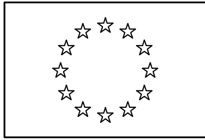
011723/EU XXIV.GP
Eingelangt am 04/05/09

EN



COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 30.4.2009
SEC(2009) 580

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

IMPACT ASSESSMENT

{C(2009) 3159}
{C(2009) 3177}
{SEC(2009) 581}

1. Introduction ... 3
2. Procedural issues and consultation of interested parties ... 4
3. Problem definition ... 5
3.1. Policy Context ... 5
3.2. Problem definition ... 6
3.3. Expected development if no EU action is taken (baseline scenario) ... 20
3.4. Subsidiarity ... 23
4. Objectives ... 24
5. Policy options ... 25
5.1. Substantive policy options ... 25
5.2. Choice of instrument ... 31
6. Analysis and comparison of impacts ... 34
6.1. Comparison of substantive options: Directors remuneration ... 35
6.2. Comparison of substantive options: remuneration in the financial sector ... 39
6.3. Discussion of coherence and future developments. ... 47
7. Monitoring and Evaluation ... 49
7.1. Monitoring ... 49
7.2. The evaluation reports ... 49

1. INTRODUCTION

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

Remuneration of directors has been a constant focus of media attention[1], academics[2] and policy makers. The average level of executive remuneration has increased substantially over the last 15 years. An important part of this increase is due to the constantly growing importance of variable pay (performance based pay) in the composition of directors' remuneration. Whilst variable pay was originally intended to improve performance, 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 media and public attention recently on egregious cases of reward for failure.

The mismatch between executive pay and performance raises serious questions about the appropriateness of the incentive systems currently used for executive directors in listed companies and whether these lead to excessively short-term management actions and “pay for failure". This has been of particular concern in the financial services sector because of the ongoing financial crisis.

Whilst remuneration policies and compensation schemes in financial services were not solely responsible for the crisis, there is a general consensus that badly designed policy and schemes at all levels in the financial services industry contributed to "short-termism" and excessive risk-taking without adequate regard to long-term global performance.

Remuneration policy/compensation schemes in the financial sector are part of the ongoing work of the G20 Group. In their Declaration at the Washington, D.C. Summit on the Financial Markets and the World Economy[3] on 15 November 2008, G20 Leaders committed to *"Strengthening Transparency and Accountability of financial institutions"*. They further called for priority work on *"Reviewing compensation practices as they relate to incentives for risk taking and innovation"*. During the London Summit (2 April 2009) the G20 leaders agreed to *"endorse and implement the Financial Stability Forum's (FSF) tough new principles on pay and compensation and to support sustainable compensation schemes and the corporate social responsibility of all firms"*.

The Commission's existing Recommendation on Directors´ remuneration[4] in listed companies adopted in 2004 does not cover all the relevant issues. In particular, the Recommendation does not require executive remuneration to be aligned with the long term interest of companies. Moreover, the scope of the existing Recommendation on executives in listed companies does not fully cover the remuneration problems identified in the financial sector which go beyond executives and listed financial institutions.

The question of the scope and content of the 2004 Recommendation therefore needs reviewing as a matter of urgency[5], and the potential impacts of a revised framework assessed.

The Commission Communication of 4 March 2009[6] indicated that the Commission would strengthen its 2004 Recommendation on remuneration of directors of listed companies 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 in Autumn 2009 by legislative proposals providing that supervisors may impose capital sanctions on financial institutions whose remuneration policy is found to generate unacceptable risk.

2. PROCEDURAL ISSUES AND CONSULTATION OF INTERESTED PARTIES

In February 2009, a Steering Group was formed by DG MARKT to monitor the progress of the impact assessment report. The Steering Group was made up of representatives of the Directorates-General EMPL, ENTR, TAXUD, ECFIN and COMP and included a representative of the Secretariat-General and the Legal Service. The Steering Group met three times (19 February, 12 March and 26 March 2009). The minutes of the final meeting are attached in Annex 4.

The Impact Assessment Board delivered its opinion on 3 March 2009 D(2009)2748. Following the Board's opinion several changes were made to this IA, in particular the following: The sections on problem definition and causes of the problem have been integrated, restructured and expanded to present more clearly the different dimensions of the problem and the evidence that underpins them. The sections on policy options (including sub-components) and, in particular, analysis of impacts have been changed and substantially expanded so that they are closer linked to the problem drivers identified and so that the IA report can be read more easily without consulting Annex 2. The more contentious sub-components, in view of the objectives set, have been high-lighted. Moreover, the discussion of the various effects on the supply of directors/employees has been further elaborated, including the international aspects. More explanations have been given to justify the scope of the new recommendation for financial services and its potential role in the future supervisory legislation. Agenda planning or WP reference: 2009/MARKT/059 (executive remuneration) and 2009/MARKT/062 (remuneration in financial sector).

In preparing this impact assessment report, contributions from the following stakeholders and events have been taken into account: Member States' contributions in the framework of the Economic & Financial Committee (EFC) leading to conclusion of the ECOFIN Council and the European Council of December 2008; OECD public consultation meeting on 18 March 2009; Committee of European Banking Supervisors' (CEBS) consultation on its draft principles and public hearing on 20th March 2009; The outcome of a stakeholder meeting on 23rd March 2009 organised by COM; the draft interim report of a "comply or explain" study on application of Corporate Governance codes across the EU commissioned by the European Commission; discussions in the Company Law Experts Group meeting on 4 March 2009; the European Corporate Governance Forum's meetings in November 2008 an February 2009 and subsequent statement delivered on 24 March 2009; consultation of the Advisory Group on Corporate Governance and

Company Law; bilateral meetings held on 11th March and 13th March with stakeholders including representatives from the banking industry, insurance industry and pension funds, Committee of European Securities Regulators and Committee of European Insurance and Occupational Pensions Supervisors.

3. PROBLEM DEFINITION

3.1. Policy Context

The current legal context in the European Union will be described, firstly as regards executive remuneration in listed companies, and secondly as regards remuneration in the financial sector. Later sections of the document also provide separate analysis of these two subjects which are interrelated but which have differing dimensions. The policy response on both subjects should therefore be coherent but it needs to be calibrated to fit the different dimensions of the problems identified.

3.1.1. Directors' remuneration in listed companies

Corporate Governance, which can be defined in many ways, is usually understood as the system by which companies are directed and controlled[7]. The European Commission adopted in 2003 an action plan for "modernising Company Law and Enhancing Corporate Governance in the European Union". Adopted in the wake of a series of corporate governance scandals (Enron, Tyco, Worldcom, Ahold), the European Commission indicated that "poor corporate governance performance, by some companies, has greatly undermined confidence in capital markets". The Commission announced several initiatives of importance for directors' remuneration. Firstly, a Directive that would require, *inter alia*, that listed companies publish an annual corporate governance statement which would refer to the corporate governance code that they apply subject to a "comply or explain" approach[8]. Secondly, Recommendations on the role of non executive/supervisory[9] directors and supervisory board committees and on directors' remuneration.

- Recommendation on the role of non executive/supervisory directors and supervisory board committees[10].

The Recommendation addresses the role of non executive or supervisory directors in key areas where executives may have conflicts of interest vis-à-vis shareholders. It includes minimum standards for qualifications, commitment and independence of non executive/supervisory directors. The Recommendation foresees that nomination, remuneration and audit committees should be set up although the board itself must remain fully responsible for its decisions. In particular, remuneration committees should be composed exclusively of non executive directors with a majority being independent.

- Recommendation on directors' remuneration[11].

The recommendation contains three main elements: 1) it invites Member States and listed companies to ensure disclosure of directors' remuneration policy and total remuneration

and benefits granted to individual directors; 2) remuneration policy should be subject to a vote (advisory or binding) by shareholders; 3) share based incentive schemes should be subject to prior shareholders' approval.

The Commission chose Recommendations as a policy response because it was essential to act quickly. Moreover, Recommendations provided the necessary flexibility in view of the diversity of corporate governance rules and systems in place in the Member States: they remain free to choose how they wish to give effect to the Recommendations. This could for example be done through regulatory measures or ‘comply or explain’ codes.

Though the 2004 Recommendation refers to the linkage between executive directors' pay and performance (to be included in the remuneration policy statement) and indicates that share-based schemes should be subject to the prior approval of shareholders, it does not touch on the amount and structure of directors’ remuneration. For a multitude of legal, financial and fiscal reasons, it was considered that the amount and structure of directors' remuneration should be left primarily to individual companies to decide.

3.1.2. Remuneration in the financial services industry

The corporate governance framework described above also applies to directors of companies in the financial sector, provided that their companies are listed.

There is currently no single EU instrument specifically targeting remuneration schemes of executives and employees of financial services companies, in particular no mention is made of remuneration policy as part of risk management. However, the policy context slightly varies in different areas of the financial sector as, for instance, provisions on conflicts of interest or on relations with clients (often known as "conduct of businesses rules") may have an impact on remuneration. For a detailed analysis, see Annex 1.

Remuneration issues in the framework of national plans to rescue banks have also been addressed at Community level. The Commission's Communication on the application of State Aid rules to measures taken in relation to financial institutions in the context of the current global financial crisis[12] recalls that public intervention has to be decided at national level but within a coordinated framework and on the basis of a number of EU common principles. One of these principles is that the management should not retain undue benefits and that governments are able to intervene to address this if necessary.

The Commission's recent Communication on the recapitalisation of financial institutions in the current financial crisis[13] states that in the case of recapitalisation of banks which are not fundamentally sound, limitations of executive remunerations or the distribution of bonuses should be included as a behavioural safeguard.[14]

3.2. Problem definition

The current mismatch between executive pay and performance raises 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.

Remuneration schemes in the financial services industry favoured excessive risk-taking in financial institutions at the expense of their long-term performance[15].

3.2.1. ***Directors' remuneration in listed companies***

Corporate Governance essentially focuses on the problems that result from the separation of ownership and control, and addresses in particular the principal-agent relationship between shareholders and executive directors (agency theory[16]). The main underlying assumption is that, especially in the case of a dispersed ownership company, there may be misalignment/conflict of interests between the management (agents) and the shareholders (principals). Where this potential conflict of interests goes together with an asymmetry of information (i.e. the management has privileged access to core information), this can lead to mismanagement of the company. This leads to costs described as agency costs. In order to minimise these and thus maximise value creation/economic welfare, there is a need (i) to remedy this asymmetry of information which is detrimental to shareholders, through appropriate monitoring mechanisms of executive directors and disclosure of information; and (ii) to align executive directors' and shareholders' interests through appropriate incentives (such as performance-based pay of executive directors).

