been completely released, the regulators would no longer be powerful enough to clear up the mess, which will be detrimental to the financial reform as a whole.¹⁹ Therefore, since the very beginning of the reform, the regulators have been

¹⁸ This is translated from a Chinese idiom '一放就乱，一管就死'.

¹⁹ Victor C. Shih, *Factions and Finance in China: Elite Conflict and Inflation* (n10) 13-4

very cautious about shifting the decision-making power of bankers' remuneration from the state to the market.

9.2.2.3 Comparison

Generally speaking, the reforms of bankers' remuneration in the UK and China are in opposite directions. In the UK, the role of the state should be enhanced while the market should be relatively restricted. On the contrary, in China, the power of the state should be limited while the market should be given the autonomy to operate by itself. Nevertheless, during both reforms, the originally predominant side remains strong. In the UK, the regulators have tried to keep themselves from making unnecessary and excessive intervention, whereas in China, the regulators have insisted on their role as final controllers.

9.2.3 The Effect: Different Practices

In last two subsections, the differences in the problems of bankers' remuneration and the regulatory approaches between the UK and China have been compared. The reforms come down to how to properly deal with the relationship, in particular, the power allocation between the state and the market on the issue of bankers' remuneration. The detailed measures taken by the two countries' regulators demonstrate that both of the approaches have been deeply impacted by their traditional institutions and ideologies. As a result, the reforms have been limited by the originally predominant side between the state and the market. It demonstrates the arduousness and complexity of the institutional innovation in bankers' remuneration.

Nevertheless, during the post-crisis decade, the reforms have brought changes to banks' remuneration practices. The empirical studies on the remuneration practices of major UK and Chinese banks have been carried out in Chapter 5 and 8 respectively. The studies have revealed the effects of the two regulatory frameworks. In the face of different problems and having taken different approaches, the regulatory effects in the UK and China also differ from each other.

9.2.3.1 The UK

In the UK, bankers' remuneration practice has been substantially changed by the regulation. The majority of the measures in the Remuneration Code have been efficiently implemented.

First, LTIPs have become the predominant remuneration component, whereas short-term bonuses have been substantially axed. At the same time, the minimum length of deferral in performance-based remuneration has been extended from three years before the GFC to five or seven years afterwards. Clawback and *malus* have also been incorporated in banks' remuneration policies. Therefore, in practice, the focus of performance-based remuneration has shifted from short-term to long-term interests.

Second, the FCA and the PRA have required banks to redesign the assessment system of bankers' performance by applying risk-adjusted metrics. The purpose is to attach bankers'

remuneration with prudential risk-taking. The regulators did not prescribe the specific metrics or the weightings of each metric. Instead, they have left the issues to banks. In practice, UK banks have materially reformed the systems of performance metrics and assessment, with an emphasis on risk control and financial stability.

In the UK banking sector, high-level compliance with the post-crisis regulation of bankers' remuneration has been observed. Many measures have been effectively implemented and been operating productively. However, not all of the measures have been rigidly followed.

The EU bankers' bonus cap has only been enforced on a formalistic basis. Without the possibility to reject the implementation of the cap, in practice, UK banks have created the role-based pay to circumvent the cap, in order to avoid the decline of total remuneration level. The EBA required UK banks to abolish the role-base pay. However, none of the banks has done so, which has also been acquiesced by the UK regulators. A significant difference between bankers' bonus cap and other measures is that it enables the regulators to directly intervene in banks' internal decision-making process and replace banks to determine bankers' remuneration level and structure. Therefore, this intrusive measure has been considered counterproductive for the application of other market-based measures.

Shareholder 'Say on Pay' is another counterproductive measure. It empowers shareholders to make the final decisions on bankers' remuneration, which would result in a terrible retrogression of bankers' remuneration back to the pre-crisis incentive model. Therefore, it contradicts with the principles of long-term financial stability and the public interest, and will substantially limit the effects of other regulatory measures, which aims at cultivating bankers' long-term views. 'Say on Pay' is not a measure enacted by the FCA or the PRA for the special reform of bankers' remuneration. As a consequence, its problem has not been paid sufficient attention by the banking regulators. In the future, they should take special actions to rectify the counterproductive effect of 'Say on Pay'.

Besides, in terms of applying risk-adjusted and stability-based incentive mechanism, the strength of the UK regulation is not sufficient: equity-based remuneration is still the dominant form of variable remuneration; the indicators of financial stability and risk control are still less important than the indicators of profitability; debt-based remuneration and other forms of variable remuneration have not been introduced. In the future, the UK banking regulators should avoid being overcautious. Instead, they should introduce more advanced and useful measures to guide banks' remuneration reforms.

9.2.3.2 China

In the UK, market-based measures have been efficiently implemented, whereas bankers' bonus cap, which has been regarded as an intrusive measure, has been circumvented. In China, the situation has been opposite. In practice, the modern and market-based measures, which are based on the international standards and Western experience, have been poorly

implemented. On the contrary, the intrusive measures which enhance strong state control have been rigidly followed.

In the regulatory books, the stipulations of some modern and market-based measures are too general. For instance, the regulators have not provided any detailed instructions about how to carry out clawback and *malus*. Without concreteness, banks have not put them into practice at all. There are detailed regulatory requirements on some other measures. Nevertheless, these measures have not been properly enforced, either. For instance, the MOF has stipulated all the types and weightings of performance metrics and provided the calculation formulas to assess bankers' performance. The system of performance metrics and assessment is very intrusive, and banks have very limited discretion to make adjustments to the assessment of bankers' performance. Nevertheless, the design of the system is still advanced. It has attempted to attach bankers' remuneration with the goals of business growth, risk control and financial stability. If the system had been well implemented, it would have enhanced the pay-to-performance sensitivity in Chinese banks. However, the empirical evidence shows that bankers' performance-based remuneration was determined by neither bankers' individual performance nor banks' overall performance. That is to say, the system has not been effectively implemented. Besides, the empirical evidence also demonstrates that the proportion of deferral was not based on the responsibilities of individual bankers or their impact on banks' risk-taking, which means that the measure has only been implemented on a formalistic basis.

Contrary to the poor implementation of these modern and market-based remuneration methods, the traditional administrative and politicised approach of remunerating, managing and incentivising bankers remains predominant. Political promotion remains the most important form of incentives in all of the SOCBs and majority of the JSCBs. As a consequence, the strong tradition of political incentives has become a key obstacle to the reform of bankers' remuneration.

Obviously, the recent regulatory efforts in China have made limited achievements in the marketisation and modernisation reform of bankers' remuneration. The expectation on the regulatory framework has not been fulfilled. Compared to the UK, the regulation of bankers' remuneration in China is less efficient. In the future, the Chinese banking regulators should avoid being overcautious about its control. Instead, they should take more bold and resolute steps to activate the remuneration market.

9.2.3.3 Comparison

In both the UK and China, the problems of bankers' remuneration could be concluded as the inappropriate power allocation and the inefficient interaction between the market and the state. The regulations have been trying to adjust the relation between the two forces, in order to achieve the balance between them and maximise the pursuits of financial stability

and the public interest. However, neither of the two jurisdictions have fully achieved the objectives. The main barriers are the old institutions and norms in the financial systems.

Path dependence can be commonly observed in institutional transitions. Moreover, it is stronger at the early stage because the old institutions are still powerful. Therefore, in the two jurisdictions, the reforms have been handicapped by the originally stronger side between the market and the state. In essence, people who have benefited from the interests generated by the old institutions will reject any changes, making the institutions path dependent. In next section, how the old institutions in the UK and China have been influential on the reforms of bankers' remuneration will be discussed.

9.3 The Reasons for Choosing Between the Market and the State: An Institutional Interpretation

9.3.1 Institutions and Interests

Each country has its own particularities in the economy, politics, legal system and cultural tradition. These fundamental institutions play a decisive role in shaping a country's financial system. The specific institutions of the financial system define the property rights of different participants in the financial market, which substantially determines their interests. Therefore, the utilities and choices of individuals and organisations in the financial market, and the patterns of interaction between market participants and their expectations on each other, are all fettered by the institutional framework.²⁰ In terms of bankers' remuneration, different market players have different interests. They all hope that regulators' policies would be inclined towards their own interests. When the interests of different market participants are conflicting, it will be difficult for policy makers to fulfil all of the requirements. If policy makers also have their own interests in bankers' remuneration, the maximisation of their own interests will be prioritised. In essence, the regulatory approaches of bankers' remuneration are governments' reactions to the conflicting interests of different market players, and the endeavours to maximise their own interests. Moreover, both the interests of different market players and the government's interests, have been formed by the existing institutions of the financial system.

This subsection will analyse the institutions and the structure of interests in relation to bankers' remuneration in the UK and the Chinese financial systems. In order to make the discussions clearer, they are diagrammed in Figure 9.1 and 9.2 respectively.

9.3.1.1 The UK

The UK's financial market is highly privatised. Governmental ownership of financial resources is regarded economically inefficient and politically and ideologically

²⁰ Douglass C. North, *Institutions, Institutional Change and Economic Performance* (CUP 1990) 107-10

undesirable.²¹ Apart from the temporary governmental ownership in several large UK banks due to the bailouts during the GFC, the UK banking sector is always characterised by the high-level marketisation and privatisation since the Thatcherism Privatisation in the 1980s. Even today, the process of ‘privatisation’ or ‘de-nationalisation’ is still preferred by both the market and the government.²²

In the highly privatised financial market, the main participants include financial institutions, their shareholders, directors and managers, and broad financial consumers, namely, the public. The government is the regulator who oversees the operation of the market. It makes laws to define and protect property rights and other rights. It also enacts regulations to guide or restrict market conduct. The laws and regulations can be regarded as the government’s resolutions to balance the interests among a variety of market participants. However, the government itself is not a market participant. It is an independent force beyond all market players. To a large extent, the high proportion of private ownership in the UK financial market ensures the government’s independence. Moreover, the financial watchdogs: the FCA and the PRA, are independent from politics to exercise their regulatory power.²³ Therefore, the UK government usually has no direct private interests in the financial market. The main pattern of interaction between the state and the market is through regulation.

In the financial market, participants are bound by institutions. That is to say, their interests are based on the existing institutional framework. Nevertheless, their interests can be changed when there are new institutions, such as regulation. Market participants all expect that the new regulations will benefit themselves or at least will not reduce their utilities. If the existing institutions are conducive to some parties’ interests, these parties tend to be conservative and will stymie any changes. On the contrary, the parties whose interests have been impaired will try to overturn the existing institutional framework.²⁴

In terms of bankers’ remuneration, the high pay level and huge equity awards are in the interests of banks and bankers. For banks, competitive remuneration will attract excellent financial elites and enhance banks’ competitiveness in the global financial markets. For individual bankers, high pay packages secure them huge pecuniary benefits. Equity-based

²¹ Svetlana Andrianova *et al*, ‘Is Government Ownership of Banks Really Harmful to Growth?’ (2010) DIW Berlin Discussion Paper No. 987 https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1633841 accessed 5 April 2017, 1

²² The nationalisation of RBS, Lloyds, Northern Rock and other financial institutions was an expedient during the GFC. Now the UK government is planning its retreating from the banking sector. Emma Dunkley and Martin Arnold, ‘Government Shelves Plans to Sell RBS and Lloyds Shares’ *Financial Times* (London, 25 June 2016) <https://www.ft.com/content/e02972d2-3aca-11e6-8716-a4a71e8140b0> accessed 26 December 2017.

²³ The independence of the financial regulators is a standing focus of the UK Parliament and the government. Emma Dunkley and Caroline Binham, ‘UK MPs Push to Protect FCA’s Independence’ *Financial Times* (London, 18 April 2016) <https://www.ft.com/content/648d2e92-0489-11e6-a70d-4e39ac32c284> accessed 5 April 2017

²⁴ Mancur Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups* (Harvard University Press 2002) 6-7

incentives fulfil their ambitions for careers and reputations because bankers' risky and expanding strategies could make the bank's financial statements and share price 'look fantastic'. The pre-crisis deregulation provided a relaxing policy environment, in which banks and bankers could maintain their 'win-win' coalition for high pay level and huge equity-based awards. Therefore, banks and bankers will favour less regulatory intervention and prefer to stay with the 'light touch' approach.

However, the public will not allow high-level bankers' remuneration and risk-generating incentive mechanism after they suffered the financial turmoil and paid for the bailouts of failed banks. Consumers have been aware that once banks take too many risks and make the financial system unstable, it is their interests that will be consequently damaged. Therefore, the public has urgently resorted to the government to intensify the regulation of bankers' remuneration.

As just mentioned, the UK government does not have direct private interests in the financial market. Nevertheless, it still has its own pursuits in financial regulation. Generally speaking, for any government, maintaining its political power and authority is of utmost importance. To this end, a government must try to secure the support from the majority in society. The public support, in the form of votes, is based on the achievements in economic development and social stability, for which the government needs to carry out legislative and regulatory activities.

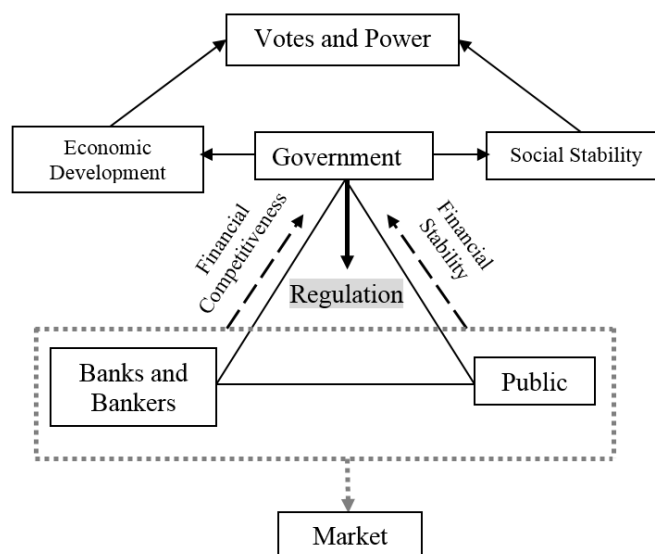
Nevertheless, sometimes the goals of economic development and social stability are not compatible with each other. In the UK financial market, the pursuit of banks and bankers for financial competitiveness conforms to the goal of economic development, while the public demand for financial stability is integrated with the goal of social stability. In the UK, immediately after the GFC, due to the special circumstances, maintaining social stability was more emergent in the short run, whereas economic development was also of crucial importance for the country to recover from the Crisis and achieve continuous prosperity in the long run. As one of the key issues of the post-crisis banking regulatory reform, the regulation of bankers' remuneration has embedded both of the two goals.

Maintaining public confidence in the financial system for social stability was the primary target after the GFC. Thus, the UK government has adopted a series of regulatory measures to intervene in bankers' remuneration with the purpose of eliminating excessive risk-taking. At the same time, the competitiveness and freedom in the financial market, which are essential for keeping the banking industry dynamic and attractive, have also been taken into consideration. For this reason, most of the regulatory measures on bankers' remuneration are market-based. It demonstrates that the UK government wants to guide and instruct market players, rather than replacing the market mechanism. Of course, due to the previous remuneration failures, the incentives in bankers' remuneration should be attached to financial stability and the public interest. Nonetheless, in the eyes of the UK government,

as long as these objectives are met, bankers' remuneration should not be further controlled or interfered by regulation.

Therefore, the UK regulatory framework of bankers' remuneration, on the one hand, has shown the public that the government has been determined to tighten the regulation of bankers' remuneration to enhance financial stability and risk control. On the other hand, it has left much leeway to banks to encourage financial competitiveness. It has attempted to reach an equilibrium between the conflicting interests of banking practitioners and public consumers. By doing so, the government hopes to make both sides satisfied to the maximum and thereby consolidate its own power.

Figure 9.1 The Structure of Interests in the Regulation of Bankers' Remuneration in the UK



9.3.1.2 China

The differences between the Chinese financial system and Western financial systems are often attributed to state control and political intervention. Different from the UK, in China, the government overwhelmingly holds substantial stakes in the financial market through the state ownership in important financial institutions. State ownership means that the government is the controlling shareholder, which ensures state control. By controlling the operations and internal governance systems of major banks, the government can smoothly enforce its policies for economic reform and development.²⁵

Nowadays, the Chinese financial system has been far more diversified. Along with economic growth and financial development, more and more foreign and private capital has been attracted to the Chinese financial market. Foreign and private capital can invest in the state-owned sector as minority shareholders or establish private financial institutions.

²⁵ Victor C. Shih, *Factions and Finance in China: Elite Conflict and Inflation* (n10) 107

Currently, in the diversified financial market, the participants include financial institutions with different ownership structures and capital backgrounds, and public consumers.

Different from the UK, the relationship between the Chinese government and the financial market is more complex. On the one hand, for all kinds of financial institutions, the government is the market regulator. It has the power and the responsibilities to enact laws and regulations, which define the rights and obligations of market players, and supervise their conduct. However, on the other hand, as the controlling shareholder, it determines SOCBs' business strategies so as to control the allocation and operation of state-owned financial capital. In this sense, it is also an essential market participant. Therefore, in terms of the relationship with the financial market, the Chinese government has dual capacities: the financial regulator and an important participant. However, the dual capacities are very often contradictory with each other.

As the regulator, the government's primary objective is to provide a benign and healthy institutional environment to promote financial reform and development. In the context of China's transitional reform, banking regulation should be conducive to market competitiveness, and the modernisation and marketisation of bank corporate governance. Therefore, the Chinese banking regulators have been trying to establish a professional and modern system of banking regulation. However, at the same time, the government is also the biggest and most important participant in the Chinese financial market. With substantial stakes, it is also in the government's interests to control the state-owned financial capital and prioritise the development of SOCBs to other financial institutions.

