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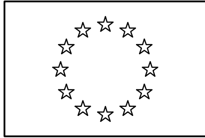

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 30.4.2009
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COMMISSION STAFF WORKING DOCUMENT

accompanying the

COMMISSION RECOMMENDATION

complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies

and the

COMMISSION RECOMMENDATION

on remuneration policies in the financial services sector

EXECUTIVE SUMMARY OF THE IMPACT ASSESSMENT

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EXECUTIVE SUMMARY

1. INTRODUCTION AND PROCEDURAL ISSUES

The impact assessment addresses the subject of executive remuneration policy in listed companies and remuneration policy in the financial services sector.

The average level of executive pay has increased substantially over the last 15 years, largely as a result of the growing importance of variable (performance based) pay in the composition of directors' remuneration. Whilst performance based pay was originally intended to align recipient interests with those of shareholders, various studies have questioned whether there is in fact a strong link between executive pay and performance. At the same time, there has been much public attention recently on egregious cases of reward for failure.

Furthermore, there is a general consensus that badly designed remuneration policies and compensation schemes in the financial services industry contributed to "short-termism" and excessive risk-taking without adequate regard to long-term performance of financial institutions.

The Commission's existing Recommendation on Directors´ remuneration in listed companies adopted in 2004 does not cover all the relevant issues. In particular, the Recommendation does neither require executive remuneration to be aligned with the long term interest of companies, nor does it fully cover the remuneration problems identified in the financial sector which go beyond executives and listed financial institutions.

The Commission Communication of 4 March 2009 indicated that the Commission would strengthen its 2004 Recommendation and table a new Recommendation on remuneration in financial services to address perverse incentives and excessive risk-taking throughout firms. The Communication also stated that the Recommendations would be followed by legislative proposals bringing remuneration schemes within prudential oversight.

In preparing this report, contributions from various stakeholders (Member States, organisations, academics etc.) were taken into account.

2. SUBSIDIARITY

The interrelatedness of the financial systems and the capital markets in the Member States is evident. Dysfunctional remuneration policies in the financial sector have been identified as one of the contributory factors in the financial crisis which has led to the paralysis of the capital market. Also outside the financial sector, remuneration policy relating to directors in listed companies is likely to affect investor confidence and may consequently affect the internal market for capital. Action from Member States alone is likely to result in different sets of rules, which may undermine or create new obstacles to the proper functioning of the internal market. Common standards at EU level are necessary to promote the internal market and avoid regulatory arbitrage.

3. PROBLEM DEFINITION

3.1. Directors remuneration in listed companies

The examples of mismatch between executive pay and performance raise fundamental questions about the appropriateness of incentive systems used for executive directors in listed companies and whether these lead to excessively short-term management actions and pay for failure. Poor incentives/structure of executive pay can lead to unjustified transfers of value from shareholders to executives and prevent companies from using resources in a productive manner. This can affect the long term performance and sustainability of the companies and thus also investor confidence, employment, competitiveness and long term economic growth. The problem addressed is not how much directors are paid, but the mismatch between pay and performance.

The causes of this mismatch are multiple and complex. Structural problems in the incentive contract (e.g. excessive use of variable pay without adequate consideration that both time horizon and conditions for pay out are sufficiently linked to long term performance criteria or excessive reliance on stock market oriented results); the misuse of severance pay; and the insufficient oversight of the remuneration process (lack of accountability of directors towards shareholders, a passive attitude of shareholders, an inadequate role of the remuneration committee and a conflict of interest in the role of remuneration consultants) have played a substantial role in the current situation.

3.2. Remuneration in the financial services sector

There is broad consensus that compensation schemes based on short-term returns, without adequate consideration for the corresponding risks, contributed to the financial institutions engagement in riskier businesses.

This issue not only involves directors´ pay, but extends to remuneration schemes at other levels in the financial sector, notably for those persons whose work involves risk-taking (e.g. traders) and whose remuneration for a variable part is a function of performance. It also extends to unlisted financial institutions.

The causes of the problem are found to be related to perverse incentives in the remuneration schemes, lack of an appropriate corporate governance system and insufficient supervisory oversight.

4. BASIS FOR EU ACTION

4.1. Directors remuneration

At national level, several initiatives have been taken (or are ongoing) to improve the linkage between directors' pay and performance and avoid the potential misuse of severance pay, e.g. in France, Germany, the Netherlands, Italy, Belgium and Austria. However, several other Member States have not undertaken any changes. Substantial differences in corporate governance rules on directors' pay could contribute to distortion (between directors and between companies) within the internal market because of regulatory arbitrage.