Whether, and the extent to which, an executive director will fully pursue shareholders' interests depends on finding an appropriate way to motivate the executive director. Agency theory suggests that the performance-based pay contract, which links pay to the company's wealth via performance indicators, is the most appropriate way.

Mismatch between executive pay and performance

The average level of executive remuneration has increased substantially in recent years not just in absolute terms but also in relation to average workers' pay[17]. While this increasing level of executives' pay is perceived by some stakeholders to be a problem[18] it is not necessarily evidence of economic inefficiency, i.e. that the performance based contract has failed.

However, the current financial and economic crisis has highlighted not only the high level of executive pay, but also a mismatch between executive pay and performance. Payment of very high salaries, bonuses and severance payments to executives when at the same time companies are underperforming, workers are being laid off and banks are being bailed-out by taxpayers' money has created public outcry in several Member States[19]. Whilst the level of executive pay remains a very debated question, a mismatch between executive pay and performance raises fundamental questions about the appropriateness of the incentive systems used for executive directors in listed companies and whether these lead to excessively short-term management actions and to "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 more productive manner. Wrong incentives may also lead to short term management actions. Such problems can affect the long term performance and sustainability of the companies and therefore also affect investor confidence, employment, competitiveness and long term economic growth. Reduced investor confidence will in and of itself affect

negatively the availability and cost of capital and reduce the efficiency of the capital market. Going beyond the individual examples of "pay for failure" mentioned in the press, there is also in the literature in general little evidence of any strong linkage between the increase in pay of executives and company performance. The 2008 ILO report on the world of work compares multiple studies on the subject. Several papers providing a meta-analysis of existing research (Tosi et al., 2000; Dalton et al, 2003) suggest that no widespread, strong link between compensation and performance has been established so far[20]. The ILO report concludes that "*Overall, a stable and significant relation between pay and performance has yet to be established; where such exists, it may be expected to be country-specific, depending largely on a country's economic, institutional and cultural peculiarities*". Other sources than the ILO report also support that there is only a weak link between executive pay and company performance[21].

The main issue to be addressed in this impact assessment as regards executive remuneration is not how much directors are paid (level of pay) but rather structural problems in incentive schemes which can lead to a mismatch between executive pay and company performance, in particular at the expense of long-term performance.

Sections below (3.2.2 to 3.2.3) analyse the different causes for this mismatch. The causes are interlinked and mutually re-enforcing. Performance criteria and structural problems in the incentive contract are essential aspects of the problem. However, the lack of accountability of directors towards shareholders has also played an important role in maintaining the situation. Furthermore the short term horizons of institutional shareholders have also contributed to an excessive emphasis on short term profit driven behaviors by focusing too much on increasing share value. This in turn raises more fundamental questions on the role of shareholders in ensuring effective corporate governance.

3.2.2. Inappropriate structure of directors' remuneration

3.2.2.1. The choice of performance incentives

Although there is a wide range of pay practices, the structure of directors' remuneration can be, broadly, divided into the following categories:

- Fixed pay also called base pay or salary which is intended to cover the core role and responsibilities of the day-to-day running of the company by the executive director.

- Variable pay, which comprises the following elements:

- Annual bonuses (short term incentives): this kind of variable pay is intended as a reward for meeting annual performance objectives (they are usually paid in cash but sometimes have a part paid in equity).
- Long-Term Incentives (LTI): this kind of variable pay is intended to reward meeting performance related to two- to five-year period objectives. These awards are sometimes described as performance shares, performance units or long-term cash incentives. Restricted stock awards are also granted as an

incentive to ensure that the executive directors' interests are aligned with those of the shareholders.

- Other stock awards: Stock options are most commonly used as an incentive for the executive directors to increase through their action share price and shareholders' returns. Stock options are sometimes included in what is considered LTI – and are other times treated separately.

In most cases, however, the total remuneration of top executive directors goes beyond cash and equity payment[22].

Economic theory for performance based pay of executives relies on the assumptions that: (i) incentive schemes are a useful tool to achieve appropriate balance between risk-sharing and incentives for executives; and (ii) share value systematically reflects the real economic situation of companies (and thus is a good indicator of the performance).

The choice of performance incentives for executives' remuneration and the mix and time horizon of the chosen incentives is a difficult exercise which needs to be calibrated to the specifics of each company (business strategy, sector of activities, risk appetite etc.) if the interests of the executives are to be effectively aligned with those of the shareholders.

Concerns have been raised on the consequences of performance based pay for executives:

- As for the mix between fixed and variable pay, a too high variable pay component could under certain circumstances have negative effects. E.g. if the fixed component is low some companies can find it difficult to cut or eliminate a bonus in a poor financial year.[23] It is also argued that variable pay, especially stock options, is often difficult to value both for remuneration committees and shareholders.[24] This implies that the risk of paying too much compared to performance could increase the more the variable part makes out of the total remuneration package.

- Furthermore, if a too large part of this variable pay is equity based, it can lead to too much reliance on market orientated results. This in turn, can lead to management actions seeking to artificially increase the share price value of a company, including through fraudulent behaviour[25].

- The performance criteria adopted in relation to variable pay and the time horizon (often quarterly earnings) [26] and conditions for payout are often insufficiently aligned with the long term interests of the company. In a recent survey[27] of more than 400 financial executives, 80 percent of the respondents indicated that they would reduce discretionary spending on such areas as research and development, advertising, maintenance, and hiring in order to meet short-term earnings targets and more than 50 percent said they would delay new projects, even if it meant sacrifices in value creation. This provides evidence that there seems to be excessive focus of some corporate leaders, investors and analysts on short-term, quarterly financial earnings and a lack of attention to the strategy, fundamentals, and conventional non-financial approaches to long-term value creation.

Given the individual character of what constitutes an efficient remuneration policy, and the lack of consolidated data on individual companies' remuneration structure compared to their company performance, it is difficult to measure the precise extent of the problems relating to choice of performance incentives, remuneration mix and time horizon. However, it is possible to present some general findings on current remuneration structure practices, which could give some evidence of where the problems especially are to be found:

- A sharp rise in the use of variable pay, especially equity based remuneration, account by far for most of the increase in executive remuneration[28].

- As for the current practice on the mix of salary, bonus and LTI, a comparative study[29] from 2008 of executive pay structure in the 50 biggest companies in Europe and the 50 biggest companies in the US finds that a typical CEO package in Europe is made up of 26% salary, 35% annual bonus and 39% long term incentives (LTI) compared with 15% salary, 28% bonus and 57% LTI in the US. However, practices in Europe vary significantly from country to country.[30]

- All chief executives of European companies covered were paid an annual bonus. The median bonus paid to European chief executives was 130% of base salary. The most common maximum bonus opportunity was 200% of base salary. Most bonus plans (67%) for chief executives of European companies are driven by a profit-related measure but many use a number of other performance measures as well.[31]

- 17 out of the 50 European companies operate deferred bonuses for their chief executives (notably in the UK).[32] Under such plans part or all of the chief executive's bonus payments are deferred for a period after which they are usually paid over in the form of share or (less commonly) cash, conditional on continued employment. The deferred bonus value is usually indexed to company share price during the deferral period. However, deferred pay is used only by around 1/3 of the companies, and seems in general to be conditional only on continued employment, and not so much as a possible clawback instrument in case of poor long term performance.[33]

- The most prevalent long-term incentive plans for European companies are performance share plans, closely followed by share option plans.[34] Earnings per Share (EPS) remains the most prevalent performance measure used for share option plans but other measures, e.g. premium priced options in Germany, are common. Total Shareholder Return (TSR) remains by far the most prevalent measure for performance share plans. The median aggregate fair value of European chief executives' long-term incentive awards is 120% of base salary, ranging from a median of 55% in Germany to 270% in France.

The European data thus suggests that the variable part is in general quite high (74% in the 50 biggest companies) and has been rising up to now, especially the equity based variable remuneration. Concerns linked to excessive use of variable pay may therefore be relevant, in particular, those related to a substantial directors' dependency on annual bonuses and on stock market orientated results. Unfortunately the latter do not systematically reflect the real economic situation of companies[35]. The data on deferment

of bonuses also suggests that the time horizon and conditions for pay out are in many cases not linked to long term performance. Therefore, setting out principles targeting certain aspects of the remuneration mix and the time horizon and conditions for payout could potentially address the problem of a lacking linkage between executive pay and (long term) performance.

3.2.2.2. The (mis)use of severance pay

Golden parachutes payments originated in the US. The US Supreme Court case law defined golden parachutes or severance pay as an « *Agreement between a corporation and its top officers which guarantee those officers continued employment, payment of a lump sum, or other benefits in the event of a change of corporate ownership. »*[36]

Originally, these arrangements were introduced as a further incentive to align the interests of management with those of shareholders. The purpose was to ensure that, in case of a takeover bid, in particular a hostile one, management in place would not try to resist because of fear of loosing their position to the detriment of shareholders' interests.

However the use of golden parachutes has progressively expanded. Mergers or mere change of the composition of the ownership are nowadays sufficient to trigger a golden parachute payment. In some cases, no conditions are attached apart from a termination of the contract of the top executive.

Proponents argue that golden parachutes are necessary to retain and hire good top executives, especially in sectors that are subject to merger and acquisitions. Furthermore they consider that it is fair to grant an indemnity to a departing CEO given the risks attached to his position. On the other hand, opponents argue that CEO's and top executives are already compensated for their position/responsibility and there should not be any severance pay in case of termination of their contract.[37]

In the 1980s/1990s in the wake of important mergers, golden parachutes made frontline news because of the amount of compensation that was offered to departing CEO's. In Europe, it is difficult to have a complete vision on golden parachutes and to compare the situation in different Member States. Firstly, the compensation package is designed differently and can include cash, shares and even pension benefits depending on the country. Secondly, these agreements are subject to different legal[38] and tax[39] regimes in different Member States and are not subject to the same degree of scrutiny as to their validity by national courts. Lastly, the disclosure of their content or degree of involvement of shareholders in their conception varies among Member States. Some Member States[40] do not have any rule or voluntary commitment in place. In other Member States[41] companies must report compensation linked to early termination of the contract in the annual report. In the Netherlands, regulation is quite comprehensive and severance pay assurances have to be reported in advance and in detail. In France, payment of golden parachutes depends on compliance with performance criteria published beforehand.