Obviously, the government's interests in its capacity as the market participant are contradictory with the interests in its capacity as the financial market regulator. Specifically, tight control and intervention in SOCBs are conflicting with the objective of promoting the marketisation and modernisation of bank corporate governance. In addition, policy inclination to SOCBs will result in other banks in a disadvantageous position, which is not compatible with the objective to enhance the competitiveness of the financial market. As a consequence, it is impossible for the Chinese government to perform as an independent regulator with a detached and equal view on all of the financial institutions. During the processes of rule-making and implementation, the government's own economic and political interests in state-owned financial capital would be taken into account. As a consequence, its responsibilities as the market regulator would be disturbed.

The conflicts of the government's interests are embodied in its regulatory measures of bankers' remuneration. On the one hand, the government has established a professional regulatory framework, in order to introduce modern and market-based remuneration and incentive methods. However, on the other hand, it has also adopted intrusive actions, in order to directly intervene in the decision-making of bankers' remuneration. Moreover, in

practice, the administrative and politicised approach, through which the government can control banks' top personnel, remains predominant.

There are also conflicts among the interests of other market participants. SOCBs and their top bankers have benefited from the traditional administrative and politicised approach. Through this approach, the interaction between the government and SOCBs is on a 'win-win' basis: the government is able to control the state-owned financial resources in SOCBs and SOCBs are entitled to the government's policy support and privileges. Moreover, for SOCBs' bankers, most of them have developed their careers in the 'inside system' and been bureaucrat-minded. Sticking to political incentives is in their interests to get promoted to higher positions in the bureaucratic system. These bankers are more ambitious for the success as a bureaucrat rather than an entrepreneur. The marketisation and modernisation reform of bankers' remuneration will replace political incentives. As a consequence, their political careers will be significantly impaired. If the remuneration and incentive system is completely marketised, bankers with rich experience in the private financial sector would be more competitive. However, SOCBs' bankers will lose their endowments and face the risk of losing their positions. Therefore, SOCBs and their bankers will be reluctant to push forward the reform of bankers' remuneration.

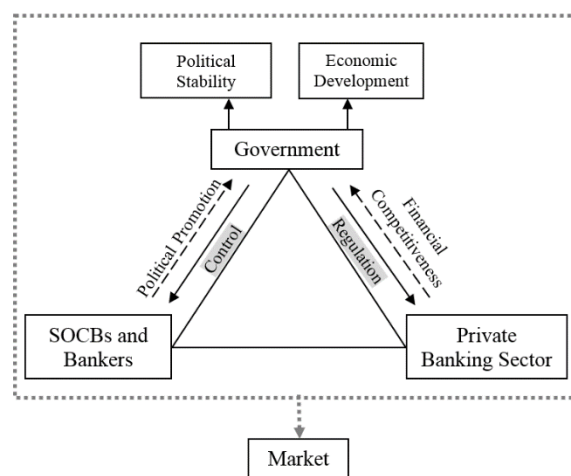
On the contrary, the reform is in the interests of the private banking sector. In China's financial market, the private sector has long been in a less supported and weaker position. No matter the quality and quantity of financial resources or market shares, private banks are always inferior to SOCBs. This is the consequence of the long-term unbalanced policies which are only in favour of the state-owned banking sector. Therefore, the private banking sector expects that the government's role as an independent regulator can be enhanced, in order to carry out the all-round reform of financial liberalisation and marketisation. Therefore, private banks can get more opportunities to compete with SOCBs. If the reform of bankers' remuneration is successful, the corporate governance models and incentive mechanisms of SOCBs will be market-oriented. Bankers' strategies and decisions will also be based on market competition. As a result, the financial environment will become more competitive and fair. Thus, the private banking sector hopes that the government can take regulatory reforms to push forward the marketisation and modernisation of bankers' remuneration.

Clearly, the requirement of SOCBs and their bankers to stick to the traditional administrative and politicised approach is coherent with the government's interests in controlling the country's important financial resources. Whereas the pursuit of the private banking sector to modernise and marketise bankers' remuneration is compatible with the government's objectives to promote financial competitiveness and push forward the transitional reform. Therefore, the current regulatory measures of bankers' remuneration and their implementation processes are the consequence of the Chinese government

balancing the conflicting interests of its two different capacities in the financial market, and the conflicting interests of different market players.

Similar to any other national government, the fundamental and ultimate purpose of the Chinese government is to keep its political power sustainable and robust. To this end, the Chinese government needs to achieve social-economic development and political stability. By balancing the conflicting interests between different market players, and the conflicting interests of its own, the government has been trying to pursue both social-economic development and political stability through its regulatory activities on bankers' remuneration.

Figure 9.2 The Structure of Interests in the Regulation of Bankers' Remuneration in China



To summarise, in both the UK and China, the current regulatory framework of bankers' remuneration is essentially a process of the government trying to balance the interests between different market players and pursue its own interests. The interests of these parties have been substantially fettered by the existing institutions of the financial system, which are inherently embedded in a country's ideologies of economic and social development and its political and legal traditions. Next subsection will examine the original institutions in the UK and China, which have shaped the different interests in bankers' remuneration and the current regulatory frameworks.

9.3.2 Path Dependence

Institutions are subject to path dependence. In essence, path dependence means that the historical institutions at the starting points have defined the interests of individuals and organisations and shaped their choices, which have a substantial impact on their understanding of the current institutional framework and their attitudes towards institutional changes. Therefore, how the social-economic system is operating in the current period and how it will be developing in the future are confined by the original institutional

framework.²⁶ Individuals and organisations that have obtained vested interests from the original institutional framework tend to stick to it, whereas those with few interests will advocate institutional changes in order to overturn the current structure of interests. However, at the beginning stage of any institutional reform, the parties with vested interests are usually stronger because they have possessed the majority of the power and resources. They will reject reforms and establish more institutions to consolidate the existing framework.²⁷

Based on the view of path dependence, this subsection will look back to several decades ago to reveal the origins of the institutional frameworks of the UK and Chinese financial systems.

9.3.2.1 The UK

Since the late 1970s, a series of economic deregulation measures were introduced by the Thatcher government, which ushered the neo-liberalism era in the UK's modern economic history. Benefiting from the policies for economic liberalisation, in particular, the privatisation of financial institutions, the UK financial market boomed rapidly.²⁸

The history of the City of London as an international financial centre can date back to the 19th century. In the contemporary era, taking the opportunity of financial globalisation, the UK further consolidated its dominant position in the international financial markets. The long-term prosperity was attributed to the policies taken by the Thatcher government to ease and eliminate the restrictions on market competition and financial innovation.²⁹ During that period, many regulatory restrictions adopted during the post-war period, which would limit the development of the City as a leading financial centre, were removed. In particular, the Building Society Act 1986 and the Banking Act 1987, the key pieces of legislation which formed the pre-crisis regulatory framework, were based on the principle of 'government control releasing'.³⁰ Even after the Thatcher government, neo-liberalism-oriented financial regulation continued until the GFC. Therefore, the UK financial industry had been developing in a relaxing and 'light touch' regulatory environment.

²⁶ John Bell, 'Path Dependence and Legal Development' (2012-2013) 87 *Tulane Law Review* 787, 791-2

²⁷ This is defined as the 'increasing returns' character of institutions. Douglass C. North, *Institutions, Institutional Change and Economic Performance* (n20) 95

²⁸ Mimoza Shabani *et al*, 'The Financial System in the UK' (2015) FESSUD Studies in Financial Systems No.4 <http://fessud.eu/studies-in-financial-systems/> accessed 14 April 2017, 153

²⁹ Hyman P. Minsky, 'Global Consequences of Financial Deregulation' (1986) Wallenberg Forum: 'Financial Fragility and Global Growth' Working Paper http://digitalcommons.bard.edu/hm_archive/378/?utm_source=digitalcommons.bard.edu%2Fhm_archive%2F378&utm_medium=PDF&utm_campaign=PDFCoverPages accessed 14 April 2017, 7

³⁰ Mimoza Shabani *et al*, 'The Financial System in the UK' (n28) 31

The ideology of deregulation and privatisation was rooted in the UK financial market and had a profound influence on its development.³¹ For instance, after recovering from the GFC, the UK government has started to sell out its shares in major UK banks which were obtained due to the bailouts.³²

Not only financial regulation but also the regulation of corporate governance in the UK is characterised as relaxing and flexible.³³ The regulation of corporate governance is on a ‘comply and explain’ basis, which significantly enhances the autonomy of companies, while limiting the power of the legislature and regulatory bodies. It has been acknowledged that ‘the UK company law gives the greater flexibility to the founders and controllers of companies to design and structure their businesses to suit their needs than any other legal system’.³⁴ The flexibility and autonomy given to companies are believed conducive to encouraging market competitiveness. Therefore, if the corporate governance model or specific corporate governance devices in a company can provide sufficient strength to its business, the regulators will not stop the private sector from doing so unless there is a serious detriment to public order and safety or human rights. Therefore, before the GFC, executive remuneration was almost untouched by regulation, while left to companies’ discretion.

In history, the UK’s relaxing institutional framework stimulated economic growth and industrial innovation. An efficient common law system which protected private property rights had been developing, whereas intrusive institutions which would hinder the free mobility and allocation of resources were waived.³⁵ The historical experience has reinforced the understanding that institutions which protect private property rights and facilitate the operation of the market mechanism would be optimal. It is ideologically and politically correct that any law or regulation should not impose any hindrance on the competitiveness of the financial market and the autonomy of businesses.

Clearly, the UK’s approach and philosophy of banking regulation and bank corporate governance before the GFC were materially determined by the economic policies and political ideology which had gradually formed in its social-economic development in the second half of the 20th century. As analysed in last subsection, banks and bankers have

³¹ Ibid, 150; Hyman P. Minsky, ‘Global Consequences of Financial Deregulation’ (1986) Wallenberg Forum ‘Financial Fragility and Global Growth’(n28) 7; Joseph E. Stiglitz, ‘The Role of the State in Financial Markets’ (1994) The World Bank Annual Conference on Development Economics 1993 <http://documents.worldbank.org/curated/en/239281468741290885/pdf/multi-page.pdf> accessed 15 April 2017, 20

³² ‘Government Sells More Shares in Lloyds Banking Group’ *BBC News* (London, 22 November 2016) <http://www.bbc.co.uk/news/business-38062159> accessed 15 April 2017

³³ Marc T. Moore, ‘Private Ordering and Public Policy: The Paradoxical Foundations of Corporate Contractarianism’ (2014) 34 (4) *Oxford Journal of Legal Studies* 693, 697

³⁴ Petri Mäntysaari, *Comparative Corporate Governance: Shareholders as a Rule-maker* (Springer 2005) 86

³⁵ Douglass C. North and Robert Paul Thomas, *The Rise of the Western World: A New Economic History* (CUP 1973) 152-6

benefited from the relaxing and deregulated environment for decades. They do not want the government to impose strict regulation on bankers' remuneration, while advocating the merits of less intervention in market operation. The arguments are also persuasive to the UK government since attracting world-leading financial institutions and excellent financial elites is of great significance to the country's financial and economic development. Therefore, although the GFC did bring the 'light touch' regulatory approach to an end, the UK government is still cautious, in order to avoid making impediments to financial competitiveness. In today's institutional arrangements for bankers' remuneration, the profound influence of the institutional and ideological origins, which emphasise the limited role of governmental regulation and the significance of market autonomy, can still be observed.

9.3.2.2 China

The institutional arrangements that are deemed economically inefficient in the UK: state ownership and state control, however, sustained the tremendous social-economic changes in China. It is often deemed that the state-centred approach performs underlying efficient functions in the specific context of China.³⁶

Generally, the state-owned banking sector is less profitable than the private banking sector. However, with more policy and financing support, SOCBs are advantaged in terms of accumulating the best financial resources from society. They can also efficiently implement the government's policies on monetary system, agriculture, industrial innovation, fundamental constructions, international trades and other pillar areas of the national economy. State control over the banking sector and financial resources has been justified by the doctrine of 'concentrating the best forces on major issues' (集中力量办大事). At the very beginning of China's economic reform, its industrial foundation was very vulnerable. Moreover, the country had no real financial market or institutions. In this context, only the government would be efficient to utilise the limited resources to bolster the speed rise of the national economy.

In the early 1990s, the Chinese authorities confirmed the developing routine of the socialist market economy. A series of economic policies that could vitalise the private sector were adopted. In many economic areas, the market mechanism was introduced and developed. Nevertheless, knowing the importance of state control to the national economy and political stability, it was not removed from the essential industries, including banking and finance.

Accordingly, the institutions in support of state control, such as direct administrative management over state-owned assets and the bureaucratic model of personnel in SOEs have been retained and enhanced. The laws and regulations protecting private property rights and

³⁶ Yasheng Huang, *Capitalism with Chinese Characteristic: Entrepreneurship and the State* (CUP 2008) 13

facilitating the operation of the private sector remain insufficient.³⁷ On the contrary, the laws and regulations protecting state-owned assets have been strengthened, such as the enactment of the Law of the PRC on the State-Owned Assets (中华人民共和国企业国有资产法). Therefore, the institutional environment remains supportive of the state-owned banking sector, while the private banking sector has still been given less protection and fewer opportunities.

In the planned economy, there was no free market and the state was the only decision maker. In the early stage of economic reform, it was indispensable for the state to play an essential role. However, after three decades, the market mechanism has been primarily established and the national economy has been booming. In this context, more autonomy should be released to banks, in order to make the financial market more dynamic. However, the existing institutional framework and the structure of interests in the financial market have been deeply embedded in the original paradigm of state control. Both the state-owned sector and the government have been subject to the vested interests. As a consequence, even if the government has been aware of the importance to accelerate the process of financial liberalisation and marketisation, in practice, it turns out to be very difficult to make an institutional breakthrough.

Looking back to the historical trajectories of the two countries' economic and financial development, it is clear that the divergent regulatory approaches originate from their divergent institutional traditions. In terms of the regulation of bankers' remuneration, both the market approach in the UK and the state approach in China have been fundamentally influenced by their traditional patterns of 'market-state' interaction.

9.4 Conclusion

This chapter has compared the regulations and practices of bankers' remuneration in the UK and China. It has examined the differences between the two countries in the problems of bankers' remuneration, the regulatory approaches and the remuneration practices. This chapter has also analysed the reasons for the differences through the perspective of institutionalism. It has answered the question: how and why are the regulations and practices of bankers' remuneration in the UK and China different from each other?

The problem in the UK is that the market of remuneration was distorted and resulted in inefficiencies. Therefore, the purpose of regulation is to correct market failure and provide remedies for market defects by imposing restrictions on market conduct. After the GFC, the UK government has enhanced its intervention in bankers' remuneration by enacting a series of regulatory measures. These measures direct banks to link remuneration incentives with the objectives of long-term stability and risk control. Nevertheless, all of the initiative

³⁷ Ibid, 4

measures only aim at providing guidance and instructions to banks, rather than replacing the fundamental role of the market in deciding bankers' remuneration. The only intrusive measure: bankers' bonus cap, has been strongly criticised by the UK banking regulators. Therefore, the post-crisis regulatory framework of bankers' remuneration in the UK is still market-based. In banks' remuneration practices, the market-based measures have been efficiently implemented, whereas bankers' bonus cap has been circumvented. The efficient implementation of the market-based measures demonstrates that the issue of bankers' remuneration has been incorporated in banking regulation. Nevertheless, the rejection to the intrusive rule indicates that both the UK regulators and the banking industry would still prioritise the market mechanism. Clearly, the post-crisis regulatory philosophy in the UK is that market is the fundamental mechanism to adjust bankers' remuneration while regulation is the supplementary mechanism to rectify market defects and inefficiencies. In short, the regulation and practice of bankers' remuneration in the UK is based on the market approach.

The problem in China is the absence of a competitive and efficient market of bankers' remuneration, which has impeded the transitional banking reform. Therefore, the purpose of regulation is to promote the marketisation and modernisation of bankers' remuneration. With reference to the international standards and Western experience, the Chinese banking regulators have established a regulatory framework, which includes a number of modern and market-based remuneration and incentive methods. However, during the reform, in order to avoid market disorder and maintain the control over the state-owned banking sector, some intrusive and anti-market measures have been taken. These measures enable the state to supplant the role of the market in deciding bankers' remuneration, which are the big retreating steps in the marketisation and modernisation reform. In practice, all the compulsory orders through which the regulators can directly decide bankers' remuneration level and structure, have been rigidly complied with. In striking contrast, the market-based measures have not been implemented or only implemented on a formalistic basis. Furthermore, the majority of Chinese banks, especially those owned by or connected with the state, have adhered to the traditional administrative and politicised approach. As a result, bankers in these banks are still subject to political incentives. Clearly, different from the UK, the regulation and practice of bankers' remuneration in China rely heavily on the state approach.

The outcomes of the comparative analysis raise the questions below. In the UK where market conduct should be restricted by more state intervention, why is bankers' remuneration still regulated by the market approach? In China where state control should be limited and market mechanism should be introduced, why is bankers' remuneration still regulated by the state approach?

The essential reason is that the existing economic and political institutions in the UK and Chinese financial systems, in particular, the patterns of 'market-state' interaction are path

dependent. Therefore, they have a material and profound impact on the current regulatory approaches. The traditional institutions have defined the property rights of different market participants and determined the structure of interests among them. Their utilities and choices have also been confined by the existing institutional framework. Usually, individuals and organisations that have obtained vested interests tend to adhere to the traditional institutions while those have been in inferiority are supportive of institutional changes. The reform is a consequence of the government balancing the requirements of different market players and considering its own interests and objectives. Besides, at the early stage, it is usually more difficult to push forward the reform since the parties with vested interests are stronger. Therefore, in both the UK and China, the regulatory reforms of bankers' remuneration are significantly oriented by the previous approaches and philosophies.

However, when maintaining the old institutions will induce more problems than benefits, and impede the government from realising the objectives of economic development and political stability, more actions will be taken to remove the institutional barriers. Currently, in either the UK or China, it is not the end of the regulatory reform of bankers' remuneration. In the future, there will be more steps, which will enhance the reform for a more efficient remuneration and incentive system in the banking sector.