4.2. Remuneration in the financial services sector

Self-regulation and international standards are not sufficient to achieve an effective and durable change of practices on remuneration in financial institutions. Initiatives by Member States, supervisors or CEBS, do not necessarily have the same scope of application. National supervisors may also interpret common supervisory rules differently. Consequently, even if there is overlap between the different initiatives there is not yet a common set of principles on remuneration policy in financial services at EU level. Moreover, in the absence of action at EU level, national authorities in Member States may hesitate to adopt more stringent rules on remuneration policies as it would potentially create a competitive disadvantage for their financial sector. In the absence of action, there are serious risks of regulatory arbitrage.

5. OBJECTIVES

The two initiatives seek to contribute to the long-term viability of companies and to reduce risks to financial stability. In particular, the initiative on directors' pay aims at aligning the incentives in the remuneration policy with the objective of long-term viability both on structure of pay and on corporate governance. The initiative on remuneration policy in the financial services sector aims at aligning the incentives in remuneration policy of companies in this sector with the objective of long-term viability and of sound risk management by improving the structure of pay, corporate governance and supervision of financial institutions.

6. CHOICE OF INSTRUMENT

6.1. Directors remuneration

A Recommendation is the preferred instrument. This is in line with the existing approach and it would continue to give flexibility to Member States on the implementation of the principles, as they could decide to put the principles in a corporate governance code under the ´comply or explain' mechanism and adapt the principles to their legal traditions. Depending on how the principles are applied by Member States, a Recommendation would also provide companies with flexibility, in accommodating companies of different size and sectors.

6.2. Remuneration in the financial services sector

A Recommendation is the preferred instrument. This enables the Commission to adopt general principles applicable to the entire financial services industry across a range of different financial institutions which differ in goals, activities and culture. The measures to be taken by Member States following the Recommendation could be tailored to each particular sector of activities. In addition, a Recommendation allows the Commission to adopt principles which are sufficiently detailed so as to provide some guidance on the structure of remuneration policies, and thus to react rapidly and efficiently in the context of the current crisis. The Commission would also be able to send a clear political message.

Even if the Recommendation is followed by legislation on the supervisory review of remuneration policies adopting a Recommendation would have the advantage of providing a rapid policy response pending the negotiation and the implementation of legislation. It would also act as a catalyst for consistent principles to be applicable throughout the financial services industry.

7. POLICY OPTIONS AND IMPACTS

The substantive policy options assessed are: (A) No action; (B) Improved implementation of existing EU framework; (C) New provisions on directors´ remuneration and (D) New provisions on remuneration policy in the financial services sector. Within C and D several non-exclusive sub-options are considered.

7.1. Directors remuneration in listed companies

Option C is the preferred option. It combines new principles on the structure of the remuneration and on the process of the design and operation of the remuneration policy.

On structure of remuneration policy, it introduces internal benchmarking of directors' remuneration to the other executive directors in the board and the (senior) employees in the company. It also sets a limit on severance pay and provides for no severance pay in case of failure. It advocates a balance between fixed and variable pay and links the award of variable pay to predetermined and measurable performance criteria. Finally, to promote the long term sustainability of the company, it provides for: a balance between long and short term performance criteria; a deferment of variable remuneration; a minimum vesting period for stock options and shares; a holding of part of shares until the end of employment and a possibility of clawback of the variable pay component.

On governance, it includes principles aimed at improving shareholders' oversight of remuneration policies, namely an improved disclosure to shareholders and an enhanced responsibility of shareholders, especially institutional investors, to exercise their voting rights on directors' remuneration. To avoid conflicts of interest, it also provides that non-executives should not receive share options. To strengthen the role and accountability of the remuneration committee, it advocates that at least one member of the remuneration committee should have sufficient expertise in the field of remuneration and that members of the remuneration committee attend the general meeting where the remuneration statement is discussed in order to provide explanations to shareholders. Finally, to ensure the independence for remuneration consultants, it states that consultants who advise the remuneration committee should not advise the company as well.

7.2. Remuneration in the financial services sector

Option D is the preferred option. It combines new principles on the structure of the remuneration, on the process of design and operation of the remuneration policy, on the disclosure to external stakeholders and on supervisory review. On structure of remuneration policies, it introduces a general principle requiring remuneration policy to be consistent with sound and effective risk management. For this purpose, financial institutions should strike a balance between fixed and variable pay-components with a sufficiently high level of fixed component so as to ensure that staff does not rely on bonus payments. Variable components should: be linked to performance, a major part of it deferred to take into account the risk horizon of the underlying performance; be subject to a clawback, where appropriate, and; the performance measurement criteria should privilege longer-term performance and adjust the underlying performance for risk, cost of capital and liquidity.