According to a study conducted by the private consulting firm Hay Groupe in 2007, “golden parachutes” of French CEOs when they leave their position are the highest in Europe even if their income levels are in the European average. According to the study, French CEOs would “double their basic salary and yearly bonus” the day they leave, whereas only 50% of American CEOs get this kind of package.

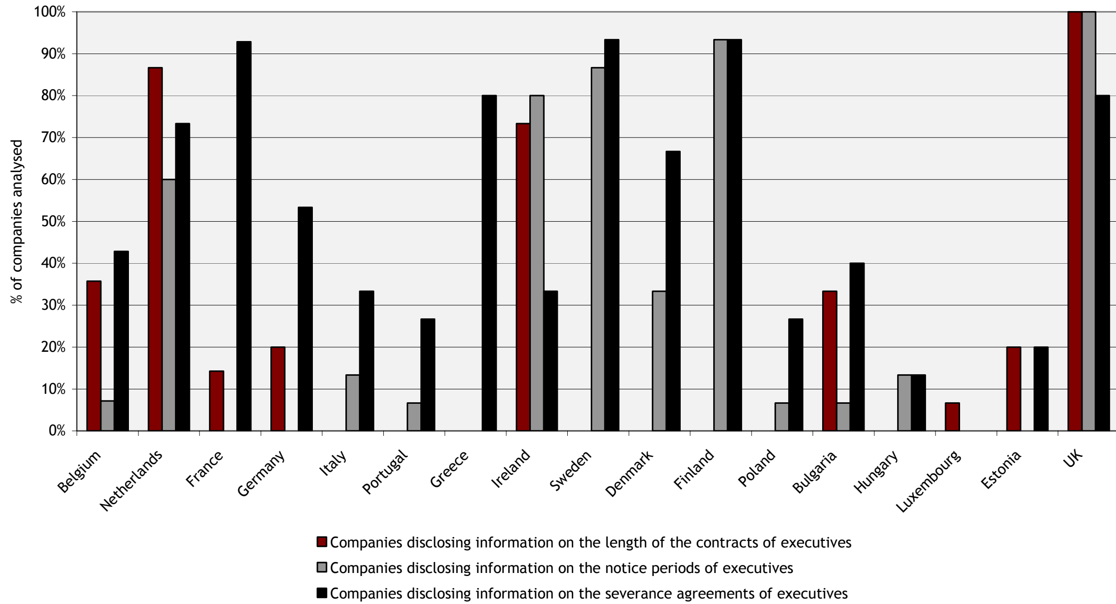
Although not limited to the financial sector the financial crisis has renewed the attention on golden parachutes in the case of failed financial institutions and generous high severance pay for their CEO’s that were negotiated beforehand (even though government money was being poured in). Here again the lack of linkage between the performance of the departing CEO's and the level of the severance pay caused public outcry and were considered a reward for failure.[42] In short, even though situation seems mixed due to different legal regimes and contents of severance pay, it is clear that use of severance pay has moved from its original intention (merger and acquisition situation) and that there seems to be rarely use of stringent performance related conditions foreseen by national rules (except France). Addressing severance pay would thus be another (complementary) way of targeting the link between executive pay and performance.

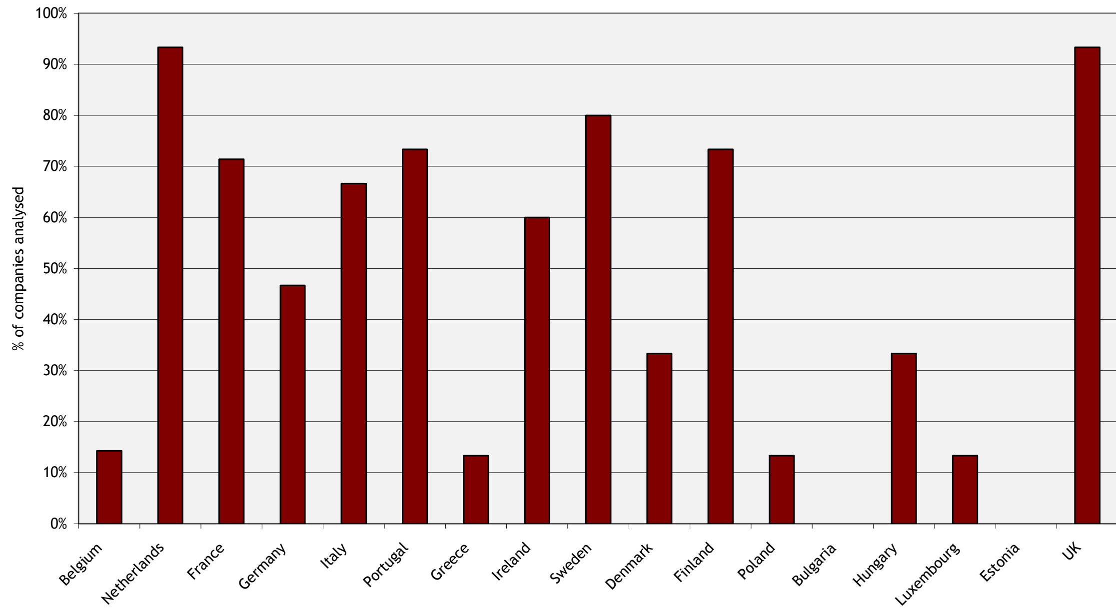
3.2.3. Insufficient oversight of remuneration process

3.2.3.1. Lack of accountability of Directors towards shareholders[43]

In 2007, the Commission services examined to what extent the 2004 Recommendation on directors' remuneration had been followed in Member States' laws and/or corporate governance codes (following the "comply or explain" approach). The report[44] revealed some positive developments but also some weaknesses. The recommendations on disclosure on individual director's pay and on approval by shareholders of share-based remuneration had been largely followed[45]. However, the implementation of the recommendation on the disclosure of the remuneration policy, in particular how remuneration is linked to performance continued to be low across Member States. Furthermore, the large majority of Member States do not recommend an advisory vote by shareholders on the remuneration policy and only a few[46] require a separate binding vote on directors' remuneration.

Consolidated and comparable data are scarce as to how companies comply in practice with the forementioned Recommendations. Many important companies continue not to disclose performance criteria and bonus targets[47]. A study analysing the quality of disclosure by companies shows that information on the fixed and variable component of the remuneration policy and in particular, the linkage between performance and remuneration continue to be one of the least published pieces of information by companies[48].



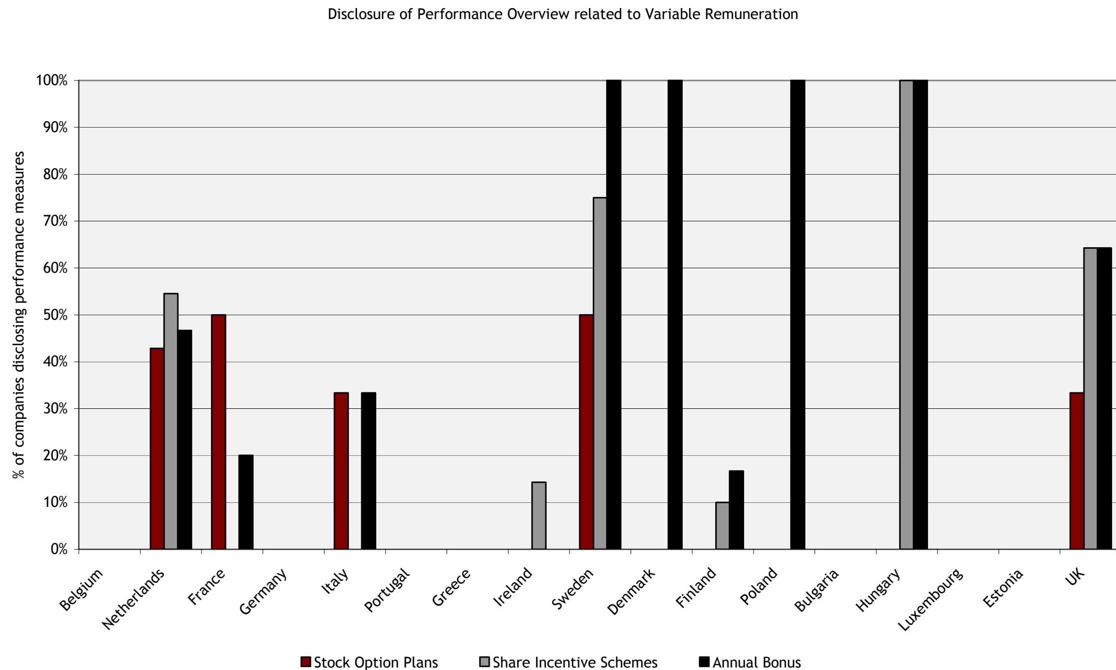


Source: Riskmetrics group

As shown in the charts, disclosure of performance measures or targets differs substantially between countries but remains relatively unsatisfactory in average. Without such disclosure it is difficult for shareholders to exercise their rights or apply pressure on executive remuneration. Addressing better disclosure would therefore be a prerequisite

for holding directors (and those responsible for setting the pay) more accountable for directors' remuneration.