Chapter 10

Conclusion

10.1 The Findings of the Thesis and the Answers to the Research Questions

Guided by the research questions in the introduction chapter, the problems of bankers' remuneration in the UK and China, the regulatory approaches adopted by the two countries' banking regulators, and the implementation processes and effects of the regulations have been examined in detail and compared in depth. Moreover, the divergences between the UK and China in their practices and regulations of bankers' remuneration have been identified and analysed. The deep-seated reasons of the divergences which are embedded in the two countries' economic, legal and political institutions have also been discussed.

Based on the findings and analyses in previous chapters, this thesis is able to provide integrated and insightful answers to the research questions.

In the UK, the practice of bankers' remuneration before the GFC was problematic. The structural arrangement and incentive mechanism of bankers' remuneration, in particular, the application of equity-based remuneration and share price-oriented performance metrics, stimulated bankers to adopt high-risk strategies so as to create instant benefits in the short run. However, banks' long-term sustainability and the stability of the financial system were completely disregarded. Finally, banks' excessive risk-taking resulted in a serious banking crisis.

To deal with the problem, the UK banking regulators, i.e. the FCA and the PRA started to take measures to intervene in the practice of bankers' remuneration after the GFC. As a result, a professional regulatory framework on the basis of the international standards and EU rules has been established. In addition, the UK regulators have introduced more initiatives to tighten the regulation. With the objectives of maintaining financial stability and protecting the public interest, the UK's regulation of bankers' remuneration has focused on a shift from the short-term and share price-oriented incentives to the long-term and risk-adjusted incentives. In the regulatory framework, most of the measures have attempted to direct and guide banks' remuneration policies and practices in a moderate but not intrusive way, in order to avoid any infringement of banks' autonomy and market discipline. On the contrary, the EU bankers' bonus cap directly intervenes in the level and structure of bankers' remuneration and is counterproductive against other measures. Therefore, it has been continuously criticised by the UK authorities.

In the post-crisis remuneration practices of UK banks, most of the measures have been effectively and strictly enforced, while bankers' bonus cap has been circumvented through the introduction of a new type of fixed remuneration: the role-based pay. Nevertheless, in general, the regulation has significantly reformed the remuneration and incentive system in the UK banking sector. Apparent and positive changes, such as the extension of the length

of deferral in performance-based remuneration, the application of clawback and *malus*, and the adoption of risk-adjusted metrics, have been observed in practice. Despite some contradictions and imperfections in the framework, it has, to a large extent, effectively enhanced the function of bankers' remuneration in promoting banks' long-term development, maintaining financial stability and protecting the public interest.

In China, the three decades before the GFC witnessed the tremendous development of its banking sector. In general, China has preliminarily established a modern and multi-layered banking system. Nevertheless, the modernisation and marketisation reform of bank corporate governance at both institutional and ideological levels, has lagged behind. In particular, the remuneration and incentive systems in Chinese banks were still organised through the administrative and politicised approach, which was handed down from the planned economic system. As a key aspect of corporate governance, the system of bankers' remuneration and incentives has an essential impact on the decision-making in banks. The administrative and politicised approach, which opposes market dynamics and autonomy, has seriously impeded the efficiency of bank corporate governance and the transitional banking reform.

Therefore, bankers' remuneration has been put on the reform agenda of bank corporate governance. Following the trend of regulatory tightening in the global financial markets, the Chinese banking regulators have also established a regulatory framework, with reference to the international standards and the experience of developed financial markets. With the new framework, the regulators want to instruct Chinese banks to apply modern and market-based remuneration methods and incentive mechanisms. At the same time, by learning from the lessons of the remuneration failures in the West, the Chinese regulators have also paid attention to the risk control function of bankers' remuneration.

Despite these efforts, the way through which the Chinese banking regulators have been trying to reform the practice of bankers' remuneration is intrusive. Some measures have been imposed on banks through political and administrative orders. In particular, to avoid excessive risk-taking, the regulators directly reduced and capped the total level of bankers' remuneration and suspended the application of equity-based remuneration. To promote the use of performance-based remuneration and enhance pay-to-performance sensitivity, the regulators have enacted a detailed system to assess bankers' performance, with little autonomy left to banks. In fact, these measures replace the role of banks in deciding bankers' remuneration with the state, and infringe the primary purpose of the regulatory reform.

In practice, many banks have strictly complied with the remuneration cap and the injunction on equity-based remuneration. In striking contrast, the modern and market-based measures based on the international standards and Western experience have not been properly implemented. Performance-based remuneration has only been applied on a formalistic basis, rather than being subject to bankers' or banks' performance. Clawback and *malus* remain

completely unenforced. Moreover, in SOCBs and many state-related banks, bankers are still managed and incentivised as bureaucrats, wherein the opportunities of political promotion remain the predominant method of incentivisation. Therefore, the current regulatory framework in China is not as efficient as expected with regard to promoting the modernisation and marketisation of bankers' remuneration. There are still significant obstacles at both the regulatory and practical levels.

Obviously, the practices and regulations of bankers' remuneration in the UK and China are substantially different.

The failure of bankers' remuneration in the UK was essentially a failure of the market. Before the GFC, bankers' remuneration operated entirely on the basis of the liberal market mechanism. However, due to market inefficiencies and defects, the practice of bankers' remuneration became distorted. Therefore, it was necessary for the government to rectify market conduct and correct market failures. Nevertheless, the liberal market mechanism has a long history and is deeply rooted in the UK financial market. The *laissez-faire* ideology has significantly influenced the philosophy and conduct of economic regulation. Therefore, even if the UK banking regulators have decided to step into the practice of bankers' remuneration, they still insist on the principle that market is the primary mechanism, while regulation is the supplementary mechanism, not a replacement. Therefore, the UK's regulatory approach of bankers' remuneration is still market-based.

More importantly, the insistence on a market-based regulatory approach is also a consequence of the UK government balancing the conflicting interests of different market players and weighing up its own pursuits. These different interests and pursuits have been materially shaped by the existing institutions in the UK's liberal financial system. In particular, the current regulatory framework is a balance between the requirement of the public to control and reduce bankers' remuneration and the interests of banks and bankers in competitive remuneration packages. It is also a balance between the government's purposes in relation to promoting financial competitiveness and economic development on the one hand and to maintaining social and political stability on the other. As a consequence, the current regulation has imposed restrictions on bankers' remuneration in order to control excessive risk-taking, while at the same time guaranteeing the autonomy of banks.

The essential problem of bankers' remuneration in China is the absence of a mature and integrated market. Instead of the *laissez-faire* market, the predominant mechanism for deciding bankers' remuneration and incentives is state control and political intervention. This traditional approach has become inefficient and impeditive in the context of transitional financial reform. For this reason, the Chinese banking regulators have tried to promote a modern and market-based reform of bankers' remuneration.

However, historically, China has lacked any tradition of the liberal market mechanism. On the contrary, it has maintained a long tradition of state control and political intervention.

During the reform of bankers' remuneration, the regulators still tend to emphasise the role of the state in making all-round arrangements for the remuneration practices of banks. In order to stabilise the market and social order, the regulators do not dare to largely release its power or leave much discretion with banks. As a consequence, there are contractions in the regulatory framework. On the one hand, the banking regulators have enacted many modern and market-based measures, while on the other hand, the implementation of these measures and banks' practices to pay and incentivise their bankers are still subject to state control and political intervention.

The state-oriented approach in China is also highly embedded in its existing institutions of the financial system. Traditionally, the banking sector was entirely operated by the government. Nowadays, the government still holds substantial stakes in major and large banks. To maintain the leading position in the financial system and the power over key financial resources, controlling banks' decision-making processes and top personnel is essential. At the same time, however, enhancing financial competitiveness and diversity is a necessary step to push forward the financial reform and develop the national economy, which is also in the government's interests with regard to maintaining its position and power. Therefore, the regulation of bankers' remuneration in China also embodies the government's balanced stance between its different interests and purposes. In addition, it demonstrates the tension between the requirement of the state-owned banking sector to stick to political incentives and the demand of the private banking sector to introduce market-based remuneration and incentive mechanisms.

In conclusion, based on the comparison of the practices and regulations of bankers' remuneration in the UK and China, it can be learned that in both countries the current regulatory framework of bankers' remuneration is inherently influenced by the existing institutions of the financial system. In the short run, the institutions are stable. Therefore, both the market approach in the UK and the state approach in China are path dependent. Nevertheless, in the long run, institutions will evolve on a gradual and incremental basis. Therefore, in the future, the reforms of bankers' remuneration will gradually move forward through mild and moderate steps and improvements.

In essence, the regulatory reform of bankers' remuneration is an institutional change and it cannot be accomplished at one stroke. Instead, it can only be achieved in a gradual way. Therefore, the ongoing reforms of bankers' remuneration in the UK and China, whether the purpose is to tighten governmental intervention or enhance market autonomy, should be pushed forward through incremental changes. The following two sections will discuss the proposals regarding feasible measures for the UK and Chinese regulators to advance their reforms.

10.2 Recommendations for the Regulatory Reform in the UK

The drawbacks in the UK's current regulatory framework of bankers' remuneration have been discussed in previous chapters. First of all, there are contradictions between different measures, which are particularly due to the application of shareholder 'Say on Pay' and the EU bankers' bonus cap. The former empowers shareholders to decide bankers' remuneration. As a consequence, it would exacerbate the problems of bankers' short-termism and excessive risk-taking. The latter is deemed intrusive because it imposes direct control over remuneration level and structure. It is also considered counterproductive as it limits the functions of other measures. Another drawback is that the UK banking regulators have been extremely cautious about the negative effects of their intervention. As a consequence, despite the regulators' efforts to apply long-term and risk-adjusted incentives, the strength of these measures is not sufficient. In order to deal with these drawbacks, this thesis makes the following proposals for the UK's regulatory framework of bankers' remuneration.

Shareholder 'Say on Pay' and the EU bankers' bonus cap should be removed from the regulatory framework.

'Say on Pay' is universally applied to UK quoted companies in all industries. However, it has an adverse effect on banks' risk control and contradicts with the principle of banking regulation to protect the public interest. Therefore, it should be removed. However, this is technically difficult. The rules on 'Say on Pay' are stipulated in the Companies Act 2006, which is a piece of parliamentary legislation and superior to regulations. As a consequence, 'Say on Pay' cannot be abolished by the FCA or the PRA. The only possible solution is to restrict shareholder 'Say on Pay' in the banking sector through another act of the parliament, such as the FSMA 2000. In this sense, although the rules in the two pieces of legislation would still conflict, according to the doctrine of *lex specialis derogat generali*, the special law on bankers' remuneration would be prioritised over the general law on executive remuneration.

In comparison to shareholder 'Say on Pay', Brexit has technically removed the legal barriers for repealing bankers' bonus cap. In the UK, the repeal had been highly expected before Brexit. However, Brexit has brought uncertainty to the UK's financial industry and economy. In such uncertain circumstances, the repeal of bankers' bonus cap may result in more complex problems.

Brexit means that the UK will leave the single market and has to seek for other kinds of access.¹ For UK banks and the City of London, the process is full of risks. Thus, some banks

¹ Ben Martin, 'Chancellor Confirms UK Will Leave EU Customs Union and Single Market' *The Guardian* (London, 19 June 2017) <http://www.telegraph.co.uk/business/2017/06/18/chancellor-confirms-uk-will-leave-eu-customs-union-single-market/> 21 November 2017

have started to advise the UK regulators to maintain the *status quo* of banking regulation in order to be as compatible with the EU regulatory framework as possible so that UK banks can maintain the same access to the EU market as before. After Brexit, the issue of whether the cap should be immediately removed or not has led to more controversy.² The new opinion to maintain the *status quo* of banking regulation can also influence the regulators' decision. In addition, if the cap is completely removed, the public would regard it as the government scrapping the restrictions on bankers' remuneration. As a result, it may give rise to another round of public outrage.

Abolishing bankers' bonus cap would make the regulatory framework coherently functional. Nevertheless, considering the politically uncertain situation at the present moment, it would be better to leave the issue until the political and economic relationship between the UK and the EU is stabilised.

Nevertheless, to be well prepared for the removal of bankers' bonus cap, the UK banking regulators could take some other initiatives, which will promote prudential risk-taking and maintain public confidence, while not restraining market autonomy.

The regulators could guide banks to adopt debt-based remuneration as a form of variable remuneration. Debt-based remuneration makes debts a greater share while making equity less dominant. It can link bankers' interests with debtholders' interests. Therefore, debt-based remuneration will reduce the incentives for bankers to create immediate shareholder returns and increase share price in the short run. It will encourage bankers to be more prudent in risk-taking and more attentive to debtholders' interests.³

In fact, some studies have found that the deferred parts of bankers' remuneration, after they have been allocated to bankers but not actually paid, can be regarded as the inside debts banks owe to their bankers. Empirical evidence has shown that when managers' holdings of inside debts increase, they are more conservative in risk-taking.⁴ Nevertheless, this effect is essentially due to the long-term character of deferral. Inside debts are not publicly traded, therefore, in comparison with publicly traded debts, they are less sensitive to the bank's risk-taking activities. In contrast, the price fluctuations of publicly traded debts are decided by the riskiness of banks' businesses. If a part of bankers' remuneration is in publicly traded debts, bankers will be less inclined towards risk-taking.⁵ Moreover, if the debts are

² Longjie Lu, 'The End of Bankers' Bonus Cap: How Will the UK Regulate Bankers' Remuneration After Brexit?' (2016) 27 (7) *European Business Law Review* 1091, 1223

³ Frederick Tung, 'Pay for Banker Performance: Structuring Executive Compensation for Risk Regulation' (2011) 105 (3) *Northwestern University Law Review* 1205, 1227

⁴ Chenyang Wei and David Yermack, 'Deferred Compensation, Risk, and Company Value: Investor Reactions to CEO Incentives' (2010) Federal Reserve Bank of New York Staff Reports No. 445 https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr445.pdf accessed 11 January 2018, 21

⁵ Frederick Tung, 'Pay for Banker Performance: Structuring Executive Compensation for Risk Regulation' (n3) 1228

unsecured and subordinate to deposits and other debts, bankers will be even less stimulated to make highly risky decisions.⁶

The mechanism of debt-based remuneration tightly aligns bankers' interests with banks' risk control and management. In this sense, it satisfies the regulatory purposes of maintaining financial stability and protecting the public interest. However, only Lloyds has adopted convertible bonds since 2013.⁷ In the UK banking sector, the application of debt-based remuneration remains rare. Therefore, it is the regulators' responsibility to encourage and guide banks to introduce debt-based remuneration. By doing so, the regulators would not play an intrusive role because debt-based remuneration is based on the market mechanism to incentivise bankers. It is the bank's performance at the bond markets that decides the amounts of debt-based remuneration. Therefore, debt-based remuneration is also compatible with the market-based regulatory philosophy in the UK.

Apart from debt-based remuneration, the alignment between bankers' remuneration and banks' risk control could be further achieved by applying more stability-based performance metrics and increasing the weightings of these metrics. It has been observed that some stability-based indicators, such as CET-1 ratio and liquidity, have been used to evaluate bankers' performance. However, compared to the financial indicators of profitability and shareholder return, they are still minor. Therefore, the thesis also suggests that the UK banking regulators should guide banks to adopt more stability-based indicators, such as NPL ratio, the exposure to different kinds of risks, the fluctuation of bond market price, and so on, to evaluate bankers' performance. At the same time, the aggregate weightings of stability-based indicators should be increased to no less than 50% of all indicators. By doing so, bankers' performance will be more closely attached to their risk-taking activities.

All in all, removing the counterproductive regulatory measures and applying debt-based remuneration and stability-based performance metrics to further cultivate bankers' long-term perspective and encourage prudential risk-taking, appear to be constructive proposals to improve the regulation of bankers' remuneration in the UK.

10.3 Recommendations for the Regulatory Reform in China

The Chinese regulatory framework is not efficient or productive as expected to push forward the reform of bankers' remuneration.

The original purpose of the regulation is to modernise and marketise the practice of bankers' remuneration and incentives, meaning that the traditional administrative and politicised approach would be abandoned. However, in reality, both the banking regulators and Chinese banks have gone the other way around, and the dominant position of the

⁶ Ibid, 1230

⁷ Please refer to Appendix E.2.

administrative and politicised approach has not been broken up. On the contrary, this approach has been reinforced during the implementation of the regulation.

The Chinese government has dual but irreconcilable capacities in the financial market. It is not only the market regulator but also the dominant market player. As the regulator, reforming bankers' remuneration is consistent with the government's purpose of providing a benign and competitive environment for financial development. Whereas as the dominant market player, the government also wants to reinforce its own interests in state-owned financial resources. If the government has all-embracing and strong regulatory power in its capacity as the market regulator, this power would be distorted and manipulated to pursue the government's own interests in its capacity as the dominant market player. This problem has already been observed in the recent regulatory reform of bankers' remuneration.

In order to deal with the problem, there are two different solutions: limiting the power of the government as the market regulator or removing its private interests in state-owned financial resources as the dominant market player. Obviously, the state-owned economy has always been the pillar of China's national economy and has a long and deep tradition. Many of the existing economic and political institutions have been operating to protect the government's interests in the state-owned sector. Since institutions are subject to path dependence, the second solution, which aims for a radical change to the existing institutional framework and structure of interests, will not be successful. In contrast, the first solution, which can be exercised by gradually decentralising and disempowering the banking regulators, will help to mitigate governmental intervention and cultivate a loose regulatory environment and more business autonomy. Therefore, rather than empowering the regulators to actively arrange everything for the reform of bankers' remuneration, they should do less. Based on this direction and principle, this thesis makes the following proposals.