On governance of remuneration policies it introduces: a general principle that remuneration policy should be transparent internally, clear, properly documented and contain measures to avoid conflicts of interest; that the (supervisory) board should have responsibility for the

oversight of the operation of the remuneration policy for the institution as a whole with an adequate involvement of internal control functions and human resources departments or experts; that those involved in the design and operation of remuneration policies should be independent; that remuneration policy should be updated over time and; that staff members should know in advance the criteria used to determine their remuneration and have access to their appraisal process.

On disclosure it introduces a general principle that remuneration policy should be adequately disclosed to external stakeholders in a clear and easily understandable way. There are different ways to achieve this transparency. A general principle stating that the application of all the principles should be subject to a proportionality test, depending on the size of a financial undertaking and the nature and complexity of its activities, would also apply to disclosure.

On supervisory review of remuneration policies Option D requires supervisors to ensure, using the supervisory tools at their disposal, that financial institutions apply the principles on sound remuneration policies to the largest possible extent and have remuneration policies consistent with effective risk management. It also provides for supervisors to take account of the nature and scale of the financial institution and the complexity of its activities (proportionality).

Finally, on the scope of application of the new principles, firstly, the preferred option is to have them apply to all actors in the financial services industry. This would avoid any possible loopholes and prevent a distortion of competition between different sectors. However, as some of the principles may be of more relevance to certain categories of financial institutions than others, Member States may, when implementing the principles, adapt and complement them according to the specific situation of given financial institutions.

Secondly, the preferred option includes applying the principles to all financial institutions, whatever their size. If there are unsound remuneration policies which induce excessive risk-taking in a large number of small financial institutions, together these institutions could generate a systemically important risk. However, to avoid unnecessary costs for the financial institutions, Member States may take account of, their size, scope of activities and complexity.

Thirdly, the principles could apply to all categories of staff, but with a particular focus on those involved in risk-taking activities. Alternatively, their scope of application could be limited only to those categories of staff whose activities have an impact on the risk profile of the financial institution. Either approach could equally be retained as preferred option.

7.3. Coherence and future perspectives

These Recommendations are to be viewed as part of a wider package.

The Commission announced on 4th March a legislative proposal to bring remuneration policies in the financial services sector within prudential oversight. The forthcoming legislative proposal will deal with remuneration policy in banks and investment firms and will be included in the package of modifications of the Capital Requirements Directive planned for June 2009. Similar legislative initiatives in other financial sectors (such as insurance) may also be needed and will be considered. Meanwhile, a Recommendation on remuneration

policy in the financial services sector could provide guidance on principles to be applied and a starting point for dialogue between financial undertakings and relevant supervisors.

At present, national supervisors are responsible for applying these principles. Their positions in this respect are coordinated to a certain extent through the European committees of EU national supervisors (CESR, CEBS, CEIOPS). In due course, if changes are made to the supervisory architecture of the EU, as recommended by the de Larosière report, supervision in this area would need to be integrated into the new structures. This would include, as appropriate, a role for the European Systemic Risk Council as far as systemic risks of cross border financial groups are concerned and enhanced coordination between supervisors on micro-prudential supervision.

Following the London Summit (2 April 2009), the G20 agreed to *"endorse and implement the FSF's tough new principles on pay and compensation and to support sustainable compensation schemes and the corporate social responsibility of all firms"*. The proposed Recommendation on financial services is consistent and complementary to the FSF principles.

The financial crisis has stressed-tested Corporate Governance regimes in banks and investment firms and they have been found to be sorely wanting. As announced in the 4th March Communication, this will be the subject of a report, to be produced for the end of this year.

Finally, the relative unsatisfactory application of the existing Recommendations on directors' remuneration may raise serious questions on the effectiveness of corporate governance rules. The Commission's services have launched a study on this issue and results are expected ultimo 2009.

8. MONITORING AND EVALUATIONS

The new Recommendations would include a provision inviting Member States to notify the Commission of measures taken. Furthermore, the Commission intends to increase monitoring mechanisms to enhance effective application of the Recommendations.

After one year, the Commission will examine both Recommendations in the light of the experience acquired and outcome of the above-mentioned monitoring.