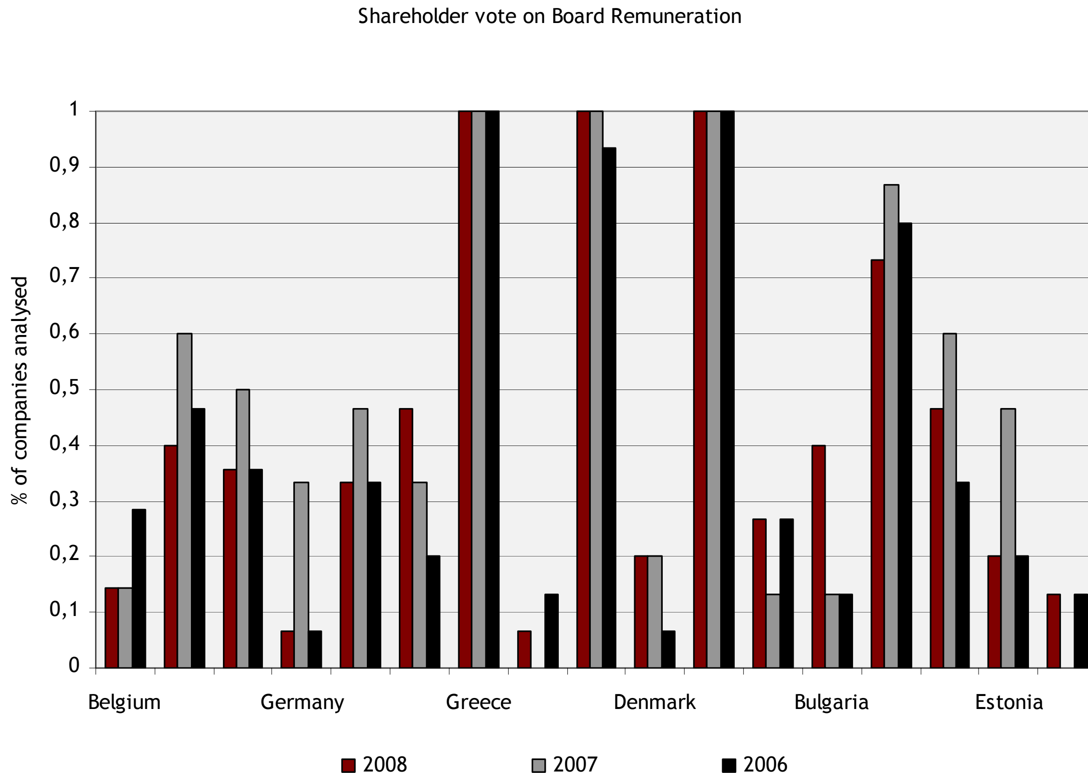
Source: RiskMetrics Group



Furthermore, it seems that shareholders take a rather passive stance on remuneration issues even when they do have a say. Thus, to the extent shareholders are consulted, remuneration issues do not appear to be particularly contentious issues during companies' general meetings. The overall level of dissent by shareholders on remuneration proposals among companies sampled in Europe by Riskmetrics' study amounted to 4.8% in first semester 2008[49]. This low level of dissent can be partially explained by separate/alternative meetings on the remuneration issues between management and their institutional investors/shareholders ahead of the general meetings in order to find prior agreement. It is interesting to note though that of all the issues presented to investors at the shareholder meetings sampled in RiskMetrics study, the most contentious by far are votes related to share incentive plans (as they directly impact on shares' value). Apart from anecdotical evidence[50], this would tend to confirm that shareholders are more concerned about share value than remuneration of directors.

This situation is reinforced by the fact that even institutional shareholders do not always have in mind real long term objectives and may also look for short-term share value increases. Studies show that average holding periods by institutional investors are between one and two years[51]. In the US, the average share is held for less than a year[52]. Academic studies tend to prove that equity markets dominated by institutional investors may have shorter time horizon[53].

Encouraging shareholders to be more active and use their monitoring rights could therefore also help reducing problems of linkage between executive pay and performance.



Source: RiskMetrics Group

3.2.3.2. Inadequate role of remuneration committee

In 2007, the Commission services also reported on the application by Member States of the 2005 Recommendation on the role of non executive/supervisory directors and supervisory board committees. It concluded that one of the most important objectives of the Recommendation was to promote a balanced presence and role of independent non-executive or supervisory directors in the major fields of potential conflicts of interest between management and shareholders. Unfortunately, a significant number of Member States have not recommended the presence of independent directors in all board committees. Furthermore, the law or the corporate governance code in some Member States do not recommend a strong presence of independent members in remuneration and audit committees. In these Member States, executive directors may still be able to have a major influence on their own remuneration and control over the company's accounts may be inadequate. As a result, the costs for the company and risk of abuse may remain high.

As stated above, the role of remuneration committees is crucial as they propose remuneration policy (fixed and variable) to the board and individual director's

remuneration. However academics have questioned the effectiveness of remuneration committees[54]. For some, remuneration committee members have been too much under the control of the management and top executives to properly exercise their role. Without going quite as far as this, others note that remuneration committees are still seeking legitimacy, have not yet adapted to their relatively new role and tend to reproduce main stream tools in designing remuneration policy and packages. As a consequence not enough time is spent in organising and strengthening their role but more on justifying their position and seeking approval from their main institutional shareholders[55].

Therefore, targeting the role and resources within the remuneration committee could further strengthen the check on linkage between executive pay and performance.

3.2.3.3. The role of remuneration consultants

It is argued that the level of directors' remuneration is higher whenever remuneration consultants are involved[56]. Questions have been raised as to the standards and methodology used by remuneration consultants when they analyse executives' markets and external benchmarks for fixing levels of remuneration[57]. Some consider that they are to blame for designing extremely complicated remuneration packages mostly based on short term profit (market price value). A second issue is the potential conflict of interests that may arise when a consultancy firm advises both the management and the remuneration committee on the remuneration policy of the company. Measures addressing this conflict of interest could be considered to reduce the problem. Further transparency over their activity may also be needed[58]. Some institutional shareholders have already called for a code of ethics for remuneration consultants[59].

3.2.4. Remuneration in the financial services industry

It is not the purpose of this analysis nor is there space in this document to analyse all the causes of the financial crisis. The analysis here only relates to those causes of the current financial crisis that are most directly relevant to the remuneration issue in the financial services sector, namely issues related to the mismanagement of risks.

The OECD recently provided a thorough analysis (both at macro and micro economic level) of the causes of the financial crisis, in particular the mismanagement of risks. From the macroeconomic perspective, the report[60] explains that as a result of the monetary policy in force in major economies, "*interest rates fell as did risk premia"*. As a consequence of low interest rates "*investors were encouraged to search for yield to the relative neglect of risk which, it was widely believed, had been spread throughout the financial system via new financial instruments"*.

Many economic agents seemed to believe that liquidity was available without limit. At the same time, management standards and internal controls failed to appraise the risk of the new complex financial instruments that were invented. As stressed by the de Larosière report: *"In this environment of plentiful liquidity and low returns, investors actively sought higher yields and went searching for opportunities. Risk became mis-priced. Those originating investment products responded to this by developing more and*

more innovative and complex instruments designed to offer improved yields, often combined with increased leverage"[61].

This analysis is shared at global level. In the Working Group documents of the G20, it is further stated that *"at the same time, regulated banks and financial institutions supported the acceleration of financial innovation and the push towards more unregulated pools of capital by establishing off-balance sheet and structured investment vehicles. These unregulated investment vehicles, created in response to features of the regulatory and accounting framework, often financed their operations without minimum capital buffers or adequate liquidity plans, were exposed to maturity mismatches, and held asset compositions whose risks were often misunderstood"*. [62]

In April 2008, a Counterparty Risk Management Policy Group III (CRMPG III or the Policy Group)[63] was formed in the US to analyse the (then) credit market crisis of 2007 and 2008. In its report of summer 2008, the Group was among the first[64] to conclude that compensation schemes in the financial services were one of five primary driving forces of the financial crisis and to stress the need for better linkage between compensation schemes and long term firm wide profitability (in line with Institute of International Finance recommendations)[65].

Badly designed compensation schemes in the financial services industry (with strong emphasis on short-term profits) contributed to excessive "short-termism" and risk taking from financial institutions without adequate regard to their long-term global performance. It is important to note that this issue not only involves directors´ and managers´ pay, but extends to remuneration schemes also 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.

The EU working group on pro-cyclicality set up by the ECOFIN Council concluded that *"remuneration policies can enhance pro-cyclicality by promoting short-termism. Following the FSF Report recommendation and recent initiatives by some EU countries, supervisors could address this concern through Pillar 2 guidance. A coordinated approach at EU level would seem appropriate."*

Remuneration policies/compensation schemes in financial services can not be held as solely responsible for the financial crisis.. Other causes such as the role of credit rating agencies, the regulatory and supervisors' failures substantially contributed to the crisis[66]. However compensation schemes based on short-term returns, without adequate consideration for the corresponding risks, substantially contributed to the financial institutions engagement in riskier businesses[67]. Risk management within financial institutions and oversight by regulators did not keep pace with financial innovations, mispricing of risks and the linkage between risks and remuneration schemes.

Sections below analyse why remuneration policies in banking and investment firms contributed to excessive risk taking. Perverse incentives played a significant role in this regard. Serious shortcomings in internal control (lack of appropriate corporate

governance checks) and in oversight of supervisors failed to effectively prevent the mismanagement of risks.

3.2.5 Perverse incentives

While annual cash bonuses are a key variable element of remuneration common in many companies across business sectors, it is nowhere as deeply embedded as in the financial services industry.

Investment banks have long set aside an important portion of their income for employees' compensation/remuneration: for large investments banks that portion can exceed 50 percent of net revenue[68] with a total compensation pool in some cases above $10 billion[69]. Much of that pool is normally set aside to be paid as bonuses[70]. Bonuses typically make up a more than a substantial portion of an employee's pay in investment banks, sometimes more than 75 percent of the total (as fixed salary is relatively low). Often the pay of traders far exceeds that of executives. Companies' managements count on the promise of year-end bonus money to motivate employees and make sure they remain in the company. As to the employees[71], they see bonuses as a normal part of their compensation, regardless of firm profitability.

The structure of the bonuses in particular in banks and investment firms appears to have had adverse consequences in terms of excessive risk-taking and to be detrimental to long term performance because of their short term nature (annual basis). In other words, while bankers and traders take a piece of any profits they generate, there is no such thing as a negative bonus so they never share in the losses. As a consequence, losses are born by shareholders and possibly taxpayers but only to a small extent by employees themselves. Furthermore when these pay incentives are not or not correctly adjusted for risk and are systematically used, they may contribute to instability in the global financial system.

Several emblematic cases have highlighted the deficiencies in terms of risk management and disproportionate potential rewards in the financial sector industry. Although it is too early to draw conclusions on the basis of the Kerviel case[72], which is under judicial investigation, it is interesting to note that Mr Kerviel claimed that, at the peak of his success, he recorded $500m profit without the bank noticing. In the same vein, he was able, during the weeks preceding his sacking, to take positions with a value of €50bn. He later justified this by explaining that *"he wanted to seem like an exceptional trader and anticipator of the market and wanted to get a higher bonus"*. He further claimed that for 2007, he was counting on getting a bonus of €300,000. As indicated by the FSF, *"the lack of attention to risk also contributed to the large, in some cases, extreme absolute level of compensation in the financial services industry"*.