Specifically, the injunction on equity-based remuneration should be explicitly abolished in order to allow banks to explore diverse remuneration and incentive methods. As mentioned before, since 2014, several Chinese banks have been permitted to implement pilot projects on equity-based remuneration. This has been regarded as a signal that the government will gradually lift the ban. This process should be accelerated so as to allow more banks to apply equity-based remuneration at the same time. If all banks were to be given the discretion to design and implement their own equity-based remuneration schemes, they would compete with each other to retain and attract bankers. In this way, the movement of bankers between banks would be more frequent and the competition mechanism would gradually form and develop. Moreover, the introduction of equity-based remuneration would increase the total amount of bankers' remuneration. In SOCBs and the majority of JSCBs, the total remuneration level has been very low. If the total remuneration level were to increase, bankers would have more expectations about their economic benefits, which would make them more business-minded but less attentive to political promotion. As a consequence,

political incentives would become less and less important, which would pave the way for a shift from political incentives to economic incentives.

In addition, in the future, the regulators should not impose compulsory remuneration caps, especially when there is no financial crisis or emergent situation. Without compulsory caps, banks have more discretion to offer competitive remuneration packages. This action will have similar effects to the introduction of equity-based remuneration. It will encourage banks to compete with each other for financial elites and rely more on economic benefits to incentivise bankers.

The regulators have introduced a variety of modern and market-based remuneration measures. Nevertheless, these measures have not been effectively implemented by banks. According to the regulation, the metrics are completely determined by the regulators, and the assessment process of bankers' remuneration is also predominantly controlled by the regulators, thus allowing banks very little discretion. As just mentioned, it is dangerous when the regulators are too powerful and intrusive because regulatory power would be manipulated for the government's own interests. No matter how advanced the system of performance metrics and assessment is, if the government does not properly lead and promote the implementation of these advanced measures, instead exerts the regulatory power to put banks' top personnel and decision-making under political control, these measures will not have positive effects on the modernisation and marketisation reform. In addition, the system of performance metrics and assessment within the current regulation is a 'one-size-fits-all' system. Banks cannot make adjustments to the evaluation of bankers' performance or the determination of bankers' performance-based remuneration according to banks' special circumstances. In order to deal with this drawback, the implementation of the modern and market-based performance metrics and assessment system should not be principally controlled by the regulators. On the contrary, banks should be allowed to play an essential role in designing the types and weightings of performance metrics, and the assessment methods. The regulators can enact threshold standards, such as the minimum weightings of risk-adjusted and stability-based metrics, and provide specific instructions and guidance on the request of banks.

In order to complete the marketisation and modernisation of bankers' remuneration in China, it is very important to enhance the competition among banks for excellent financial elites. In order to enhance competition, it is necessary for banks to have the autonomy to design their own remuneration and incentive systems. Therefore, the Chinese banking regulators should remove those intrusive measures and gradually shift its role from controllers and commanders to instructors and supervisors.

10.4 The Impact and Contributions of the Thesis

The thesis has potential impact on the regulatory practice of bankers' remuneration. It also makes significant academic contributions.

In terms of the impact on regulatory practice, first of all, it has revealed to the public the real problems of bankers' remuneration and the real reasons for regulatory intervention. The emotional understanding of the public is that bankers greedily extracted huge fortunes from banks and therefore caused the financial meltdown and tremendous economic losses. This thesis has explained the issues of how bankers' remuneration was practised and how it influenced banks' decision-making in different financial markets. It helps to establish a reasonable understanding of bankers' remuneration and the regulatory activities of national governments.

More importantly, the thesis has demonstrated that the current regulatory approach of bankers' remuneration in a country is inherently and fundamentally embedded in the existing institutions of its financial system, which distinguishes it from the regulations in other countries. It has revealed to both the international and national banking regulators the plurality and complexity of the practices and regulations of bankers' remuneration. It has also enlightened different national regulators on the importance of the institutional origins of their regulations, which helps them to better understand their special problems in bankers' remuneration and seek for proper measures to push forward the reforms. In this sense, the findings and analyses in this thesis provide significant implications to the ongoing reforms in the UK and China. In addition, they are conducive to understanding the particular issue of bankers' remuneration in a third country.

In terms of the academic value of this thesis, it makes the following contributions.

First, previous academic debates about bankers' remuneration have partially focused on the issues in developed financial markets, whereas ignored the special issues in emerging markets. This thesis has extended the research scope by probing into bankers' remuneration in China. Furthermore, it has also provided a framework of comparative law and finance for an overall and thorough interpretation of the practice and regulation of bankers' remuneration. This comparative framework could be applied to future comparative studies on bankers' remuneration or other issues of bank corporate governance between developed and emerging markets.

Second, the thesis has provided a perspective of institutionalism to shed light on the question why in different types of financial markets, the problems of bankers' remuneration, the regulatory approaches and the effects of the regulations have shown huge divergences. Previous studies have only discussed bankers' remuneration at the regulatory or practical level, while not having examined the issue at the institutional level. In this sense, the perspective of this thesis is more insightful and deeper than previous studies. Moreover, it

provides a lens for understanding the issue of bankers' remuneration in a third country and other issues in bank corporate governance.

Last but not least, the empirical research in this thesis could benefit future studies. The views and arguments of this thesis are bolstered by the empirical evidence obtained through the quantitative and qualitative research, which calculated and analysed the data and information about the level, components and structure, and incentive mechanism of bankers' remuneration, as well as bankers' career trajectories. The thesis has provided robust and strong evidence to reveal the remuneration practices and the implementation processes of the regulatory measures in the UK and China, which was not undertaken by previous studies. The empirical research methods developed in this thesis can be applied to enhance the studies on bankers' remuneration and other issues in bank corporate governance.

All in all, in the future, based on this thesis, scholars can examine the practices and regulations of bankers' remuneration in other economies. They can also carry out empirical research on bankers' remuneration in other kinds of UK or Chinese banks and financial institutions.

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Appendix A

The Levels of Bankers' Remuneration in the UK 'Big Four' Banks Before the GFC

(The Original Data of Figure 3.4)

A.1 Data Collection

The data of bankers' remuneration levels (total amounts) is collected from the 'Big Four' banks' annual reports from 2000 to 2007.

Data collection is based on the criteria below:

1. Only the remuneration of executive directors is collected; the remuneration of non-executive directors (including chairmen) is excluded.
2. In a specific financial year, only the remuneration of the executive directors who worked throughout that year is included.

A.2 Data Calculation

The total amount of each banker's annual remuneration include:

1. The emolument, usually including basic salary, fees, benefits, cash bonuses or cash-based performance pay. The total amount of emolument was directly given by the banks.
2. Share options exercised by bankers. If the value gained by bankers was not directly given by the banks, the author calculates it with the formula:

$$\begin{aligned} & \textit{The value of exercised share options} \\ & = \textit{Numbers of shares} \times (\textit{The market price on exercised date} - \textit{Exercised price}) \end{aligned}$$

3. Vested benefits in a restricted share scheme. This scheme was only provided by HSBC and it directly disclosed the value of the gains.
4. Vested ordinary shares in other equity-based remuneration schemes, such as LTIPs. If the value was not directly given by the banks, the author calculates it with the formula:

$$\begin{aligned} & \textit{The value of vested ordinary shares} \\ & = \textit{Numbers of shares} \times \textit{The market price on vested date} \end{aligned}$$

5. These items below are not considered as part of the total amount:

- (1) The benefits in pension arrangements;
- (2) Any reward in the form of share option or ordinary share that had not been exercised or vested.

A.3 Original Data

2000	2001	2002	2003	2004	2005	2006	2007
HSBC							
Bond 3,643,344.05	Bond 1,927,000	Bond 2,919,000	Bond 2,577,000	Aldinger 5,407,000	Bond 5,286,205.42	Flint 2,008,000	Flint 2,714,542.50
Dalton 857,402.88	Croisset 609,000	Croisset 609,000	Croisset 1,334,000	Bond 4,262,000	Flint 1,516,000	Geoghegan 3,261,727.82	Geoghegan 3,950,000
Eldon 1,449,000	Dalton 679,000	Dalton 1,276,000	Dalton 1,258,520.98	Eldon 1,732,000	Geoghegan 961,000	Green 3,848,000	Green 4,048,000
Flint 1,089,120	Eldon 1,284,000	Eldon 1,750,000	Eldon 1,384,000	Flint 1,663,130	Green 2,892,000		
Green 1,017,000	Flint 915,000	Flint 1,620,172.09	Flint 1,186,000	Green 2,114,000	Jebson 1,837,000		
Jebson 845,000	Green 1,600,490.47	Green 1,989,450	Green 1,391,000	Jebson 1,334,308.74			
Whitson 1,759,988.88	Jebson 850,950	Jebson 1,495,975	Jebson 1,022,000				
	Whitson 2,161,573.82	Whitson 2,990,000					
Average 1,522,979.40	Average 1,253,376.79	Average 1,831,199.64	Average 1,450,360.14	Average 2,752,073.12	Average 2,498,441.08	Average 3,039,242.61	Average 3,570,847.50
Barclays							
Barrett 1,742,000	Barrett 1,862,000	Barrett 2,440,625.28	Barrett 3,093,545.84	Varley 2,257,287.32	Varley 2,417,686.40	Varley 2,650,412.48	Varley 2,639,603.08
Lendrum 777,922.58	Lendrum 936,195.14	Lendrum 531,897.60	Lendrum 910,635.36	Hoffman 1,449,636.44	Hoffman 1,161,407.52	Diamond 26,259,476.42	Diamond 14,167,317.35
Varley 1,114,393.86	Stewart 779,000	Stewart 1,722,790.80	Varley 1,205,504	Kheraj 1,563,000	Kheraj 1,467,095.60	Hoffman 3,052,075.70	Hoffman 1,550,192.92
	Varley 1,183,444.48	Varley 1,158,009.76		Roberts 1,309,722.60	Roberts 1,393,856	Kheraj 3,902,312.82	Seegers 6,601,679.44
				Davis 1,337,000		Roberts 4,224,189.34	
Average 1,211,438.81	Average 1,190,159.91	Average 1,463,330.86	Average 1,736,561.73	Average 1,583,329.27	Average 1,610,011.38	Average 8,017,693.35	Average 6,239,698.20
RBS							
Mathewson 4,051,300	Goodwin 1,572,000	Goodwin 2,580,000	Goodwin 3,447,438	Goodwin 3,115,710	Goodwin 2,903,860.42	Goodwin 3,996,000	Goodwin 5,374,911.2

Goodwin 2,262,000	McLuskie 703,400	McLuskie 1,390,535.55	McLuskie 1,865,308.3	Pell 1,798,426	Pell 1,989,325.90	Pell 2,540,476.34	Cameron 3,267,668.20
McLuskie 3,218,751	Pell 1,039,000	Pell 1,725,000	Pell 2,328,527	Watt 1,600,549.7	Fish 7,564,984.88	Fish 6,439,308.80	Fish 1,927,343.69
Robertson 3,444,342	Robertson 1,114,000	Robertson 1,353,000	Watt 1,926,762	Fish 2,836,682.81			Fisher 2,359,128.93
Fish 1,347,000	Watt 690,000	Watt 1,433,000	Fish 2,407,522.60				Pell 2,480,566.40
	Fish 2,213,000	Fish 3,871,812.03					Whittaker 13,898,837
Average 2,864,678.60	Average 1,221,900	Average 2,058,891.26	Average 2,395,111.58	Average 2,337,842.13	Average 4,152,723.73	Average 4,325,261.71	Average 4,884,742.57
Lloyds							
Atkinson 609,000	Atkinson 1,165,000	Atkinson 567,000	Daniels 1,064,000	Daniels 1,903,000	Daniels 3,007,312	Daniels 2,451,702	Daniels 4,094,000
Ellwood 856,000	Ellwood 1,001,000	Daniels 1,263,000	Fairey 1,140,000	Fairey 1,478,000	Fairey 1,462,000	Fairey 1,919,473	Fairey 2,196,000
Holt 435,000	Fairey 1,673,000	Ellwood 742,000	Kane 916,672	Kane 858,000	Kane 919,000	Dial 1,719,000	Dial 2,783,000
Kane 494,000	Kane 548,000	Fairey 643,000	Hampton 733,000		Tate 1,075,000	Kane 1,335,000	Kane 2,070,000
Pritchard 496,000	Pritchard 588,000	Kane 418,000			Weir 963,000	Tate 1,303,000	Tate 2,142,000
Ross 468,000	Ross 650,000	Pritchard 437,000				Weir 1,310,000	Weir 2,311,000
		Ross 478,000					
Average 559,666.67	Average 937,500	Average 649,714.29	Average 963,418	Average 1,413,000	Average 1,485,262.40	Average 1,673,029.17	Average 2,599,333.33
The Average of the 'Big Four' Banks							
1,539,690.87	1,150,734.17	1,500,771.56	1,636,359.86	2,021,547.69	2,436,573.96	4,263,803.58	4,316,839.37

Appendix B

The Variable Remuneration Schemes and Incentive Mechanisms Adopted by the UK ‘Big Four’ Banks Before the GFC

B.1 The Overview of Variable Remuneration Schemes

The table below shows the variable remuneration schemes adopted by the ‘Big Four’ banks from 2000 to 2007. All the information is collected from the banks’ annual reports in this period. The schemes are classified in four types:

1. Annual bonus schemes. During this period, most of the annual bonus schemes or annual incentives were cash-based. The only exception was the Executive Share Award Scheme in Barclays, which was part of its Annual Bonus Scheme. Specifically, shares in the Executive Share Award Scheme made 25% of bankers’ annual bonuses and the other 75% were in cash.
2. LTIPs in the form of share option. These schemes usually contained a three-year vesting period and a set of performance metrics.
3. Other share option schemes. These options were usually for all employees and not based on performance. However, these options were still subject to a vesting period.
4. LTIPs in the form of restricted share. These schemes contained a three-year deferral arrangement and a set of performance metrics.

Apart from the four kinds of schemes listed above, there were some special and additional schemes of variable remuneration. Usually these special and additional schemes were adopted in a very short period or just for an individual banker. They included:

- 1) The Sharepurchase Scheme in Barclays. It was adopted from 2002 to 2007. In essence, this scheme was a share option scheme. Nevertheless, it provided tax benefits and additional dividends as the benefits for all UK employees in Barclays when they purchased the bank’s shares. It encouraged staff to hold more shares.
- 2) The Phantom 2000 Plan and the Citizens Long-term Incentive Plan in RBS. Only one director Mr Fish participated in both of the plans. The former provided dividends and benefits in share price increase, while not offering any shareholdings to the executive. The latter was a cash-based LTIP. These two plans did not belong to the four major types, so they are not shown in the table below.
- 3) The Medium-term Incentive Plan in Lloyds. It was a cash-based scheme with a two-year deferral arrangement. It was cancelled since 2002. This scheme did not belong to the four major types, so it is not shown in the table below.

		2000	2001	2002	2003	2004	2005	2006	2007	
HSBC	Annual Bonus Schemes	Annual Performance-related Payments			Annual Cash Bonus					
	Other Share Options	Group Share Option Plan								
	LTIPs in Restricted Share	HSBC Holdings Restricted Share Plan 2000						HSBC Share Plan		
		HSBC Holdings Savings-related Share Option Plan								
Barclays	Annual Bonus Schemes	Annual Cash Bonus and Executive Share Award Scheme								
	LTIPs in Share Option	Incentive Share Option Plan								
	Other Share Options				Sharesave					
	LTIPs in Restricted Share							Performance Share Plan		
RBS	Annual Bonus Schemes	Annual Bonuses			Short-term Annual Incentives					
	LTIPs in Share Option	Executive Share Option Scheme							Executive Share Option Plan	
	LTIPs in Restricted Share				Medium-term Incentive Plan					
Lloyds	Annual Bonus Schemes	Annual Incentive Scheme								
	LTIPs in Share Option	Executive Share Option Scheme								
	Other Share Options	Sharesave								
	LTIPs in Restricted Share							Performance Share Plan		Long-term Incentive Plan

B.2 The Incentive Mechanisms in Annual Bonus Schemes

Scheme	Performance Metrics	
HSBC Annual Performance-related Payments	2000-2002	Financial: revenue generation and expense control
		Non-financial: customer relationships, professional skills and ethical standards
HSBC Annual Cash Bonus	2003-2005	Financial: PBT of the Group and individual business performance*
	2006-2007	Financial: revenue growth, EP, PBT, EPS and cost efficiency
		Non-financial: customer satisfaction and employee engagement
Barclays Annual Cash Bonus and Executive Share Award Scheme	2000-2004	Financial: EP; individual business performance*
	2005-2007	Financial: EP and PBT of the Group; EP and PBT of individual business unit
		Non-financial: leadership contribution
RBS Annual Bonuses	2000-2001	Financial, operational and individual targets*
RBS Short-term Annual Incentives	2002-2004	Financial, operational and individual targets*
	2005-2007	Financial: EPS growth, ROE and Operating Profit (OP) of the Group; OP, costs, income and loan impairments of individual business unit
		Non-financial: customer numbers and satisfaction; employee engagement and efficiency
Lloyds Annual Incentive Scheme	2000-2001	Financial: EP, revenue growth and expenses
		Non-financial: customer service
	2002-2007	Financial: income; EP, PBT, franchise growth and risk
		Non-financial: customer service and employee development

*There were no further details or specifications disclosed in banks' annual reports.