Furthermore, the remuneration structure reinforces the pro-cyclicality of risk taking as shown by the example above to the extent that variable pay and thus performance pay can lead to herd behaviour. [73]

Measures targeting the remuneration structure could therefore potentially reduce the problem of excessive risk-taking.

3.2.6 *Lack of an appropriate corporate governance system*

The importance of the current financial crisis raises serious questions about the adequacy of the existing corporate governance practices in banks and investment companies, including on the setting of compensation policies throughout these financial institutions.

In their analysis of the crisis, public authorities, academics, journalists, central bankers and supervisors generally agree that the structure of compensation schemes applied in the banking industry was skewed towards short-term performance -be it for successful traders or for directors- and excessive risk-taking. The key question seems to be how this was possible when corporate governance principles of reference, e.g. the 8 Corporate Governance Principles of the Basel Committee, stress the need for the board to approve for compensation policies and practices to be consistent with the bank's corporate culture, long term objectives and strategy (and control environment).

Several existing reports[74] highlight that there has been in many cases a severe mismatch between remuneration policy, risk management and internal control systems. Despite the importance given to risk management by regulators and corporate governance principles, the financial crisis has revealed shortcomings in practices both in internal management and in the role of the board in overseeing risk management systems, including remuneration policies. According to the Senior Supervisors Group report[75], senior management at firms which suffered the biggest losses tended to champion the expansion of risk without commensurate focus on controls across the organisation or at the business-line level. At these firms, senior management's drive to generate earnings was not accompanied by clear guidance on the tolerance for expanding exposures to risk. It is also argued that risk management departments in some firms lacked independence, influence or sufficient authority and power as compared to sales and trading business[76]. In some banks, the lower prestige and status of risk management staff vis-à-vis traders played an important role in excessive risk-taking. Société Générale[77], for instance, noted that "*the general environment did not encourage the development of strong support function able to assume the full breadth of its responsibilities in terms of transaction security and operational risk management. An imbalance emerged between front office, focused on expanding their activities and the control functions which were unable to develop the critical scrutiny necessary for their role*". The same situation was noted in Credit Suisse[78], HBOS[79] and Bear Stearns[80]. On the role of the board, the IIF 2008 report concludes that the financial crisis "*raised questions about the ability of certain boards properly to oversee senior management and to understand and monitor business itself*". Reports have also documented that risk management information was not always available to the board or in a form corresponding to their monitoring of risk[81]. Furthermore, it is often asserted that bank's boards lack sufficient expertise. One study[82] estimates that at eight US major financial institutions, two thirds of directors had no banking or financial experience. Moreover, many of the directors without a financial background happened to sit on highly technical board committees such as those covering audit and risk.

Thus targeting the governance of remuneration policy could potentially reduce the problem of excessive risk-taking.

3.2.7 *Insufficient oversight by supervisors*

Under the current European supervisory framework[83], supervisory and regulatory authorities do not have any role in the oversight of remuneration policies of financial institutions. The supervisory and regulatory authorities, during the authorisation process and the ongoing prudential supervision, oversee the organisational structure of financial institutions as well as their internal control and risk management, and assess the risk profile of the financial institutions taking into account *inter alia* operational and business risks, which could in principle cover risk related to ill-designed remuneration policies. However, until recently, financial supervisory and regulatory authorities have not focused on the implications for risk of remuneration policies[84]. Instead, supervisory strategy has focused on risk management and control systems of financial institutions. Risk management and control systems, however, have limitations and, as the current crisis has shown, they can fail to control risks properly. When the risk was in a traditional loan book, most financial institutions were able to control front-line incentives towards excessive risk by having strong and separate credit underwriting and monitoring departments. In recent years, when risk has become more multidimensional and complex and the array of means of taking risk has grown large, simple one-dimensional balance between front-line and risk management personnel is no longer sufficient. Greater balance within the compensation system itself is needed to reduce the burden on risk management systems and increase their effectiveness. Measures targeting the role of the supervisor could potentially contribute to this.

3.3. Expected development if no EU action is taken (baseline scenario)

The following section sets out the scenario if the EU were not to act to deal with the identified problems. The development of a baseline scenario is necessary to be able to compare the impacts of other options.

Directors' remuneration:

In January, the European Commission launched a study on corporate governance monitoring and enforcement in the Member States. The objective of the study is to evaluate the effectiveness of the corporate governance rules, including on directors' remuneration in the EU. The study further includes a survey on how the comply or explain principle is perceived in practice by relevant stakeholders[85]. The ongoing study (delivery expected by end 2009) will thus provide useful information on how EU corporate governance rules are enforced in Member States and on their effectiveness. It will contribute to identify gaps or shortcomings in Member States and help the Commission to design a monitoring and evaluation system in this field (see last section on monitoring). However the study will be based on the existing relevant EU Recommendations and thus will not help to address the forementioned identified problems.

Meanwhile, at national level, several initiatives have been taken (or are ongoing) to address the issue of a better linkage between directors' remuneration and performance and the potential misuse of severance pay[86]. In France, following pressure from President Sarkozy, in October the MEDEF/AFEP recommended that golden parachutes, or severance bonuses, should be limited to two years' pay and should not be awarded at all to executives who resign or who are deemed to have failed and further calls for limits on additional pension contributions and the award of free shares to executives.[87] In Germany, a draft law (adopted by German cabinet on 6th March) is to be sent shortly to Bundestag to increase transparency on executives' remuneration, to introduce the notion of long-term orientation/performance for the managements' behaviour and to extend, inter alia, the vesting period of stock options to four years (instead of two). In the Netherlands, specific tax measures have been adopted targeting excessive directors' remuneration[88]. Italy has also strengthened its taxation regime for stock options. Various corporate governance codes have just been changed (such as in Belgium[89]) or are currently under revision (such as in Austria) to better address linkage between pay and performance, severance pay (golden parachutes) and the need for long term performance.

However, several other Member States have not undertaken any changes. Furthermore the diversity of national corporate governance rules and the different means available to influence on directors' remuneration (through corporate governance rules, labour law, company law or taxation) shows that, there are currently no grounds to expect a convergent approach in the Member States. Even if taxation and labour law remain mostly national matters, substantial differences in corporate governance rules on the issue of directors' remuneration could contribute to distortion (between directors and between companies) within the internal market because of regulatory arbitrage. [90]

Remuneration in financial services:

Given the gravity of the financial crisis, the issue is being addressed in different fora and at different levels. At the G20 level, the working group conclusions submitted to the G20 leaders stressed the need to adopt recommendations on remuneration policy in the financial sector: they recalled the responsibility of boards on compensation issues, the need for compensation schemes to be "consistent with the long-term goals and with prudent risk-taking of financial institutions", to promote incentives for prudent risk taking and ask financial institutions and supervisors to follow the Financial Stability Forum (FSF) sound practices principles on compensation schemes in the financial services industry[91]. The latter has just adopted such sound principles for compensation schemes in the financial sector.

The steering group of the OECD on corporate governance is currently focusing on those aspects of the OECD Principles of Corporate Governance most closely related to the current crisis, primarily board practices, effective implementation of risk management, governance of the remuneration process and the exercise of shareholder rights. It reported to the FSF at the end of March 2009 and will continue to work on the review of its corporate governance principles in the course of 2009[92].

The Basel Committee on Banking Supervision published in February 2006 the 8 Corporate Governance Principles which stress the need for the board to approve for compensation policies and practices that are consistent with the bank's corporate culture, long term objectives and strategy. The current situation has shown, however, that the banking sector seems to have had problems in implementing these principles in practice.

The financial industry itself (the Institute of International Finance-IIF) has issued revised principles on remuneration in July 2008[93].

At EU level, sector directives and regulations contain some general requirements which do not relate directly to remuneration policies but concern internal organization and risk management for certain categories of financial institutions. In particular, supervisors may include risk generated by remuneration policies in their general assessment of the soundness of financial institutions. The Committee of European Banking Supervisors (CEBS) is currently developing guidelines[94] on remuneration schemes which will be integrated into the guidelines on Internal Governance (as part of the Guidelines on the Application of the Supervisory Review Process under so called Pillar 2 - CP03 revised, 25 January 2006). These guidelines build on national measures[95]. Work currently carried out in Member States as international policies on remuneration (such as the FSF) are also taken into account. However, this approach is relevant only for certain categories of financial institutions which are subject to prudential supervision and where supervisors are empowered to review remuneration policies as part of the overall risk profile of the financial institution. Furthermore, there is for the time being no common approach on the measures which the supervisors could take on financial institutions with unsound remuneration policies.

At Member States level, there are two strands of measures:

- In the context of national rescue packages for the financial sector, several Member States[96] have included in their schemes provisions on the remuneration of executives in the affected institutions. They aim at limiting the compensation and/or adjusting the incentive structure to limit excessive risk-taking and to gear decision-making towards longer-term profitability. Some Member States have introduced caps on executives' remuneration in bailed out banks[97]. However these measures are "exceptional" measures adopted for a specific duration. They can not substitute appropriate new guidance for the future. In particular, these were measures taken within the framework of government intervention and funding.

- By national supervisors[98] as part of their Supervisory Review Process under so called Pillar 2 of Basel II Agreement[99]. These national guidelines or recommendations are sometimes made a mandatory prerequisite for banks seeking new government funding[100].

The abovementioned situation shows that there is a plethora of initiatives on the same issue but that they differ in scope and substance. IIF and FSF principles both tend to focus on risk taking but FSF tend to lay the emphasis on enforcement and rigorous application by supervisors. IIF recommends compensations based on long term performance and shareholders' interests. IIF guidelines remain, however, self-regulation

and may not exert sufficient pressures on the financial services industry to change its practices. Major financial institutions compete for talent in a global labour market and voluntary action seems unlikely to be durable as the first financial institution to move would be disadvantaged in comparison with the others. Changing remuneration practices will be challenging, time-consuming and involve material costs. It will be necessary to change attitudes and ingrained behavioural responses. In the absence of sustained external pressure, financial institutions may fail to carry out good intentions. Widespread change in practice is likely to need the help of supervisory and regulatory authorities.

Initiatives by Member States supervisors or CEBS, however, do not necessarily have the same scope of application and may be more or less prescriptive[101]. Furthermore, national supervisors may interpret common supervisory rules differently to the detriment of convergence within the EU[102]. Consequently, even if there is a lot of overlap between the different initiatives and they have much in common, there is not as yet what would be described as a common set of principles on remuneration policy in financial services at EU level.

At international level, the G20 during the London Summit (2 April 2009) 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"*. Furthermore, the US Secretary of the Treasury M. Geithner announced on 26th March 2009 a new regulatory framework for financial services. In particular he stated that *"regulators must issue standards for executive compensation practices across all financial firms. These guidelines should encourage prudent risk-taking, focus on long-term performance of the firm rather than short-term profits, and should not otherwise create incentives that overwhelm risk management frameworks."* This seems to go further than the US existing measures on executives' pay which aim mostly at capping executives' remuneration of bailed out banks. In view of the G20 mandate, it will be important to closely work with the US and other international key partners on this issue and to act more generally to ensure a better linkage between executives' pay and long term performance of companies at global scale.

3.4. 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 driving forces of the financial crisis which has contributed to the paralysis of the capital market. As explained in the problem definition, 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 good functioning of the internal market. Common standards at EU level are necessary to promote a well functioning internal market and avoid the development of different rules and practices in the Member States.

Should the instrument chosen be a legislative instrument, the legal basis is likely to be Article 95 EC. A non-legislative action in the form of a Recommendation would be based on the second indent of Article 211 EC.

4. OBJECTIVES

Objectives for executive remuneration in listed companies:

General	Specific		Operational
To contribute to the long-term viability of companies	To align the incentives in remuneration policy of companies with the objective of long-term viability in:	Structure of pay:	To improve the structure of pay by strengthening the link between pay and performance, especially long-term performance
		Corporate governance:	To improve corporate governance on remuneration policy to ensure the long-term viability of the firm

Objectives for remuneration policy in the financial sector:

General	Specific		Operational
To contribute to the long-term viability of companies To reduce risks to financial stability	To align the incentives in remuneration policy of companies in the financial sector with the objective of long-term viability and of sound risk management in:	Structure of pay:	To improve the structure of pay by strengthening the link between pay and performance, especially long-term performance
			To improve structure of pay by preventing incentives for excessive risk-taking in remuneration policy
		Corporate governance:	To improve corporate governance (decision-making mechanism) on remuneration policy
		Supervision:	To strengthen the role of supervisors as regards oversight on remuneration policy in the context of risk management

5. POLICY OPTIONS

In this chapter, options will be identified for policies which could target the problems described in chapter 3 and could realise the objectives set out in chapter 4. Paragraph 5.1 will describe substantive options to target the content of the identified problems.

5.1. Substantive policy options

The following policy options have been identified:

A. Baseline scenario;
B. Improved implementation of existing EU framework with regard to directors´ remuneration and remuneration policy within the financial services sector;
C. New provisions on directors´ remuneration;
D. New provisions on remuneration policy in the financial services sector.

5.1.1. Option A: Baseline scenario

This option implies that the baseline scenario as described in paragraph 3.3 will be maintained. This option does not include the development of new policies, or the development of new practical or legislative tools to improve implementation of the current framework.

5.1.2. Option B: Better implementation of existing EU framework

A) Director's remuneration

This option takes the existing EU framework on directors´ remuneration, consisting of the Commission Recommendation on directors´ remuneration and the Commission Recommendation on independent directors, as a starting point. It is based on the idea that measures to target better implementation by Member States and application by companies of the principles included in the existing recommendations would address the identified problems in the area of directors´ remuneration. Option B does not include the development of new policies on the substance of the EU framework.

Improving implementation of principles included in a non-binding instrument such as a recommendation starts with monitoring and evaluation of the implementation and application of those principles. To improve the monitoring methods that are currently used, a European scoreboard system could be developed, or a system for more regular evaluation, including through a dialogue with relevant authorities in Member States.

Another way of enhancing implementation would be by starting a dialogue with (some) affected parties. In this respect, a dialogue with shareholders, and more specifically institutional shareholders, might be effective. Shareholders have an interest in appropriate remuneration policies and well-functioning remuneration processes. Moreover, they have advisory or decisive rights in the remuneration process in several Member States. If they became more vocal about what they consider to be appropriate remuneration policies and

necessary rights to exercise efficient oversight, it might improve remuneration policies and (possibilities for) shareholder oversight. Institutional investors are in a special position, compared to private shareholders, because they usually hold larger stakes and have a professional infrastructure which enables them to develop well-balanced and effective voting policies. A direct dialogue with companies could also be considered.

B) Remuneration policy in the financial services sector

This option implies that better implementation of the existing EU legislative framework in the financial services sector by Member States, national regulators and financial institutions would address the identified problems on remuneration in the financial sector. This option does not include the development of new policies on the substance of the EU framework on remuneration in the financial sector.

This means an improved implementation and enforcement by Member States, financial institutions and national regulators of provisions of different sectorial directives and regulations on internal organisation and risk management of financial institutions. This also means an improved use by regulators of existing tools of prudential supervision to ensure that the remuneration policies of financial institutions are compatible with sound and effective risk management.

5.1.3. Option C: New provisions on directors´ remuneration

This option goes beyond the existing framework on executive remuneration and implies the development of new, additional principles or provisions (depending on the instrument, see paragraph 5.2.1.) on directors´ remuneration. It follows from paragraphs 3.2.2 and 3.2.3 that the problem drivers related to directors´ remuneration can be categorised into two groups: I) drivers relating to the structure of directors´ remuneration and II) drivers relating to the decision-making process of, and oversight on, directors´ remuneration. New principles could therefore also be set out in these two categories. This section shortly describes the main policy options. The detailed description of each policy option is provided in Annex 2 together with further explanation on why these policy options have been chosen and why some of them have been discarded.

A) Structure of remuneration (directors)

New principles could focus on the creation of an appropriate remuneration policy including incentives, which promote long term value creation within the company and reflect the principle of pay for performance. The following options could be envisaged:

(1) link pay to performance:

- internal benchmarking;
- link variable remuneration to performance;
- limit risks associated with variable remuneration;
- setting out principles on severance pay;

(2) promote long term sustainability of the company:

- balance long and short term performance criteria;
- deferment of variable remuneration;
- vesting periods for stock options and shares;
- hold a number of shares until the end of employment;
- clawback of variable payments, where data is manifestly misstated.

These options are complementary and not mutually exclusive, so the preferred policy option on structure of directors´ remuneration could be composed of a combination of these options.

B) Governance of the remuneration process

On the decision making process, the principles could strengthen the supervisory role of shareholders and non-executive directors and/or the remuneration committee on the remuneration policy and its application. The following options could be envisaged:

(1) improve shareholder oversight:

- clear and understandable remuneration statement;
- additional disclosure of elements of the remuneration policy;
- responsibility of shareholders, in particular institutional investors;

(2) strengthen the role of the remuneration committee:

- not granting share options to non-executive directors;
- require sufficient expertise of the remuneration committee;
- increase accountability of the remuneration committee;

(3) address role of remuneration consultants:

- remuneration consultants should not advise the remuneration committee and the human resources department or the executive directors at the same time.

These options are complementary and not mutually exclusive, so the preferred policy option on governance of the remuneration process could be composed of a combination of these options.

A detailed description of the suboptions are set out in Annex 2. Annex 2 also addresses a number of alternative suboptions with regard to the structure of directors´ remuneration and governance of the remuneration process, which have finally not been included in Option C either because they do not fall clearly within the problem definition or are unlikely to reach the objectives as defined in section 4.

5.1.4. Option D: New provisions on remuneration policy in the financial services sector

This option implies the development of new provisions on remuneration policies within the financial services sector. As explained in paragraphs 3.2.5 to 3.2.7 the problem

drivers related to remuneration policies within the financial services sector concern the: (i) structure of remuneration, (ii) the governance with respect to decision-making and oversight of remuneration policies, (iii) the supervisory oversight. New principles could therefore also be set out in three categories. In addition, the scope of the application of new principles needs to be considered. This section shortly describes the main policy options. The detailed description of each policy option is provided in Annex 2 together with further explanation on why these policy options have been chosen and why some of them have been discarded.

A) Scope of the new provisions

On the scope of the new provisions, the following options could be contemplated:

(a) new provisions might apply (i) only to banks and investment firms for which there is already a consensus of a clear link between the incentive structures used and key factors at the origin of the financial crisis or (ii) to a broader range of actors in the financial services industry in order to avoid distortion of competition and to promote sound remuneration policies across all sectors of activities;

(b) new provisions might apply (i) to all financial institutions independent of their size in order to promote sound remuneration policies across the whole sector or (ii) only to significant, systemically important companies whose failure would have an important disturbance in the functioning of the whole financial services industry;

(c) new provisions might apply (i) only to those categories of staff whose activities have an impact on the risk profile of the financial institution and who thus need to be properly incentivised in order to avoid excessive risk-taking or (ii) to all categories of staff in order to promote consistent remuneration policy aligned with effective risk management throughout the financial institution.

Options under (a), (b) and (c) are complementary as they address three different aspects of scope, so the preferred policy option on scope of the new provisions could be composed of a combination of elements of these three options.

B) Structure of remuneration

On structure of remuneration, it could be envisaged that the remuneration policy should:

(a) be consistent with and promote effective risk management and be designed in order to take into account longer-term interests of the financial institution, such as sustainable growth, its business strategy, objectives and values;

(b) fix a maximum limit on annual remuneration, termination payments and variable component of the remuneration or subject them to restrictions in order to establish a link between the pay and the real performance;

(c) strike an appropriate balance between fixed and variable components of remuneration so staff members do not need to rely exclusively on bonus payments to be adequately compensated and to better align remuneration with real longer-term performance;

(d) link the variable component to longer-term performance, especially by including a deferred element so that bonuses do not consist only of upfront cash payments;

(e) subject variable payments to a claw-back if these payments have been awarded on the basis of data which has been manifestly misstated;

(f) include variables relating to individual, business unit and financial institution wide performance in the performance criteria and assess performance not only on the results of the current financial year but also on longer term performance;

(g) adjust the measurement of performance for risks, cost of capital and liquidity required in order to take account of the real performance of the individual, business unit and the financial institution.

Option (a) is an over-arching principle. Options (b) to (g) are possible means of achieving this principle. These options are complementary and the preferred policy option could be a combination of them.

C) Governance

The process of the design and operation of the remuneration policy should promote the objective of having remuneration policies consistent with effective risk management and the longer-term interests of the financial institution. This process should therefore be designed in a manner to avoid conflicts of interest. Furthermore, the procedures for determining remuneration within the financial undertaking should be clear and documented and should be internally transparent.