B.3 The Incentive Mechanisms in LTIPs

Scheme	Performance Metrics and Weightings		Measurement					
HSBC Holdings Restricted Share Plan 2000	2000-2004	TSR ranking among a certain group of banking peers	TSR ranking in 3 years			Vested awards		
			The upper quartile and above			150%		
			The median and above			100%		
			Below the median			nil		
			Slide scale applied when TSR ranking between the median and the upper quartile					
HSBC Share Plan	2005-2007	EPS growth (50%) TSR ranking among a certain group of banking peers (50%)	EPS growth in 3 years	Vested awards	TSR ranking	Vested awards	TSR ranking	Vested awards
			52% or above	100%	1-7	100%	12	50%
			24%	30%	8	90%	13	40%
			Slide scale applied when EPS growth rate between 24% and 52%		9	80%	14	30%
					10	70%	14 or below	nil
Barclays Incentive Share Option Plan	2000-2004	EP growth TSR ranking among a certain group of banking peers	Cumulative EP in 3 years	Exercisable options	TSR ranking in 3 years	Exercisable options		
			Above target range	2× initial awards	1	4× initial awards		
			Within target range	1× initial awards	2	3× initial awards		
			Below target range	0.5× initial awards	3	2× initial awards		
			Negative EP growth	nil	4-6	1× initial awards		
					7 or below	nil		
Barclays Performance Share Plan	2005-2007	EP growth (50%) TSR ranking among a certain group of banking peers (50%)	Cumulative EP in 3 years	Vested awards	TSR ranking in 3 years	Vested awards		
			Above first range	3× initial awards	1	3× initial awards		
			Within first range	2.5× initial awards	2	2.5× initial awards		
			Within second range	2× initial awards	3	2× initial awards		
			Within third range	1.5× initial awards	4	1.5× initial awards		
			Within fourth range	1.25× initial awards	5	1.25× initial awards		
Greater than previous	1× initial awards	6	1× initial awards					

			Lower than previous	nil	7 or below	nil	
RBS Executive Share Option Scheme	2001-2006	EPS growth	EPS in 3 years exceeding the growth in RPI plus 9%				
RBS Executive Share Option Plan	2007	EPS growth	EPS growth per annum		Exercised options		
			12% or above		100%		
			6%		30%		
			Slide scale applied when EPS growth rate between 6% and 12%				
RBS Medium-term Incentive Plan	2001-2007	EPS growth (50%) TSR ranking among a certain group of banking peers (50%)	EPS growth and TSR ranking		Vested awards		
			Upper decile performance		200% initial awards		
			Upper quartile performance		100% initial awards		
			Basic performance: EPS exceeding the growth of RPI plus 3% and TSR ranking above the median of all comparators		50% initial awards (25% since 2005)		
			Basic performance unsatisfied		nil		
Lloyds Executive Share Option Scheme	2000	EPS growth TSR ranking among a certain group of banking peers	EPS per annum exceeding the growth of RPI plus 3%		TSR ranking among the top fifty companies in the FTSE 100		
	2001-2003	TSR ranking among a certain group of banking peers	TSR ranking in 3 years	Exercised options	TSR ranking in 3 years	Exercised options	
			1	100%	6	29%	
			2	86%	7	23%	
			3	71%	8	17%	
			4	57%	9	14%	
			5	43%	10 or below	nil	
	2004-2005	TSR ranking among a certain group of banking peers	TSR ranking in 3 years	Exercised options	TSR ranking in 3 years	Exercised options	
			1	100%	6	65%	
			2	100%	7	47.5%	
			3	100%	8	30%	
			4	100%	9 or below	nil	
			5	82.5%			
	Lloyds Performance Share Plan	2004-2005	TSR ranking among a certain group of banking peers	TSR ranking in 3 years		Vested Awards	
				1		2× initial awards	
5				1× initial awards			

			8		0.5× initial awards	
			9 or below		nil	
			Slide scale applied between 1 to 5 and 5 to 8			
Lloyds LTIP	2006-2007	EPS growth (50%) TSR ranking among a certain group of banking peers (50%)	EPS growth per annum	Vested awards	TSR ranking	Vested awards
			RPI + 6% or above	100%	median + 7.5% or above	100%
			RPI + 3%	17.5%	Equal to the median	17.5%
			Below RPI + 3%	nil	Below the median	nil
			Slide scale applied between RPI + 3% and RPI+6%		Slide scale applied between median and median + 7.5%	

Appendix C

The Structures of Bankers' Remuneration in the UK 'Big Four' Banks Before the GFC

(The Original Data of Figure 3.6)

C.1 Data Collection

The data used to reveal the remuneration structures of group chief executives is collected from the annual reports of the 'Big Four' banks from 2000 to 2007.

C.2 Data Calculation

The structure of bankers' remuneration is shown by the proportions of fixed remuneration, annual incentives and long-term incentives in total remuneration. If banks provided the percentages, the data is directly used. (Only RBS directly provided the percentages in 2004, 2005 and 2006). Otherwise, the percentages of fixed remuneration, annual bonuses and LTIPs need to be calculated.

Fixed remuneration includes basic salary, fees and benefits. The value of pension arrangements is excluded. Usually, the figures of fixed remuneration were directly disclosed by banks.

Annual incentives usually refer to the annual bonus schemes, the figures of which were also directly given by banks.

Long-term incentives refer to the benefits in LTIPs, usually in the forms of share option and restricted share. The data of share options and restricted shares granted in a specific year is estimated by the author in line with the formulas below:

The estimated value of granted share options

$$\begin{aligned}
 &= \text{Number of shares} \\
 &\times (\text{The highest market price during the specific financial year} \\
 &\quad - \text{exercise price})
 \end{aligned}$$

The estimated value of granted restricted shares

$$= \text{numbers of shares} \times \text{The market price at the granted date}$$

C.3 Original Data

Bank	Group chief executive	Fixed remuneration	Annual incentives	Long-term incentives	Total remuneration
HSBC					
2000	Whitson	642,000	700,000	361,919.48	1,703,919.48
2001	Whitson	815,000	700,000	550,000	2,065,000
2002	Whitson	770,000	1,400,000	750,000	2,920,000
2003	Green	587,000	650,000	760,745	1,997,745
2004	Green	757,000	1,000,000	1,430,000	3,187,000
2005	Green	779,000	1,750,000	2,500,000	5,029,000
2006	Geoghegan	958,000	1,535,000	2,000,000	4,493,000
2007	Geoghegan	1,101,000	1,915,000	5,000,000	8,016,000
Barclays					
2000	Barrett	1,096,000	638,000	847,629.89	2,581,629.89
2001	Barrett	1,097,000	765,000	398,589.25	2,260,589.25
2002	Barrett	1,181,000	516,000	2,478,785.92	4,175,785.92
2003	Barrett	1,169,000	1,919,000	322,616.44	3,410,616.44
2004	Varley	761,000	1,313,000	537,708.98	2,611,708.98
2005	Varley	861,000	1,388,000	1,301,331.85	3,550,331.85
2006	Varley	903,000	1,613,000	1,719,089.17	4,235,089.17
2007	Varley	993,000	1,425,000	1,925,946.02	4,343,946.02
RBS					
2000	Mathewson	597,000	635,000	1,222,706.60	2,454,706.60
2001	Goodwin	747,000	825,000	1,124,994.45	2,696,994.45
2002	Goodwin	847,000	1,733,000	924,933.02	3,504,933.02
2003	Goodwin	926,000	990,000	1,745,317.56	3,661,317.56
2004	Goodwin	1,022,000	1,500,000	1,543,266.54	4,065,266.54
2005	Goodwin	1,133,000	1,760,000	1,822,117.46	4,715,117.46
2006	Goodwin	1,236,000	2,760,000	2,038,135.25	6,034,135.25
2007	Goodwin	1,330,000	2,860,000	3,055,349.22	7,245,349.22
Lloyds					
2000	Ellwood	572,000	229,000	233,479.30	1,034,479.30
2001	Ellwood	623,000	324,000	152,686.17	1,099,686.17
2002	Ellwood	799,000	450,000	338,392.52	1,587,392.52
2003	Ellwood	806,000	258,000	700,218.30	1,764,218.30
2004	Daniels	The Bank directly disclosed the proportions.			
2005	Daniels	The Bank directly disclosed the proportions.			
2006	Daniels	The Bank directly disclosed the proportions.			
2007	Daniels	1,073,000	1,782,000	1,210,000	4,065,000

Appendix D

The Levels of Bankers' Remuneration in the UK 'Big Four' Banks After the GFC

(The Original Data of Figure 5.1)

D.1 Data Collection

The data about bankers' remuneration levels is collected from the annual reports of the 'Big Four' banks from 2008 to 2016.

The criteria are the same as those specified in Appendix A.1. (Particularly, there is no record about RBS directors' remuneration in 2013 because no directors were in their offices throughout the year.)

D.2 Data Calculation

The total amount of each banker's annual remuneration includes:

1. Fixed remuneration, including basic salary, fees, benefits and role-based pay. The total amount of fixed remuneration was directly given by banks.

2. Short-term variable remuneration. In the aftermath of the GFC, banks replaced the annual cash bonus schemes with the three-year short-term incentive schemes, which are mainly paid in conditional shares. The amounts allocated in short-term incentive schemes in the first year, will be evenly distributed over a three-year period and the vested amounts depend on the annual performance in each year. Usually, banks would publish the final figures of the paid cash bonuses and the vested short-term share bonuses in a financial year. Nevertheless, sometimes banks only gave the quantity of vested shares. In this case, the author calculates the value of vested shares with the formula:

$$\textit{The value of vested ordinary shares} = \textit{Numbers of shares} \times \textit{The market price on vested date}$$

3. Share options in LTIPs or other share option schemes. If banks did not give the final figures, the formula provided in Appendix A.2 to calculate the value of share options is applied.

4. Restricted shares in LTIPs. Restricted share is the major type of LTIPs. If banks did not give the final figures, the formula used in Appendix A.2 to calculate the value of restricted shares is applied.

5. These items below are not considered as part of the total amount:

(1) The benefits in pension arrangements;

(2) Any reward in share option or ordinary share that had not been exercised or vested.

D.3 Original Data

2008	2009	2010	2011	2012	2013	2014	2015	2016
HSBC								
Flint 1,975,000	Cheng 1,718,000	Cheng 2,836,000	Flint 5,334,000	Flint 4,592,000	Flint 2,400,000	Flint 2,491,000	Flint 2,496,000	Flint 2,136,000
Geoghegan 2,824,000	Flint 1,293,000	Flint 3,930,000	Flockhart 4,581,000	Gulliver 17,733,000	Gulliver 8,033,000	Gulliver 7,619,000	Gulliver 7,331,000	Gulliver 5,675,000
Green 2,720,932.68	Geoghegan 1,913,000	Geoghegan 6,744,000	Gulliver 11,073,000	Mackay 3,626,000	Mackay 4,358,000	Mackay 4,069,000	Mackay 4,251,000	Mackay 2,953,000
	Green 1,560,000	Green 2,623,000	Mackay 2,757,000			Moses 4,203,000	Moses 3,963,000	Moses 2,936,000
	Flockhart 1,170,000	Flockhart 3,641,000						
	Gulliver 2,854,000	Gulliver 7,020,000						
Average 2,506,644.23	Average 1,751,333.33	Average 4,465,666.67	Average 5,936,250	Average 8,650,333.33	Average 4,930,333.33	Average 4,595,500	Average 4,510,250	Average 3,425,000
Barclays								
Varley 1,198,000	Varley 1,203,000	Varley 2,994,000	Diamond 13,950,000	Diamond 2,763,000	Jenkins 8,884,000	Jenkins 9,837,000	Jenkins 9,691,000	Morzaria 4,345,000
Diamond 17,476,000	Diamond 16,984,000	Diamond 7,848,000	Lucas 1,090,000	Lucas 3,981,000	Lucas 5,249,000	Morzaria 3,566,000	Morzaria 3,840,000	
Lucas 975,000	Lucas 902,000	Lucas 1,240,000						
Seegers 1,132,000								
Average 5,195,250	Average 6,363,000	Average 4,027,333.33	Average 7,520,000	Average 3,372,000	Average 7,066,500	Average 6,701,500	Average 6,765,500	Average 4,345,000
RBS								
Pell 909,000	Hester 2,304,060	Hester 7,686,118	Hester 4,414,238	Hester 2,246,648		McEwan 3,382,700	McEwan 4,180,141	McEwan 4,528,945
Whittaker 1,483,503	Pell 933,000	Van Saun 2,298,000	Van Saun 876,000	Van Saun 3,515,912			Stevenson 2,468,823	Stevenson 2,244,914
Average 1,196,251.50	Average 1,618,530	Average 4,992,059	Average 2,645,119	Average 2,881,280		Average 3,382,700	Average 3,324,482	Average 3,386,929.50

Lloyds								
Daniels 1,151,000	Daniels 1,121,000	Daniels 2,572,000	Horta-Osório 1,966,080.69	Horta-Osório 3,379,000	Horta-Osório 6,175,000	Horta-Osório 16,378,827.19	Horta-Osório 15,583,877.09	Horta-Osório 10,067,040.87
Kane 637,009.59	Kane 1,523,000	Kane 1,408,000	Tate 1,218,000		Culmer 1,968,000	Culmer 5,626,000	Culmer 7,054,264.71	Culmer 5,482,119.97
Tate 689,000	Tate 1,807,000	Tate 1,745,000	Tookey 966,180.12			Colombas 4,909,000	Colombas 7,452,036.82	Colombas 5,476,357.69
Weir 742,000	Tookey 1,736,000	Tookey 1,579,000						
	Weir 1,767,000	Weir 1,578,000						
Average 843,336.53	Average 1,590,800	Average 1,776,400	Average 1,383,420.27	Average 3,379,000	Average 4,071,500	Average 8,971,275.73	Average 10,030,059.54	Average 7,008,506.18
The Average of the 'Big Four' Banks								
2,435,370.56	2,830,915.83	3,815,364.75	4,371,197.32	4,570,653.33	5,356,111.11	5,912,743.93	6,157,572.89	4,541,358.92

Appendix E

The Variable Remuneration Schemes and Incentive Mechanisms Adopted by the UK 'Big Four' Banks After the GFC

E.1 The Overview of Variable Remuneration Schemes

		2008	2009	2010	2011	2012	2013	2014	2015	2016	
HSBC	Annual Bonus Schemes	Annual Bonus (100% deferred)			Annual Bonus (60% deferred)						
	Other Share Options	HSBC Holdings Savings-related Share Option Plan							HSBC UK Sharesave		
	LTIPs in Restricted Share	HSBC Share Plan			Group Performance Share Plan						
Barclays	Annual Bonus Schemes	Annual Cash Bonus (non-deferral) and Executive Share Award Scheme (deferral)			Cash Value Plan and Share Value Plan (at least 40% deferred)						
	Other Share Options	Sharesave									
	LTIPs in Restricted Share	Performance Share Plan			Long-term Incentive Plan						
RBS	Annual Bonus Schemes	Annual Incentives (a significant portion deferred)									
	LTIPs in Share Option	Executive Share Option Plan									
	LTIPs in Restricted Share	Medium-term Incentive Plan			Long-term Incentive Plan						
Lloyds	Annual Bonus Schemes	Annual Incentive Plan (partly deferred)				Annual Bonus (at least 60% deferred)					
	Other Share Options	Sharesave									
	LTIPs in Restricted Share	Long-term Incentive Plan									

E.2 Incentive Mechanisms in Short-term Bonus Schemes

Scheme	Performance Metrics		Form	Deferral Arrangements
HSBC Annual Bonus	2008-2009	Financial: EPS, ROE, cost efficiency and operational losses	Shares	100%; 3 years on a pro-rata basis
		Non-financial: customer satisfaction, regulatory relationship and leadership		
	2010-2016	Financial: capital strength, ROE, RoRWA, EP, cost efficiency, PBT, liquidity, dividend, TSR, and so on.	50% cash 50% shares	60%; 3 years on a pro-rata basis; updated to 3, 5 or 7 years for different bankers (since 2016)
		Non-financial: risk and compliance, leadership, regulatory relationship, client relationship, and so on.		
Barclays Annual Cash Bonus and Executive Share Award Scheme	2008-2010	Financial, PBT: ROE, RoRWA and CET 1 ratio	75% cash 25% shares	All cash: non-deferred; 20% shares: after 3 years; 10% shares: after 5 years
		Non-financial: risk and control, employee management, customer satisfaction and reputation		
Barclays Cash Value Plan and Share Value Plan	2011-2012	Financial: PBT, ROE, RoRWA, cost control and CET 1 ratio	Cash and shares	40% < GBP 500,000 60% > GBP 500,000 100% > GBP1,000,000 (since 2016); 3 years on a pro-rata basis; updated to 3, 5 or 7 years for different bankers (since 2016)
		Non-financial: customer satisfaction and employee opinions		
	2013-2016	Financial: adjusted PBT, ROE, RoRWA, net income, adjusted costs, leverage ratio and CET 1 ratio (50%)		
		Non-financial (5C scorecard): customer and client, colleague, citizenship, conduct and company (35%) Individual objectives (15%)		
RBS Annual Incentives	2008-2010	Financial: risk-adjusted profit in excess of cost of control, cost of liquidity and all risks	Cash and shares	A significant portion deferred; 3 years
	2011-2012	Financial: ROE, risks, cost efficiency, lending, CET 1 ratio, liquidity reserves, leverage ratio, and so on.		
		Non-financial: strategy, customer services, regulatory relationship, leadership, and so on.		
Lloyds Annual Incentive Plan	2008-2012	Financial: PBT and EP (50%)	Shares	3 years
		Non-financial: individual objectives, franchise growth, risk management, customer services and employee development (50%)		
Lloyds Annual Bonus	2013-2016	Financial: underlying profit and EP (50%)	Cash, shares, notes and convertible bonds	60%; 3 years
		Balanced scorecard (financial and non-financial): finance, business building, risk management, customer services and employee development (50%)		