To achieve this, the following options could be envisaged:

(a) the (supervisory) board, as the sole body which has the overview of the objectives, business strategy and the risk profile of the financial institution, should set up general principles of the remuneration policy, determine the remuneration of directors and have the responsibility of the oversight of the operation of the remuneration policy;

(b) the board members involved in fixing remuneration policy should be able to reach independent judgment on the suitability of the remuneration policies, in the longer term interests of the financial institution as a whole;

(c) in order to provide necessary expertise to the board and to ensure independent review, internal control functions and human resources departments or experts as well as shareholders, if applicable, should be adequately involved in the process;

(d) in order to ensure that the remuneration policy is in line with the overall objectives of the financial institution, it should be updated over time to meet the financial institution's changing situation;

(e) in order to ensure transparency to staff, staff should know in advance the criteria which will be used to determine their remuneration; the appraisal process should also be properly documented and accessible to the staff member concerned.

The options are complementary. The preferred policy option could be a combination of them.

In addition, to ensure even further that the governance arrangements are effective and take into account the longer-term interests of the financial institution, the stakeholders of the financial institutions have to be adequately involved in the process of setting the remuneration policy and monitoring its operation. To adequately inform the stakeholders on the design and operation of the remuneration policy, the main characteristics of the remuneration policyshould be adequately disclosed. The form of the disclosure could be one of the following: (i) a yearly mandatory disclosure in a separated remuneration policy statement, (ii) a single mandatory disclosure at first, followed by an update in case of future modifications or (iii) a disclosure in annual financial statements as part of internal control description or (iv) a communication on request by relevant stakeholders.

D) Supervision

For supervisors to effectively review remuneration policies of financial institutions, they need to have access to all necessary information and to dispose of supervisory tools which enable them to ensure that financial institutions comply with the principles on sound remuneration policies. To achieve this, these options could be contemplated:

(a) supervisors should ensure, using the existing supervisory tools at their disposal, that financial institutions apply the new provisions to the largest possible extent and have remuneration policies consistent with effective and sound risk management;

(b) supervisors for banks and investment firms should use supervisory tools under the Basel II Accord on capital requirements, including, where necessary, capital add-ons;

(c) the supervisors should have access to all information they need to evaluate the extent to which the new provisions are followed;

(e) financial undertakings should communicate the remuneration policy to supervisors.

The options are complementary. The preferred policy option could be a combination of them.

5.2. Choice of instrument

5.2.1. Directors´ remuneration

Option B

This option includes better implementation of the existing framework on directors´ remuneration, consisting of the Recommendations on directors´ remuneration and on independent directors. The sub-options discussed under this Option (see Annex 2) are of a practical nature and do not require a discussion of the choice of instrument. However, one possible way to improve the implementation of the existing principles would be by putting (some of) the principles that are now included in a Recommendation into a binding instrument. This could for instance be considered for the principles on the disclosure of the remuneration policy and individual remuneration, and/or the principles on the shareholders vote, as they form the basis of shareholder oversight on remuneration practices. In this respect, a Directive would probably be more advisable than a Regulation, as this would still give Member States the possibility to adapt the principles to their legal systems and traditions and specific traditions regarding directors´ remuneration.

Option C

Developing new principles only through self-regulation at national level would deviate from the existing approach. This could be considered a step backwards, since there is already an existing EU framework on directors´ remuneration consisting of two EU Recommendations. Moreover, considering that Member States have implemented the existing principles in their national laws and corporate governance codes, and that there is no European corporate governance code which could provide a framework for such self-regulation, it would also be impractical. Addressing the issue through international standards only should not be considered an option either, as there are currently no international standards which address all these problems nor is it likely that they will be addressed in a comprehensive way in the immediate future. The current OECD Principles of Corporate Governance do address some aspects of executive remuneration, but do not address the specific problems identified in Chapter 3.

An action at a European level would give a necessary impulse to the Member States to effectively address directors´ remuneration in their Member State in a consistent way. At a European level, the new principles could be put into a Commission Recommendation or into a legislative instrument (a Directive or a Regulation).

A) Recommendation

Putting the new principles on directors´ remuneration into a Recommendation is in line with the existing approach. A Recommendation would continue to give flexibility to Member States with regard to the implementation of the principles, as they could decide to put (a part of) the principles in a corporate governance code under the ´comply or

explain' mechanism. They could also adapt the principles to their legal traditions and specific traditions on directors´ remuneration. A Recommendation would possibly also give flexibility to companies, depending on how the principles are applied by Member States, so that the principles could accommodate companies of different size and sectors. On the other hand, additional practical measures, such as monitoring arrangements, are likely to be necessary to ensure implementation and application of the principles.

B) Directive or Regulation

A Regulation does not seem to be an appropriate instrument for the implementation of principles on directors´ remuneration. This would deviate from the existing approach of addressing remuneration issues through a Recommendation. Moreover, the principles are not sufficiently precise to be directly applicable.

The use of a Directive would also deviate from the existing approach. However, a Directive would better ensure the implementation of the principles by Member States, while still giving the possibility to adapt to their legal systems and traditions and specific traditions on directors´ remuneration. On the other hand, a Directive would take time to adopt and implement. Moreover it would give companies little flexibility to adapt and apply the principles to their situation.

5.2.2. Remuneration in financial services

As already explained in Section 3.4 "Expected development if no EU action is taken (baseline scenario)", existing self-regulation and international standards do not seem to be sufficient to achieve an effective and durable change of practices on remuneration in financial institutions. Moreover, in the absence of EU level action, 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. For example, the Financial Services Authority (FSA) in its Consultation Paper on "Reforming Remuneration Practices in Financial Services" acknowledges that the FSA proposals could have a significant impact on London's competitiveness if there were insufficient international agreement to enforce similar principles in all major financial markets. When finalising its policy, the FSA will take into account whether there is a satisfactory alignment of implementation plans by the authorities in the major financial centres.

An action at a European level would provide the necessary impulse to the Member States to proceed with the adoption of policies on sound remuneration practices in the financial services sector. In the absence of action, there are serious risks of regulatory arbitrage. Furthermore, the new principles on EU level should restore a level-playing field between financial institutions who benefit from national rescue packages and consequently may be subject to national measures regulating remuneration practices in these intuitions, and the other parts of financial services sector.

The new principles on remuneration policies could be included in a Commission Recommendation or in a legislative instrument (a Directive or a Regulation).

A) Recommendation

The objective of the Commission in proposing new principles on sound remuneration policies in the financial services sector would be to ensure that remuneration policies are consistent with effective and sound risk management. These principles do not touch on the level of pay from the social and labour law perspective, as they are not intended to prescribe particular levels or designs of individual remuneration.

A Recommendation which allows the Commission to provide a framework for setting out principles or best practices is a suitable instrument to achieve the above-mentioned objective. It 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.

If the Recommendation is followed by legislation on the supervisory review of remuneration policies, as mentioned in the Commission Communication of 4 March to the Spring European Council, adopting a Recommendation would still have the advantage of providing a rapid policy response pending the negotiation and the implementation of a directive. It would also act as a catalyst for consistent principles to be applicable throughout the financial services industry until a new Directive has been negotiated and implemented by Member States. Furthermore, the new Directive would focus on the supervisory review and the range of measures available to the supervisors but would not apply to those financial institutions which are for the time being not regulated on the European level.

B) Directive or Regulation

A Regulation does not seem to be an appropriate instrument for the implementation of general principles on remuneration policies. First, the principles are not sufficiently precise to be directly applicable. Second, the objective of the Commission is to set up general guidance on sound remuneration practices and give Member States enough flexibility as to the manner to implement them.

As compared to a Recommendation, a Directive has the advantage of being a legally binding instrument which is more effective in imposing an obligation on Member States to adopt measures on sound remuneration policies in financial institutions and thus in achieving the objectives of the new principles. However, as mentioned above, due to the time constraints of the legislative process, a Directive would not allow the Commission to react promptly in the current financial crisis. Nevertheless, a Directive could be a suitable instrument to follow a recommendation in order to reinforce the role of the supervisors with a view to empower them to assess the remuneration policies of financial institutions

in a broader context of sound risk management. As in the case of the Recommendation, the Directive should not regulate remuneration as such but should consider remuneration policy from the general risk management perspective. As remuneration policies are part of the internal organisation and as risk related to remuneration is part of the general risk profile of a financial institution, the Directive could establish principles on sound remuneration policies against which supervisory authorities would assess the risk profile of a financial institution as part of the financial institution's internal risk management. The Directive would focus on the supervisory process and on the range of measures available to the supervisors in order to deal with remuneration policies which are not compliant with the general principles and thus with sound and effective risk management. These measures could range from requiring the financial institution to remedy the situation to imposing capital add-ons.

From a legislative perspective, it could be possible to propose a single legal instrument which would contain general principles applicable to the overall financial services industry and which would amend each relevant sectorial directive in the financial services sector (CRD, MiFID, IORP, etc.). However, it would also be feasible to amend each sectorial directive separately. This would allow for an approach tailored to each sector and, for example, for a legislative proposal to be made quickly if necessary to amend the CRD to take account of particular problems already identified for banks and investment firms.

C) The preferred option regarding the choice of instrument

The preferred option is to adopt a Recommendation which would set out principles on sound remuneration practices in the financial institutions followed by a Directive which would focus on the role of the supervisors and expressly empower them to review the remuneration policies during the assessment process of the soundness of a financial institution as a whole.

6. ANALYSIS AND COMPARISON OF IMPACTS

This Section presents the main findings of an examination of the impacts of the different policy options identified in Section 5. For a more detailed examination of the impacts see Annex 2.

For directors' remuneration in listed companies the options are discussed and measured against the two operational objectives set out in Section 4, i.e. (1) impact on strengthening the link between pay and performance, especially long-term performance, by improving the structure of pay, and (2) impact on improving corporate governance on remuneration policy (to ensure long-term viability of the firm).

For remuneration policy in the financial services sector the options are discussed and measured against the same two objectives but also the two additional operational objectives set out in Section 4, i.e. (3) impact on preventing incentives for excessive risk-taking in remuneration policy by improving structure of pay, and (4) impact on

strengthening the role of supervisors as regards oversight on remuneration policy in the context of risk management.