E.3 Incentive Mechanisms in LTIPs

Scheme (deferral)	Performance Metrics and Weightings		Measurement					
HSBC Share Plan (3 years)	2008-2010	TSR ranking (40%) EP (40%) EPS (20%)	TSR Ranking (better than % comparators)	Vested awards	Average annual EP in 3 years	Vested awards	EPS growth in 3 years	Vested awards
			75% or above	100%	8% or above	100%	28% or above	100%
			50%-75%	20%	Below 3%	nil	16%-28%	20%
			Below 50%	nil			Below 16%	nil
			Slide scale applied when TSR ranking is between 75% and 50%		Slide scale applied when EP is between 8% and 3%		Slide scale applied when EP is between 28% and 16%	
HSBC Group Performance Share Plan ¹ (5 years; 7 years since 2016)	2011	Financial	ROE (15%)	ROE	15%-19%			
			Cost efficiency ratio (15%)	Cost efficiency ratio	48%-52%			
			Capital strength: CET 1 ratio (15%)	Capital strength: CET 1 ratio	7.5%-10%			
			Dividends (15%)	Dividends	40%-70%			
		Non-financial	Strategy (10%)	Strategy	Judgement ²			
			Brand equity (10%)	Brand equity	Top 3 rating; improved in value			
			Compliance and reputation (10%)	Compliance and reputation	Judgement			
	People (10%)		People	Judgement				
	2012-2013	Financial	ROE (15%)	ROE	12%-15%			
			Cost efficiency ratio (15%)	Cost efficiency ratio	48%-52%			
			Capital strength: CET 1 ratio (15%)	Capital strength: CET 1 ratio	>10%			
			Dividends (15%)	Dividends	40%-60%			
		Non-financial	Strategy (20%)	Strategy	Judgement			
			Brand equity (5%)	Brand equity	Top 3 rating; improved in value			
			Compliance and reputation (10%)	Compliance and reputation	Judgement			
	2014	Financial	ROE (15%)	ROE	12%-15%			
			Cost efficiency ratio and Jaws (15%)	Cost efficiency ratio and Jaws	Ratio below mid 50%; jaws positive ³			
			Capital strength: CET 1 ratio (15%)	Capital strength: CET 1 ratio	>10%			
			Dividends (15%)	Dividends	40%-60%			
		Non-financial	Strategy (20%)	Strategy	Judgement			
			Compliance and reputation (15%)	Compliance and reputation	Judgement			

	2015	Financial	People (5%)	People		Judgement		
			ROE (20%)	ROE		>10%		
			Jaws (20%)	Jaws		Positive		
			Dividends (20%)	Dividends		Progressive		
	Non-financial	Strategy (15%)	Strategy		Judgement			
		Risk and compliance (25%)	Risk and compliance		Judgement			
	2016	Financial	ROE (20%)	ROE ratio	Cost efficiency (Jaws)	TSR ranking		Vested award
			Cost efficiency (Jaws) (20%)	7%	Positive	Not below median		25%
				8.5%	1.5%	Between median and upper quartile		50%
				10%	3%	Upper quartile		100%
TSR Ranking (20%)		Slide scale applied between minimum and maximum						
Non-financial		Strategy (15%)	Risk and compliance		Strategy			
	Risk and compliance (25%)	Judgement		Based on a scorecard including revenues, employee engagement and customer recommendation				
Barclays Performance Share Plan (3 years)	2008	EP (50%) TSR ranking (50%)	Cumulative EP in 3 years	Vested awards		TSR ranking in 3 years		Vested awards
			GBP 6,921 million	33%		Median (6th)		33%
			GBP 8,350 million	100%		1st		100%
			Slide scale applied when EP is between GBP 6,921 and 8,350 million			Slide scale applied when TSR ranks between 6th and 1st		
	2009-2010	Average RoRWA (50%) TSR ranking (50%)	Average RoRWA in 3 years	Vested awards		TSR Ranking in 3 years		Vested awards
			0.83%	17%		Median (6th)		33%
			1.34%	100%		1st		100%
			Slide scale applied when RoRWA is between 0.83% and 1.34%			Slide scale applied when TSR ranks between 6th and 1st		
Barclays LTIP (5 years; 7 years since 2016)	2011	RoRWA (60%) Loan loss rate (30%) Sustainability metrics (10%)	Annual RoRWA	Vested awards	Loan loss rate	Vested awards		Sustainability metrics are assessed by the committee.
			1%	23%	95 basic points	10%		
			1.5%	60%	81 basic points	30%		
			Slide scale applied when RoRWA is between 1% and 1.5%			Slide scale applied when loan loss rate is between 95 and 81		
	2012	RoRWA (60%) Loan loss rate (30%) Citizenship metrics (10%)	Annual RoRWA	Vested awards	Loan loss rate	Vested awards		Citizenship metrics are assessed by the committee.
			1.1%	23%	93 basic points	10%		
			1.6%	60%	70 basic points	30%		
			Slide scale applied when RoRWA is between 1.1% and 1.6%			Slide scale applied when loan loss rate is between 93 and 70		
2013	RoRWA (50%)	Annual RoRWA	Vested awards	Loan loss rate	Vested awards			

		Loan loss rate (30%)	1.1%	23%	75	10%	The 5Cs have equal weightings. The total score is decided by the committee.				
		5C scorecard: customer and client, colleague, citizenship, conduct and company (20%)	1.6%	60%	60	30%					
			Slide scale applied when RoRWA is between 1.1% and 1.6%		Slide scale applied when loan loss rate is between 75 and 60						
	2014	RoRWA (50%) Loan loss rate (20%) 5C scorecard: customer and client, colleague, citizenship, conduct and company (30%)	Annual RoRWA	Vested awards	Loan loss rate	Vested awards	The total score of 5Cs is decided by the committee.				
			1.08%	23%	70	10%					
			1.52%	60%	55	20%					
			Slide scale applied when RoRWA is between 1.08% and 1.52%		Slide scale applied when loan loss rate is between 70 and 55						
	2015	Net generated equity ⁴ (30%) Core return on RoRWA excluding own credit (20%) Non-core drag on adjusted ROE (10%) Loan loss rate (10%) 5C scorecard: customer and client, colleague, citizenship, conduct and company (30%)	Net generated equity	Vested awards	Core return on RoRWA	Vested awards	Non-core drag on adjusted ROE	Vested awards	Loan loss rate	Vested awards	5Cs are assessed by the committee.
			GBP 1,363 million	7.5%	1.34%	5%	4.02%	2.5%	75	2.5%	
			GBP 1,844 million	30%	1.81%	20%	2.97%	10%	55	10%	
			Slide scale applied between minimum and maximum								
	2016	Adjusted return on tangible equity (RoTE) (25%) CET 1 ratio (25%) Cost-income ratio (20%) Risk scorecard (15%) 5C scorecard (15%)	RoTE	Vested awards	CET 1 ratio	Vested awards	Cost-income ratio	Vested awards	Risk scorecard includes risk profile, control environment and risk capacity. It is judged by the committee.		5Cs are assessed by the committee.
7.5%			6.25%	11.6%	6.25%	66%	5%				
10%			25%	12.7%	25%	58%	20%				
Slide scale applied between minimum and maximum											
RBS Medium-term Incentive Plan (3 years)	2008	TSR in comparison to a certain group of banking peers (50%) Adjusted EPS growth (50%)	TSR comparison		Vested awards		Adjusted EPS growth per annum		Vested awards		
			Below median		nil		Below 5%		nil		
			Median		25%		5%		25%		
			Median + 9%		125%		9% or above		100%		
			Median + 18% or above		200%		Slide scale applied between 5% and 9%				
	Slide scale applied between median and median +18%										
	2009	TSR ranking (50%) Share price (50%)	TSR ranking		Vested awards		Share price		Vested awards		
			Median		25%		40 pence		25%		
			Among top quartile		100%		55 pence		50%		
			Slide scale applied between median and top quartile				70 pence		100%		
						Slide scale applied between 40 and 70					

RBS Executive Share Option Plan (3 years)	2008	EPS growth	EPS growth per annum				Vested awards	
			5%				30%	
			9%				100%	
			Slide scale applied between 5% and 9%					
	2009	See the performance metrics and assessment of RBS Medium-term Incentive Plan in 2009.						
RBS LTIP (5 years; 7 years since 2016)	2010-2013	TSR ranking (25%) Core bank EP ⁵ (25%) Balance sheet & risk (25%) Strategic scorecard (25%)	TSR ranking	Vested awards	Core bank EP	Vested awards	Balance sheet & risk Strategic scorecard	Vested awards
			Below median	nil	Threshold ⁶	25%	More than 50% objectives not met	0%
			Median	20%			50% objectives met	25%
			Upper quartile	100%	Maximum ⁷	100%	Two-third objectives met	62.5%
	Slide scale applied between median and upper quartile		All objectives met	100%				
	2014-2016	TSR ranking (25%) Core bank EP (25%) Safe and secure bank (25%) Customers and people (25%)	TSR ranking	Vested awards	Core bank EP	Vested awards	Safe and secure bank	Customers and people
			Below median	nil	Threshold	25%	CET 1 ratio not below 13% Cost-income ratio no higher than 56%	Metrics including advocacy, trust and engagement; assessed by the committee
			Median	20%				
Upper quartile			100%	Maximum	100%			
Slide scale applied between median and upper quartile		The fulfilment of objectives are assessed by the committee.						
Lloyds LTIP (3 years; 7 years since 2016)	2008	EPS growth (50%) TSR ranking (50%)	EPS growth per annum		Vested awards		TSR ranking	Vested awards
			RPI + 6% or above		100%		Median +7.5% or above	100%
			RPI + 3%		17.5%		Equal to the median	17.5%
			Below RPI + 3%		nil		Below the median	nil
	Slide scale applied between RPI + 3% and RPI + 6%				Slide scale applied from median to median + 7.5%			
	2009	EPS growth (30%) EP (30%) Financial synergy savings (20%) Integration balance scorecard (the success of HBOS integration) (20%)	EPS	Vested awards	EP	Vested awards	Financial synergy savings	HBOS integration
55%			25%	100%	25%			
81%			100%	185%	100%	At least GBP 1.5 billion; assessed by the committee	Assessed by the committee	
Slide scale applied between 55% and 81%			Slide scale applied between 100% and 185%					

2010	EPS growth (36%) EP growth (36%) Absolute share price (28%)	EPS	Vested awards	EP	Vested awards	Share price	Vested awards		
		158%	25%	57%	25%	75 pence	nil		
		180%	100%	77%	100%	114 pence	100%		
		Slide scale applied between 158% and 180%		Slide scale applied between 57% and 77%		Slide scale applied between 57 and 114 pence			
2011	EPS (33.33%) EP (33.33%) Absolute TSR (33.33%)	EPS	Vested awards	EP	Vested awards	Absolute TSR	Vested awards		
		6.4 pence	25%	GBP 567 million	25%	8%	25%		
		7.4 pence	100%	GBP 1,234 million	100%	14%	100%		
		Slide scale applied between 6.4 and 7.4 pence		Slide scale applied between GBP 567 and 1,234 million		Slide scale applied between 8% and 14%			
2012	EP (30%) Absolute TSR (30%) Ratio between short-term and total funding (10%) Non-core assets (10%) Net simplification benefits (10%) Customer satisfaction (measure by complaints per 1000 customers) (10%)	EP	Absolute TSR	Short-term / total funding	Non-core assets	Net benefits	Customer satisfaction	Vested awards	
		GBP 160 million	12%	20%	Below GBP 95 billion	GBP 1.5 billion	Below 1.5	25%	
		GBP 1,653 million	30%	15%	Below GBP 80 billion	GBP 1.8 billion	Below 1.3	100%	
		Slide scale applied between minimum and maximum							
2013	EP (35%) Absolute TSR (30%) Customer satisfaction (10%) Total costs (adjusted) (10%) Non-core assets (10%) SME lending (5%)	EP	Absolute TSR	Customer satisfaction	Total costs	Non-core assets	SME lending	Vested awards	
		GBP 1,254 million	8%	1.05	Below GBP 9,323 million	Below GBP 37 billion	0	25%	
		GBP 1,881 million	16%	0.95	Below GBP 8,973 million	Below GBP 28 billion	4%	100%	
		Slide scale applied between minimum and maximum							
2014	EP (30%) Absolute TSR (30%) Customer satisfaction (10%) Cost-income ratio (10%) Group ranking (10%) SME lending (5%)	EP	Absolute TSR	Customer satisfaction	Cost-income ratio	Ranking	SME lending	Share	Vested awards
		GBP 2,154 million	8%	1.15	Below 48.9%	3rd	14%	20%	25%

		Share of first-time buyer market (5%)	GBP 3,231 million	16%	1.05	Below 46.5%	1st	18%	25%	100%
			Slide scale applied between minimum and maximum							
	2015	EP (30%) Absolute TSR (25%) Customer satisfaction & Financial Ombudsman Services (FOS) uphold rate (10%) Cost-income ratio (10%) Group ranking (10%) Customer growth (7.5%) Employee engagement (7.5%)	EP	Absolute TSR	Customer satisfaction & FOS rate	Cost- income ratio	Ranking	Customer growth	Employ ee	Vested awards
			GBP 2,870 million	8%	1.15; Below 32%	Below 45.6%	3rd	12.7 million	62%	25%
			GBP 3,587 million	16%	1.05; Below 28%	Below 44.5%	1st	13.3 million	70%	100%
			Slide scale applied between minimum and maximum							
	2016	EP (30%) Absolute TSR (25%) Customer satisfaction & FOS uphold rate (10%) Cost-income ratio (10%) Group ranking (10%) Customer growth (7.5%) Employee engagement (7.5%)	EP	Absolute TSR	Customer satisfaction & FOS rate ⁸	Cost- income ratio	Ranking	Customer growth	Employ ee	Vested awards
			GBP 2,507 million	8%	Below 35%	Below 47.3%	3rd	13.4 million	66%	25%
			GBP 3,308 million	16%	Below 25%	Below 46.1%	1st	14 million	72%	100%
			Slide scale applied between minimum and maximum							

1. The form only shows the generic assessment system of bankers' performance. For different executive directors, there are individual-based performance metrics. The metrics and relevant weightings vary from one director to another according to their different roles and responsibilities. The individual-based performance metrics are not provided in this form. Please refer to banks' annual reports.
2. 'Judgement' means the assessment is made by the remuneration committee in its discretion. Usually banks do not disclose the details about the judgement-making process.
3. Jaws = revenue growth - operating expense growth
4. Net generated equity is a metric which converts the changes in CET 1 ratio into an absolute capital equivalent measure.
5. Core bank EP = return attributable to shareholders - (equity × the cost of equity)
6. Threshold of Core bank EP: average return on tangible equity over the performance period at a reasonable margin above the cost of capital
7. Maximum of Core bank EP: performance ahead of the Group's strategic plan
8. The method to measure customer satisfaction for the LTIP offered in 2016 was not disclosed by Lloyds.

Appendix F

The Structures of Bankers' Remuneration in the UK 'Big Four' Banks After the GFC

(The Original Data of Figure 5.2 and 5.3)

F.1 Data Collection

The data used to reveal the remuneration structures of group chief executives is collected from the annual reports of the 'Big Four' banks from 2008 to 2016.

In 2015 and 2016, the bankers who worked as the group chief executive in Barclays did not stay in the office for a full year. Therefore, the data of the remuneration of the group financial director is used.

In 2013, none of the executive directors in RBS were in their positions throughout the year. Therefore, the record of 2013 is omitted.

F.2 Data Calculation

The structure of bankers' remuneration is shown by the proportions of fixed remuneration, short-term incentives and long-term incentives in total remuneration. If the banks directly provided the percentages, then the data is directly used. (Only RBS provided the percentages in 2012). Otherwise, the percentages of fixed remuneration, short-term bonuses and LTIPs need to be calculated.

The granted value of both short-term and long-term incentives refers to the amounts allocated under these schemes by banks at the very beginning, which is subject to bankers' performance during the vesting period. In majority cases, banks would directly disclose the value of cash and share bonuses that have been allocated to bankers. If banks only disclosed the quantity of shares granted in a specific year, the value is estimated by the author with the same formulas for restricted shares or share options in Appendix C.2.

F.3 Original Data

Bank	Group chief executive	Fixed remuneration	Short-term incentives	Long-term incentives	Total remuneration
HSBC					
2008	Geoghegan	1,132,000	0	0	1,132,000
2009	Geoghegan	1,127,000	4,000,000	0	5,127,000
2010	Geoghegan	817,000	5,200,000	9,000,000	15,017,000
2011	Gulliver	1,516,000	2,156,000	7,500,000	11,172,000
2012	Gulliver	2,470,000	1,950,000	5,898,000	10,318,000
2013	Gulliver	1,841,000	1,833,000	3,667,000	7,341,000
2014	Gulliver	3,608,000	1,290,000	2,112,000	7,010,000
2015	Gulliver	3,674,000	1,072,000	1,969,000	6,715,000
2016	Gulliver	3,605,000	1,695,000	3,990,000	9,290,000

Barclays					
2008	Varley	1,098,000	0	3,362,634	4,460,634
2009	Varley	1,123,000	0	0	1,123,000
2010	Varley	1,154,000	2,750,000	0	3,904,000
2011	Diamond	1,824,000	4,697,446.24	6,742,668.96	13,264,115.20
2012	Diamond	947,000	2,796,449.48	6,593,361.21	10,336,810.69
2013	Jenkins	1,238,000	0	4,400,000	5,638,000
2014	Jenkins	2,150,000	0	4,400,000	6,550,000
2015	Morzaria (group finance director)	1,632,000	541,063.18	2,901,309.92	5,074,373.10
2016	Morzaria (group finance director)	1,594,000	419,708.85	2,095,554.45	4,109,263.30
RBS					
2008	Goodwin	1,336,000	0	3,349,375.43	4,685,375.425
2009	Hester	1,227,000	0	3,752,850	4,979,850
2010	Hester	1,227,000	0	4,203,431.68	5,430,431.68
2011	Hester	1,226,000	2,017,441.36	4,450,238.32	7,693,679.68
2012	Hester	The bank directly disclosed the proportions.			
2013	No directors fulfil the statistical conditions.				
2014	McEwan	1,143,000	0	3,000,000	4,143,000
2015	McEwan	2,088,000	0	1,560,000	3,648,000
2016	McEwan	2,011,300	0	2,680,000	4,691,300
Lloyds					
2008	Daniels	1,151,000	0	3,905,002.85	5,056,002.85
2009	Daniels	1,121,000	0	2,058,159.40	3,179,159.40
2010	Daniels	1,450,000	1,450,000	2,855,322.35	5,755,322.35
2011	Horta-Osório	1,251,000	0	8,671,636.81	9,922,636.81
2012	Horta-Osório	1,345,000	1,485,000	3,354,999.78	6,184,999.78
2013	Horta-Osório	1,347,000	1,700,000	3,668,999.64	6,715,999.64
2014	Horta-Osório	2,081,000	800,000	3,663,940.62	6,544,940.62
2015	Horta-Osório	2,103,000	850,000	3,346,000	6,299,000
2016	Horta-Osório	2,169,000	1,220,000	3,663,632.68	7,052,632.68

Appendix G

The Levels of Bankers' Remuneration in Chinese SOCBs

(The Original Data of the Figures and Tables is Subsection 8.2.1)

G.1 Data Collection

Before Chinese SOCBs went public, the information of bankers' remuneration was not disclosed. Therefore, only the information of bankers' remuneration levels of ICBC, BOC, CCB and BCM from 2007 to 2015 and the information of ABC from 2008 to 2015 is available. In general, only those bankers with a material impact on banks' risk-taking activities are included. The criteria below are followed:

1. Only the data of the remuneration of executive board members and senior managers is collected, while that of NEDs and supervisors is excluded.
2. In a Chinese bank, executive board members include: chairman, vice chairmen and executive directors. Senior managers include: president, vice presidents, CFO, CRO, Chief Information Officer (CIO), Auditor General, the secretary of the BOD and other senior managers. In particular, there is a very special position in the senior management of SOCBs - the secretary of the CDI. A CDI is an organ of the CCP system which exists in all state-owned or state-related social and economic organisations to supervise party members and implement the CCP's Constitution and disciplines. In SOCBs, the person at this position is directly designated by the CCP and works on a full-time basis, rather than appointed by the BOD or concurrently acted by directors or other senior managers. Secretary of the CDI represents the CCP's engagement in bank corporate governance. It is part of the senior management, therefore, the information of this role's remuneration is included.
3. According to the CBRC Guidelines, the chairman of the BOD and the president cannot be acted by the same person. However, it is very common that other roles in both the BOD and the management are acted by the same banker. In practice, usually the president is also one of the vice chairmen; some executive directors concurrently act as vice presidents; some senior managers have more than one role in the management. In these cases, the following rules are applied: (1) every banker's remuneration will be calculated only once; (2) a person who is both an executive member of the BOD and a senior manager, will be included in the BOD not the senior management; (3) a person who takes dual roles in the senior management will be recorded as the higher one.
4. In a specific financial year, only the bankers who worked throughout this year is included.

G.2 Data Calculation

The components are fixed remuneration and variable remuneration, both in cash. SOCBs directly disclosed the amounts of total remuneration, fixed remuneration and variable remuneration.

G.3 Original Data

	2007	2008	2009	2010	2011	2012	2013	2014	2015
ICBC									
Chairman	1,795,000	1,610,000	1,740,000	1,960,600	1,960,600	1,995,600	1,995,600	1,995,600	861,300
President (Vice Chairman)	1,771,000	1,535,000	1,657,000	1,893,900	1,893,900	1,978,700	1,908,900	1,974,500	861,300
Executive Director (Vice President) 1	1,533,000	1,381,000	1,481,000	1,678,800	1,678,800	1,796,200	1,830,600		765,400
Executive Director (Vice President) 2	1,517,000	1,381,000	1,481,000	1,678,800	1,678,800	1,796,200			765,100
Vice President 1	1,548,000	1,375,000	1,478,000	1,675,200	1,678,800	1,796,200	1,830,100	1,874,400	764,300
Vice President 2	1,532,000	1,381,000	1,478,000	1,678,800	1,678,800	1,796,200	1,825,800	1,872,400	762,800
Vice President 3	1,533,000	1,350,000	1,478,000		1,678,800	1,796,200		1,872,400	
Vice President 4								1,872,400	
Vice President 5								1,872,100	
CRO	1,460,000	1,314,000	1,408,000	1,602,400	1,602,400	1,715,200	1,764,800	1,807,900	1,848,100
CIO					1,602,400	1,715,200	1,761,800	1,804,700	
Secretary of the BOD	1,461,000		1,408,000		1,602,400	1,715,200	1,763,900	1,806,900	1,677,700
Secretary of the CDI	1,515,000	1,376,000	1,475,000	1,675,200	1,678,800	1,796,200		1,874,900	
Other Senior Manager	1,436,000				1,637,700	1,754,900			
BOC									
Chairman	1,675,000	1,507,000	1,606,200	1,705,800	1,866,300	1,939,100		2,091,300	794,800
President (Vice Chairman)	1,716,000	1,544,000	1,472,500	1,554,400	1,694,900	1,765,500	1,863,000	1,894,200	790,200
Executive Director (Vice President) 1	1,657,000	1,481,000	1,417,400	1,496,100	1,631,400	1,696,700	1,789,900	1,878,000	
Executive Director (Vice President) 2		1,477,000	1,416,800	1,492,600		1,677,000	1,765,300		699,900
Vice President 1	1,601,000	1,436,000	1,386,800	1,452,100	1,579,700	1,650,700	1,739,700	1,811,500	700,200
Vice President 2	1,518,000	1,369,000	1,367,500	1,505,400	1,588,700	1,664,100	1,741,000	1,817,600	
Vice President 3	1,434,000	1,363,000	1,405,400		1,632,100	1,668,500	1,743,400		
Vice President 4					1,628,200				
Auditor General					2,870,000		1,784,100	1,695,600	1,990,000
Secretary of the BOD			1,282,100	1,387,500	1,507,500		1,633,900	1,693,300	
Secretary of the CDI	1,467,000	1,363,000		1,456,300	1,590,500	1,657,000	1,748,200	1,833,200	747,500
ABC									
Chairman		1,364,700	1,614,300	1,758,400		1,980,800	1,980,800	1,909,800	
President (Vice Chairman)		1,151,700	1,450,200	1,582,600	1,735,500	1,788,900	1,788,900	1,807,000	

Vice President 1	1,716,200	1,401,500	1,294,900				1,540,900	1,604,700	
Vice President 2	1,443,800								
CFO		1,425,300	1,336,400	1,418,100	1,538,800				1,054,000
CRO		1,218,000	1,222,700	1,323,300	1,440,800	1,507,000	1,485,100	1,606,400	654,400
CIO	1,368,600	1,230,500	1,249,100	1,344,400	1,522,400	1,601,300	1,578,900	1,621,000	
Secretary of the BOD	1,376,800	1,231,700		1,326,000	1,439,300	1,505,400	1,476,700	1,516,200	1,585,000
Secretary of the CDI		1,404,900	1,336,400	1,418,100	1,538,800	1,609,500	1,578,900	1,621,000	671,400
Other Senior Manager					1,439,500	1,505,400	1,476,800	1,516,400	1,585,000

Appendix H

The Structures of Bankers' Remuneration in Chinese SOCBs

(The Original Data of the Figures and Tables in Subsection 8.2.2)

H.1 Data Collection

The criteria are the same as those explained in Appendix G.1.

H.2 Data Calculation

SOCBs directly disclosed the amounts of performance-based remuneration and deferred payments.

The proportion means the ratio between variable remuneration/deferred payment and total remuneration.

H.3 Original Data

The Amounts and Proportions of Variable Remuneration

	2009		2010		2011		2012		2013		2014	
ICBC												
Chairman	1,093,000	62.82%	1,214,100	61.92%	1,176,600	60.01%	1,166,600	58.46%	1,151,600	57.71%	1,123,600	56.30%
President (Vice Chairman)	983,000	59.32%	1,092,800	57.70%	1,059,100	55.92%	1,141,700	57.70%	1,123,900	58.88%	1,132,800	57.37%
Executive Director (Vice President) 1	928,000	62.66%	1,028,400	61.26%	966,500	57.57%	1,074,300	59.81%	1,084,000	59.22%		
Executive Director (Vice President) 2	928,000	62.66%	1,028,400	61.26%	966,500	57.57%	1,074,300	59.81%				
Vice President 1	925,000	62.58%	1,024,800	61.17%	966,500	57.57%	1,074,300	59.81%	1,083,600	59.21%	1,102,700	58.83%
Vice President 2	925,000	62.58%	1,028,400	61.26%	966,500	57.57%	1,074,300	59.81%	1,083,600	59.35%	1,102,700	58.89%
Vice President 3	925,000	62.58%			966,500	57.57%	1,074,300	59.81%			1,102,700	58.89%
Vice President 4											1,102,700	58.89%

Vice President 5											1,102,700	58.90%
CRO	889,000	63.14%	988,700	61.70%	958,000	59.79%	1,032,800	60.21%	1,045,400	59.24%	1,063,800	58.84%
CIO					958,000	59.79%	1,032,800	60.21%	1,042,400	59.17%	1,060,800	58.78%
Secretary of the BOD	889,000	63.14%			958,000	59.79%	1,032,800	60.21%	1,044,500	59.22%	1,062,900	58.82%
Secretary of the CDI	922,000	62.51%	1,024,800	61.17%	966,500	57.57%	1,074,300	59.81%			1,103,200	58.84%
Other Senior Manager					968,100	59.11%	1,050,700	59.87%				
BOC												
Chairman	945,000	58.83%	1,014,600	59.48%	1,114,300	59.71%	1,135,200	58.54%			1,228,500	58.74%
President (Vice Chairman)	850,500	57.76%	913,100	58.74%	1,002,900	59.17%	1,021,700	57.87%	1,077,400	57.83%	1,094,300	57.77%
Executive Director (Vice President) 1	814,600	57.47%	876,300	58.57%	962,600	59.00%	981,800	57.87%	1,035,400	57.85%	1,062,500	56.58%
Executive Director (Vice President) 2	817,300	57.69%	871,500	58.39%			981,800	58.55%	1,032,300	58.48%		
Vice President 1	795,400	57.36%	854,500	58.85%	938,300	59.40%	959,100	58.10%	1,011,500	58.14%	1,033,100	57.03%
Vice President 2	795,700	58.19%	857,200	56.94%	941,500	59.26%	959,100	57.63%	1,011,500	58.10%	1,032,200	56.79%
Vice President 3	798,400	56.81%			941,500	57.69%	959,100	57.48%	1,010,600	57.97%		
Vice President 4					941,500	57.82%						
Auditor General									499,000	27.97%	488,900	28.83%
Secretary of the BOD			799,300	57.61%	868,300	57.60%			945,700	57.88%	969,300	57.24%
Secretary of the CDI	791,400	61.73%	852,000	58.50%	937,300	58.93%	958,700	57.86%	1,011,500	57.86%	1,038,000	56.62%
ABC												
Chairman	933,300	57.81%	1,024,400				1,166,100	58.87%				
President (Vice Chairman)	840,000	57.92%	922,000	58.69%	1,018,600	58.69%	1,049,500	58.67%	1,030,600	57.61%	1,108,600	58.05%
Executive Director (Vice President) 1	792,700	57.45%	870,000	58.58%	961,200	58.58%	990,300	58.53%	1,022,900	58.60%	1,046,200	57.90%
Executive Director (Vice President) 2	792,300	57.43%	870,000	58.58%	961,200	58.58%						
Vice President 1	792,300	57.43%	869,700	58.58%	960,900	58.58%	989,900	58.52%				
Vice President 2	792,300	57.43%	869,700	58.58%	960,900	58.58%	989,900	58.52%				
Vice President 3			869,700									
Secretary of the BOD	763,700	60.14%	838,300	58.50%	926,200	58.50%	954,100	58.28%				
Other Senior Manager							989,900	58.52%				
CCB												
Chairman	996,930	59.33%	1,079,900	59.13%			1,163,500	58.71%	1,305,600	60.84%	1,372,000	61.03%
President (Vice Chairman)	944,460	58.74%	1,061,910	60.14%	1,104,840	59.51%	1,173,150	59.91%	1,175,040	59.27%	1,234,800	59.41%

Executive Director (Vice President) 1	891,652	59.68%	1,001,825	61.06%	1,042,670	60.45%			1,109,327	60.13%	1,165,754	60.27%
Executive Director (Vice President) 2			1,002,552	61.09%	1,043,065	60.46%			1,108,893	60.12%	1,165,754	60.27%
Vice President 1	890,976	59.67%	1,001,825	61.08%	1,042,670	60.45%	1,106,713	60.79%	1,109,327	60.13%	1,165,754	60.27%
Vice President 2	890,976	59.79%			1,043,065	60.59%	1,106,713	60.79%	1,108,893	60.12%	1,068,200	60.25%
Vice President 3					1,042,670	60.76%	1,107,554	60.81%	1,098,022	60.10%	1,101,751	60.62%
Vice President 4							1,107,554	60.81%			1,165,754	60.27%
Vice President 5											1,165,754	60.27%
CFO	817,912	60.22%	1,002,552	61.29%			1,015,958	61.29%				
CRO	891,652	59.81%					1,015,186	61.27%	1,017,175	60.55%	1,069,751	60.67%
Auditor General	817,292	60.23%					1,015,186	61.27%	1,016,777	60.54%		
Secretary of the BOD	816,982	60.22%	918,988	61.57%	956,077	60.97%	1,015,186	61.27%	1,016,777	60.54%	1,069,751	60.67%
Secretary of the CDI	891,652	59.68%										
Other Senior Manager 1	816,982	60.22%	918,655	61.57%	1,011,619	60.69%	1,074,163	60.71%	1,016,777	60.54%		
Other Senior Manager 2	816,982	60.21%	918,655	61.57%								
BCM												
Chairman	976,300	61.92%	1,044,100	62.41%	1,151,300	63.42%	1,189,000	62.68%	1,081,300	60.33%	1,160,800	60.79%
President (Vice Chairman)			939,700	61.59%	1,036,200	62.66%	1,070,100	61.91%			1,044,800	60.01%
Executive Director (Vice President) 1	829,900	62.10%	887,500	62.58%	978,600	63.60%	1,010,800	62.80%	959,000	60.74%	986,800	60.88%
Executive Director (Vice President) 2	829,900	62.10%	887,500	62.64%	978,600	63.49%	1,010,800	62.80%	959,000	60.74%	986,800	60.88%
Vice President	829,900	64.09%							944,800	61.31%	986,800	61.49%
CFO	829,900	62.10%	887,500	62.58%	978,600	63.60%						
CRO	781,000	63.88%	835,300	63.12%	921,100	63.93%	951,200	63.12%	907,300	61.09%	986,800	61.43%
CIO	781,000	62.53%	848,300	63.10%	978,600	64.28%	1,010,800	63.12%	959,000	60.74%	986,800	60.88%
Secretary of the BOD			835,300	62.99%	921,100	64.00%	951,200	63.19%	902,600	61.12%	928,700	61.25%
Secretary of the CDI	829,900	62.10%	887,500	62.58%	978,600	63.60%	1,010,800	62.80%	959,000	60.74%	986,800	60.88%
Other Senior Manager					921,100	63.99%	951,200	63.19%	902,600	61.12%	928,700	61.24%

The Amounts and Proportions of Deferred Payment

	2009		2010		2011		2012		2013		2014	
ICBC												
Chairman	548,000	31.49%	608,300	31.03%	589,500	30.07%	584,500	29.29%	577,000	28.91%	562,900	28.21%
President (Vice Chairman)	492,000	29.69%	547,500	28.91%	530,060	27.99%	572,000	28.91%	563,100	29.50%	567,500	28.74%
Executive Director (Vice President) 1	465,000	31.40%	515,200	30.69%	499,200	29.74%	538,200	29.96%	543,100	29.67%		
Executive Director (Vice President) 2	465,000	31.40%	515,200	30.69%	499,200	29.74%	538,200	29.96%				
Vice President 1	463,000	31.33%	513,400	30.65%	499,200	29.74%	538,200	29.96%	542,900	29.67%	552,500	29.48%
Vice President 2	463,000	31.33%	515,200	30.69%	499,200	29.74%	538,200	29.96%	542,900	29.73%	552,500	29.51%
Vice President 3	463,000	31.33%			499,200	29.74%	538,200	29.96%			552,500	29.51%
Vice President 4											552,500	29.51%
Vice President 5											552,500	29.51%
CRO	445,000	31.61%	495,300	30.91%	480,000	29.96%	517,400	30.17%	523,700	29.67%	533,000	29.48%
CIO					480,000	29.96%	517,400	30.17%	522,300	29.65%	531,500	29.45%
Secretary of the BOD	445,000	31.61%			480,000	29.96%	517,400	30.17%	523,300	29.67%	532,500	29.47%
Secretary of the CDI	462,000	31.32%	513,400	30.65%	499,200	29.74%	538,200	29.96%			552,700	29.48%
Other Senior Manager					485,000	29.61%	526,400	30.00%				
BOC												
Chairman	481,900	30.00%	508,300	29.80%	558,300	29.91%	568,700	29.33%			615,500	29.43%
President (Vice Chairman)	433,800	29.46%	457,500	29.43%	502,400	29.64%	511,900	28.99%	539,800	28.97%	548,300	28.95%
Executive Director (Vice President) 1	415,400	29.31%	439,000	29.34%	482,200	29.56%	491,900	28.99%	518,700	28.98%	532,300	28.34%
Executive Director (Vice President) 2	416,800	29.42%	436,600	29.25%			491,900	29.33%	517,200	29.30%		
Vice President 1	405,700	29.25%	428,100	29.48%	470,100	29.76%	480,500	29.11%	506,700	29.13%	517,600	28.57%
Vice President 2	405,800	29.67%	429,500	28.53%	471,700	29.69%	480,500	28.87%	506,700	29.10%	517,100	28.45%
Vice President 3	407,200	28.97%			471,700	28.90%	480,500	28.80%	506,300	29.04%		
Vice President 4					471,700	28.97%						

Other Senior Manager 1	408,491	30.11%	495,329	33.20%	505,811	30.34%	537,083	30.36%	508,390	30.27%		
Other Senior Manager 2	408,491	30.11%	495,329	33.20%								
BCM												
Chairman	488,200	30.97%	522,100	31.21%	575,700	31.71%	594,500	31.34%	540,700	30.17%	580,400	30.40%
President (Vice Chairman)			469,900	30.80%	518,100	31.33%	535,100	30.96%			522,400	30.01%
Executive Director (Vice President)1	415,000	31.05%	443,800	31.30%	489,300	31.80%	505,400	31.40%	479,500	30.37%	493,400	30.44%
Executive Director (Vice President)2	415,000	31.05%	443,800	31.32%	489,300	31.74%	505,400	31.40%	479,500	30.37%	493,400	30.44%
Vice President	415,000	32.05%							472,400	30.66%	493,400	30.75%
CFO	415,000	31.05%	443,800	31.30%	489,300	31.80%						
CRO	390,500	31.94%	417,700	31.57%	460,600	31.97%	475,600	31.56%	453,700	30.55%	493,400	30.71%
CIO	390,500	31.26%	424,200	31.55%	489,300	32.14%	505,400	31.56%	479,500	30.37%	493,400	30.44%
Secretary of the BOD			417,700	31.50%	460,600	32.00%	475,600	31.59%	451,300	30.56%	464,400	30.63%
Secretary of the CDI	415,000	31.05%	443800	31.30%	489,300	31.80%	505,400	31.40%	479,500	30.37%	493,400	30.44%
Other Senior Manager					460,600	32.00%	475,600	31.59%	451,300	30.56%	464,400	30.63%

Appendix I

The Levels of Bankers' Remuneration in Chinese JSCBs

(The Original Data of the Figures and Tables is Subsection 8.3.1)

I.1 Data Collection and Calculation

The collection criteria and calculation methods are the same as those for SOCBs. Please refer to Appendix G for details. The period of examination is from 2007 to 2015. However, in special cases, the data of some banks in some years was not disclosed. The missing data includes: CITIC Bank from 2013 to 2015, Everbright Bank in 2009 and 2010 and Zheshang Bank from 2013 to 2015. Besides, in some JSCBs, the secretary of the CDI can be concurrently acted by a senior manager or an executive director. In these circumstances, the banker will be recorded as the other role, rather than the secretary of the CDI.

I.2 Original Data

	2007	2008	2009	2010	2011	2012	2013	2014	2015
CITIC									
President (Executive Director)	6,486,000	5,513,100	4,961,800	4,961,800	4,961,800				
Executive Director (Vice President) 1	4,435,000	3,747,900	3,373,100	3,336,300	3,369,600	3,369,600			
Executive Director (Vice President) 2									
Vice President 1	4,426,000	3,705,000	3,334,500	3,369,600	3,334,500	3,369,600			
Vice President 2	4,372,000	3,707,000	3,336,300	3,334,500	3,292,400	3,334,500			
Vice President 3	4,070,000	3,618,000	3,292,400	3,292,400	3,320,100	3,292,400			
Vice President 4	4,420,000	3,744,000	3,369,600	3,320,100	3,322,800	3,320,100			
Vice President 5				3,322,800		3,322,800			
Secretary of the BOD			2,046,500	2,108,200	2,459,600	2,145,800			
Secretary of the CDI	4,262,000	2,070,000	3,100,000	3,100,000	3,100,000	3,140,100			
Other Senior Manager 1	4,320,000	3,689,000	3,320,100						
Other Senior Manager 2	4,270,000	3,692,000	3,322,800						
Other Senior Manager 3		3,653,000	3,178,100	3,178,100	3,178,100				
Everbright									

Chairman	4,041,000	1,600,000				449,500	495,000		
Vice Chairman	3,788,400	1,590,000				404,500	445,500		
President					1,627,600	1,636,800			
Executive Director 1	2,636,100	1,550,000			1,534,000	1,487,400	1,459,900	1,459,500	1,513,600
Executive Director 2	2,636,100								
Vice President (Audit General) 1	2,636,100	1,550,000			1,543,200	1,487,400	1,512,500		
Vice President 2	2,636,100	1,550,000			1,533,400	1,455,700	1,455,700	1,519,800	1,466,600
Vice President 3	2,636,100	1,550,000			1,533,400	1,455,700	1,455,700	1,513,600	1,460,300
Vice President 4	2,636,100	1,500,000			1,533,800	1,455,700	1,455,700	1,523,700	1,466,600
Vice President 5	2,636,100	1,500,000			1,534,000	1,455,700	1,507,700	1,624,900	1,587,500
Vice President 6	2,536,100	1,500,000			1,541,400	1,456,600	1,456,300		1,460,300
Vice President 7							2,658,700		
Vice President (secretary of the CDI) 8								1,354,600	1,520,300
Secretary of the BOD	2,536,100	1,500,000			1,541,400	1,487,400	1,512,500		1,513,600
Other Senior Manager	2,536,100	1,500,000			1,533,400				
Hua Xia									
Chairman		1,470,000	2,400,000	2,600,000	2,800,000	2,810,200	3,180,000	3,158,800	468,000
President (Vice Chairman)	2,346,400	2,110,000	1,910,000	2,600,000	2,800,000	2,810,200	3,180,000	3,158,800	468,000
Executive Director (Secretary of the BOD)	1,472,000	1,470,000	1,780,000	2,000,000	2,150,000	2,165,000	2,460,000	2,448,600	2,448,600
Executive Director	1,468,900	1,470,000							
Executive Director (Audit General)								2,448,600	421,200
Executive Director (Vice President) 1		850,000				2,190,200	1,980,000	2,448,600	421,200
Executive Director (Vice President) 2									
Vice President 1	1,478,100	1,470,000	1,770,000	2,000,000	2,150,000	2,180,400	2,460,000	2,448,600	421,200
Vice President 2	1,403,200	1,400,000	1,770,000	2,000,000	2,150,000	2,172,100	2,460,000	2,448,600	
Vice President 3	1,398,300	1,400,000				2,188,500			
CFO				2,020,000	1,910,000	2,284,700	2,854,500	2,188,600	2,231,700
Industrial									
Chairman	2,976,000	2,750,000	2,785,000	3,040,000	3,314,000	3,615,000	3,615,000	3,254,000	930,000
President (Executive Director)	2,950,000	2,650,000	2,706,000	2,950,000	3,216,000	3,508,000	3,508,000	3,157,000	930,000
Executive Director (Vice President) 1	2,269,000	2,490,000	2,533,000	2,760,000	3,008,000	3,282,000	2,785,000	2,618,000	842,400

Executive Director (Vice President) 2	2,249,000	2,320,000	2,361,000	2,570,000	2,801,000	3,056,000	2,781,000	2,559,000	
Vice President 1				2,345,000	2,555,000	2,785,000	3,056,000	2,964,000	842,400
Vice President 2				2,340,000	2,551,000	2,781,000	2,695,000	2,533,000	842,400
Vice President 3						3,690,000	2,701,000	2,539,000	842,400
Vice President 4						3,461,000	2,702,000	2,486,000	
Vice President 5						2,962,000		3,515,000	
Secretary of the BOD	1,326,000	2,000,000	2,032,000	2,215,000	2,414,000	2,634,000	2,634,000	2,555,000	842,400
Merchants									
Vice Chairman (Executive Director)							4,794,400	5,210,600	
President (CEO and Executive Director)	9,631,000	7,892,800	7,306,000	7,109,500	7,183,000	6,590,800			6,516,800
Executive Director (Vice President) 1	5,107,000	3,965,500	3,974,000	4,636,700	4,685,700	4,284,000	4,794,400	5,210,600	5,213,500
Executive Director (Vice President) 2		3,947,900	3,952,000	4,613,700	4,663,400	4,284,000			
Vice President 1	5,120,000	3,964,300	3,874,000	4,329,700	4,331,800	3,954,500	4,279,800	4,559,300	4,561,800
Vice President 2	5,123,000	3,965,500	3,874,000	4,319,700	4,328,900	3,954,500	4,279,800	4,559,300	4,561,800
Vice President 3		3,803,600	3,856,000	4,262,700	4,308,400	3,954,500	4,279,800	4,559,300	4,561,800
Vice President 4					4,155,400	3,954,500	4,279,800	4,559,300	4,561,800
Vice President 5						3,954,500		3,256,700	4,561,800
Chief Technology Officer	2,898,000	2,377,000	2,400,000	2,847,800	2,879,600	2,636,300			
Audit General	2,670,000	2,394,600	2,421,000	2,870,800					
Secretary of the BOD	2,898,000	2,377,000	2,400,000	2,847,800	2,879,600	3,295,400		3,256,700	3,910,100
Secretary of the CDI			3,874,000	4,103,800	4,146,000				4,561,800
Other Senior Manager	3,860,000		3,587,000	3,578,800				3,256,700	3,910,100
Minsheng									
Chairman	17,486,200	11,366,000	6,545,800	7,154,800	6,772,200	7,251,500	6,934,200	6,562,300	6,862,400
Vice Chairman (Executive Director)						6,370,500	6,036,900	6,121,500	6,244,300
President (Executive Director) 1	10,046,100	8,539,200	6,268,300	6,844,800	6,724,300	7,107,200	6,574,200		
President (Executive Director) 2		9,041,500							
Executive Director (Vice President) 1	7,158,500	5,896,100	4,876,500	5,696,100	5,615,900			3,244,800	
Executive Director (Vice President) 2									
Vice President 1	6,914,500	5,896,100	4,249,000	4,836,100	4,377,500	4,157,100	3,711,100	2,991,700	3,299,100
Vice President 2	6,954,500	5,896,100	4,249,000	4,836,100	4,700,900	5,048,800	4,695,500	4,425,300	

Vice President 3		5,896,100	4,249,000	4,836,100	4,700,900	5,318,300	5,077,600		
Vice President 4					4,700,900	4,077,800			
CFO	6,914,500	5,896,100	4,259,900	3,157,400	4,700,900	3,538,200	4,188,800	4,308,100	4,464,200
Secretary of the BOD	6,906,600					3,532,500	4,178,600	3,794,500	4,145,000
Other Senior Manager 1	6,551,200						3,734,000	3,883,900	4,045,300
Other Senior Manager 2							3,744,200	3,897,500	4,064,600
Other Senior Manager 3							3,734,000	3,383,900	4,045,300
Ping An									
Chairman	22,850,000	15,980,000	17,410,000	8,250,000	7,450,000	6,920,000			
President (Executive Director)	4,210,000	4,180,000	4,860,000		8,690,000	7,950,000	8,332,600	8,352,700	7,104,500
Executive Director (Vice President) 1	3,520,000	2,990,000	3,510,000	5,160,000	5,790,000	5,460,000	5,862,300	6,002,200	5,935,300
Executive Director (Vice President) 2	3,510,000	2,920,000	3,270,000	2,780,000	4,750,000	6,170,000	4,038,800	7,102,700	7,116,600
Vice President 1	2,300,000			4,340,000	2,990,000	4,330,000	7,082,600	7,113,900	5,093,100
Vice President 2						3,790,000	7,090,400	6,812,400	4,267,000
Vice President 3						4,350,000	4,204,000	4,265,600	4,040,900
Vice President 4						4,220,000	3,714,300	4,022,800	4,785,900
Vice President 5							4,444,400	4,773,500	6,938,700
Vice President 6							6,269,000	3,772,500	
CFO	3,280,000	2,860,000	3,310,000						
Secretary of the BOD	1,690,000	1,480,000	1,650,000	2,180,000	1,690,000	3,830,000	3,465,100	2,993,300	3,680,300
SPDB									
Chairman		1,760,000	1,700,000	1,977,400	2,078,200	2,098,500	2,098,500	2,098,500	920,000
President (Vice Chairman)	2,200,000	1,760,000	1,700,000	1,977,400	2,078,200		2,098,500	2,098,500	
Vice Chairman			1,700,000		2,078,200	2,098,500	2,098,500	2,098,500	
Executive Director (Secretary of the BOD)			1,900,000	2,326,400	2,445,000	2,812,900	2,812,900	2,812,900	
Executive Director			1,900,000						
Executive Director (Vice President) 1	1,940,000								828,000
Executive Director (Vice President) 2	1,940,000								
Vice President 1	1,890,000	2,000,000	2,400,000	2,907,900	3,056,100	3,421,600	3,421,600	3,453,050	828,000
Vice President 2		2,000,000	2,500,000	2,907,900	3,156,100	3,327,200	3,327,200	3,484,550	
Vice President 3		2,000,000	2,500,000	2,907,900	3,056,100	3,453,100	3,453,100	3,421,550	

Vice President 4			2,529,379	2,907,900	3,056,100	3,484,600	3,484,600	3,327,150	
Vice President 5			2,436,033	3,024,300	3,056,100	3,295,700	3,295,700	3,295,650	
Vice President 6				3,024,300	3,156,100	3,516,000			
Secretary of the BOD	1,930,000	3,836,000							1,244,500
Zheshang									
Chairman	2,400,000	2,400,000	1,200,500	2,284,500	2,714,200	2,558,300			
President (Executive Director)	2,423,500	2,470,500	1,200,500	2,284,500	2,714,200	2,558,300			
Executive Director (Vice President)	3,708,500	3,183,200	3,764,400	3,028,700	3,336,800	3,716,900			
Vice President 1	3,707,800	3,181,100	3,764,400	3,028,700	3,336,800	3,716,900			
Vice President 2	3,707,800	3,181,100	3,764,400	3,028,700	3,336,800	3,716,900			
Secretary of the BOD		2,316,800	2,504,500	2,407,000	2,669,400	2,973,600			
Other Senior Manager 1	2,793,300	2,660,500	3,095,100	2,573,000	2,819,400	2,973,600			
Other Senior Manager 2		2,200,600	2,635,200	2,423,000	2,619,400	2,885,300			

Appendix J

The Designs of the Correlation Tests with SPSS (Table 8.12 and 8.13)

J.1 The Correlation Test Between JSCBs' Ownership Structures and Bankers' pre-JSCB Career Trajectories (Table 8.12)

'Ownership structure' and 'pre-JSCB career trajectory' are the two variables in this test. The 42 bankers are numbered from 1 to 42. There are two types of ownership structure - state-related and private-based, which are given the values 0 and 1 respectively. If the banker was/is working in a state-related JSCB, the record of the variable 'ownership structure' will be 0, otherwise it will be 1. There are two types of pre-JSCB career trajectory - the 'inside system' and the 'outside system', which are given the values 0 and 1 respectively. If the banker had/have worked in the 'inside system', the record of

the variable 'pre-JSCB career trajectory' will be 0, otherwise it will be 1.

If the outcome is positive correlation, it means that state-related JSCBs tend to recruit bankers from the 'inside system' while private-related JSCBs prefer to recruit bankers from the 'outside system'.

If the outcome is negative correlation, it means that state-related JSCBs tend to recruit bankers from the 'outside system' while private-related JSCBs prefer to recruit bankers from the 'inside system'.

If the outcome is no strong correlation, it means that neither of the two kinds of JSCBs have a particular preference on bankers' working experience.

J.2 The Correlation Test Between JSCBs' Remuneration Levels and Bankers' post-JSCB Career Trajectories (Table 8.13)

'Remuneration level' and 'post-JSCB career trajectory' are the two variables in this test. The 42 bankers are numbered from 1 to 42. According to the remuneration level, the nine JSCBs have been divided into the 'bottom group', the 'middle group' and the 'top group'. If the banker was/is in a bank belonging to the 'bottom group' / the 'middle group' / the 'top group', the record of 'remuneration level' will be 0, 1 and 2 respectively. Usually, bankers have three kinds of post-JSCB career trajectory - the 'inside system', the 'outside system' and others (retired, dismissed or still working in JSCBs), which are given the values 0, 1 and 9 respectively. 9 is the default value, which means that bankers who did not continue to work after their tenures in JSCBs or are still working in JSCBs are not included in the test.

If the outcome is positive correlation, it means that in the JSCBs which offer higher level remuneration packages, bankers tend to shift to the private financial sector after their tenures in JSCBs. On the contrary, In the JSCBs which offer lower level remuneration packages, bankers tend to shift to the state-owned financial sector or the governmental system after their tenures in JSCBs.

If the outcome is negative correlation, it means that in the JSCBs which offer higher level remuneration packages, their bankers tend to shift to the state-owned financial sector or the governmental system after their tenures in JSCBs. On the contrary, In the JSCBs which offer lower level remuneration packages, bankers tend to shift to the private financial sector after their tenures in JSCBs.

If the outcome is no strong correlation, it means that bankers' preferences on their post-JSCB careers are not related to the remuneration levels offered by their banks.

J.3 The Correlation Test Between JSCBs' Practices of Performance-based Remuneration and Bankers' post-JSCB Career Trajectories (Table 8.13)

'Practice of performance-based remuneration' and 'post-JSCB career trajectory' are the two variables in this test. The 42 bankers are numbered from 1 to 42. There are two kinds of situations in terms of practicing performance-based remuneration - have not adopted or haven adopted, which are given the values 0 and 1 separately. If the banker was/is in a JSCB without a performance-based remuneration scheme, the record of 'practice of performance-based remuneration' will be 0, otherwise it will be 1. According to Table 8.9, Ping An, Minsheng and Merchants have adopted performance-based remuneration and others have not. The definition of 'post-JSCB career trajectory' is the same as that in J.2.

If the outcome is positive correlation, it means that in the JSCBs with performance-based remuneration, bankers tend to shift to the private financial sector after their tenures in JSCBs. On the contrary, in the JSCBs without performance-based remuneration, bankers tend to shift to the state-owned financial sector or the governmental system after their tenures in JSCBs.

If the outcome is negative correlation, it means that in the JSCBs with performance-based remuneration, bankers tend to shift to the state-owned financial sector or the governmental system after their tenures in JSCBs. On the contrary, in the JSCBs without performance-based remuneration, bankers tend to shift to the private financial sector after their tenures in JSCBs.

If the outcome is no strong correlation, it means that bankers' preferences on their post-JSCB careers are not related to the practices of performance-based remuneration in their banks.