In addition, where relevant, the following criteria will be used to measure the impacts both of the policy options on directors pay and the policy options of remuneration in the financial services sector: impact on aligning the incentives of the recipient with long term company interest (the degree to which the linkage between actual pay and performance is strengthened is not always the same as the degree to which the incentives are aligned); impact on the supply of talented directors/employees available to EU companies and efficiency (a measure of cost/benefit comparing the effectiveness to reach the objectives with the costs of reaching the objectives and taking into account proportionality).

6.1. Comparison of substantive options: Directors remuneration

6.1.1. Structure of pay (directors)

	Aligns interests of recipient with long term company interests	Reduces incentives to excessive risk taking	Strengthens link between pay and performance	Improves corporate governance on remuneration policy	Supply of talented directors/employees	Efficiency
Option A	=	n.a.	=	n.a.	=	=
Option B	=	n.a.	+/=	n.a.	=	=
Option C *(total)*	+	n.a.	+	n.a.	?	+
Link pay-performance	=	n.a.	+	n.a.	?	+
Promote long term sustainability	++	n.a.	++	n.a.	?	+/++

Magnitude of impact as compared with the baseline scenario: ++ strongly positive; + positive; – – strongly negative; – negative; = marginal/neutral; ? uncertain; n.a. not applicable

On structure of directors´ remuneration, option A would probably have a neutral effect. Option B could have a somewhat positive effect on the link between pay and performance, since it could improve the implementation of the existing principles on disclosure of remuneration. Option C includes the retained suboptions as set out in section 5.1.3 and described in detail in Annex 2. These suboptions consist of two packages of measures aimed at respectively linking pay with performance or promoting long term sustainability of the company. The package "Link pay-performance" consists of principles on (1) expanding the benchmarking exercise to the other executive directors in the board and the senior employees in the company (internal benchmarking), (2) limiting severance pay notably in case of poor performance, and (3) linking variable remuneration to performance and ensuring a sufficiently high proportion of fixed pay to allow a flexible bonus policy. The package "Promote long term sustainability" consists of principles on (4) balancing long and short term performance criteria, (5) deferring

variable remuneration, (6) vesting of stock options and shares, (7) holding of shares until the end of employment, and (8) clawing back payments awarded on the basis of data that afterwards have proven to be manifestly misstated.

The suboptions in the package "Promote long term sustainability" would have a strong positive effect on aligning the interests of directors with the long term interests of the company and the link between pay and performance, since they allow the company to assess a directors´ performance over a longer period of time and could prevent conflicts of interest of directors who has a significant proportion of variable and share based remuneration. The principles are proportionate as they provide guidance which effectively targets the objectives set, yet leave discretion to companies. The most contentious suboption within this package is the clawback option. Introducing a clawback of the variable component will be difficult to negotiate into contracts, problematic to enforce and could result in law suits. But the ultimate threat of clawback could be useful to send a clear political message and as a last resort solution to restore pay for performance, if necessary. Thus, a possibility for clawback in cases of payments awarded on the basis of data that are manifestly misstated could be considered although this is legally complex and its likely impact uncertain.

The suboptions in the package "Link pay-performance" would, as described in more detail in Annex 2, in complementary ways strengthen the link between pay and performance. The principles on severance pay are relatively far-reaching, but there is consistent evidence of serious abuse in this area, moreover the principles are proportionate since they would not set an absolute limit or ban on severance pay. The most contentious suboption within this package is the internal benchmarking option. Internal benchmarking would not target directly the linkage between pay and performance. However, benchmarking the remuneration of directors within the company could mitigate the upwards trend of directors´ remuneration, which is not necessarily related to improved performance. Therefore, internal benchmarking could have an indirect positive impact on the link between executive pay and performance.

Whereas Options A and B are expected to have a neutral effect on the supply of talented directors Option C could have a negative effect since some suboptions under Option C (notably suboptions 1, 2, 5, 6 and 8 above) could (indirectly) affect the level and modalities of directors´ remuneration negatively. A riskaverse director would therefore discount the value of the affected part of the remuneration. Ceteris paribus this could put listed companies in the EU at a disadvantage compared to unlisted companies in the EU, and to listed (and unlisted) companies outside the EU. The extent of the potential negative effect is uncertain. There are arguments indicating that the effect might not be that significant: the discounted value of the affected part of the remuneration would be known to directors, when negotiating the contracts, which is likely to mean they will negotiate higher fixed salaries. Moreover, other factors such as tax, language, culture and social considerations also influence executive mobility. Furthermore, the risks are such that application of the principles require effective monitoring and efforts to ensure that they are applied as widely as possible internationally to avoid regulatory arbitrage.

Overall Option A and B are expected to have a neutral effect on efficiency. The suboptions under Option C are considered to be positive to strongly positive as regards effectiveness, but since there could be some renegotiation costs and it is uncertain what the effect will be on attracting talented directors, Option C is as a whole assessed to be positively efficient (+).

6.1.2. Governance of the remuneration process

	Aligns interests of recipient with long term company interests	Reduces incentives to excessive risk taking	Strengthens link between pay and performance	Improves corporate governance on remuneration policy	Supply of talented directors/employees	Efficiency
Option A	n.a.	n.a.	n.a.	=	=	=
Option B	n.a.	n.a.	n.a.	+	=	=
Option C *(total)*	n.a.	n.a.	n.a.	+	=	+
Improve shareholder oversight	n.a.	n.a.	n.a.	+	=	+
Strengthen role and independence of rem. committee	n.a.	n.a.	n.a.	+	=	+
Remuneration consultants	n.a.	n.a.	n.a.	+	=	+

Magnitude of impact as compared with the baseline scenario: ++ strongly positive; + positive; – – strongly negative; – negative; = marginal/neutral; ? uncertain; n.a. not applicable

On governance of the remuneration process, option A would probably have a neutral effect. Option B could have a positive effect, since it could improve the implementation of the existing principles on disclosure of remuneration, shareholder oversight and the role of the remuneration committee. Option C, includes the retained suboptions as set out in section 5.1.3 and described in more detail in Annex 2. These suboptions consists of three packages of measures aimed at respectively improving shareholder oversight, strengthening the role and independence of the remuneration committee and addressing problems related to remuneration consultants. The package "Improve shareholder oversight" consists of principles on (1) the remuneration statement should be simple and understandable, (2) disclosure of additional elements of the remuneration policy (relating to the new elements proposed on structure of pay, see 6.1.1 above), (3) shareholders, notably institutional shareholders, should have a responsibility to make considered use of their voting rights on directors´ remuneration. The package "Strengthen role and independence of rem. committee" consists of principles on (4) restricting the award of share options to non executive directors, (5) at least one member of the remuneration committee should have sufficient expertise on remuneration, (6) the remuneration committee should be present and provide explanations to the shareholders at the general meeting. The suboption "Remuneration consultants" consists of a principle that (7)

remuneration consultants who advise the remuneration committee should not also advise the company.

The three packages each strengthen the effectiveness of their different parts of the corporate governance process on remuneration policy. The possible principles to be included in option C are assessed to be proportionate in relation to the objectives set. The principles relating to disclosure of additional elements of the remuneration policy, i.e. those set out in the package "Improve shareholder oversight" could improve shareholder oversight and are less far-reaching than, for instance, making the shareholders' vote binding. The principle that restricts the award of share options to non-executive directors is necessary to prevent conflicts of interest, while it does not prohibit other forms of performance related pay where the concerns of conflicts of interest are less prominent. Further, the principle relating to expertise of the remuneration committee does not require all members to have expertise and is similar to existing principles relating to expertise of audit committees. The principle on increasing the accountability of the remuneration committee could improve its functioning without changing fundamentally the role of the committee. Finally, the principle related to conflicts of interest of remuneration consultants does not restrict the use of remuneration consultants by remuneration committees, and is therefore a lighter alternative.

Option A and B are expected to have neutral effect on the supply of talented directors. Although option C introduces new principles on directors´ remuneration, it is also expected to have an overall neutral effect, since the principles included in option C do not influence the level and modalities of remuneration. The only uncertainty in this respect is linked to the more demanding tasks of the remuneration committee members. However, we consider that requiring greater expertise and providing for enhanced responsibility may mean non-executives can demand greater pay but should not pose a problem in attracting non-executives.

Options A and B are expected to have an overall neutral effect on efficiency. While involving some incremental costs Option C is overall assessed to have a positive effect on efficiency,.

6.1.3. Conclusion on directors´ remuneration

	Aligns interests of recipient with long term company interests	Reduces incentives to excessive risk taking	Strengthens link between pay and performance	Improves corporate governance on remuneration policy	Supply of talented directors/employees	Efficiency
Option A	=	n.a.	=	=	=	=
Option B	=	n.a.	=/+	+	=	=
Option C *(structure)*	+	n.a.	+	n.a.	?	+

Option C *(governance)*	n.a.	n.a.	n.a.	+	=	+

The overall preferred option is Option C which combines new principles on the structure of the remuneration and on the process of design and operation of the remuneration policy for directors in listed companies. This balance between structure and governance is the most effective in order to achieve the objective of having sound remuneration policies for directors in listed companies. The sound remuneration practices for directors have to be adopted in an internal process which avoids conflicts of interest and ensure adequate accountability of the remuneration committees towards shareholders. The enhanced role of shareholders in using their voting rights could also be effective in promoting remuneration policies consistent with the long-term interests of the company.

6.2. Comparison of substantive options: remuneration in the financial sector

6.2.1. Structure of pay

	Aligns interest of recipient with long term company interest	Reduces incentive to excess risktaking	Strengthens link between pay and performance	Supply of talented directors/employees	Efficiency
Option A	=	=	=	=	=
Option B	=	=	=	=	=
Option D *(structure)*	+	+	+	?	+
General principle related to risk taking and long termism	+	+	+	=	+
Termination payments linked to performance	++	+	++	?	+
Sufficiently high fixed component	=	=	+	=	+
Variable component linked to performance	=	=	+	=	+
Deferred element in variable component linked to future performance	++	++	++	?	+/++
Claw-back	+	+	+	-	=
Criteria for performance measurement linked to long-term	++	++	+	=	+

Measurement of performance for bonuses adjusted for risks, cost of capital and liquidity	+	+	+	?	+

Magnitude of impact as compared with the baseline scenario: ++ strongly positive; + positive; – – strongly negative; – negative; = marginal/neutral; ? uncertain; n.a. not applicable

On structure of remuneration, option A and option B would probably have a neutral effect.

Option D, including the retained suboptions as set out in section 5.1.4 and in Annex 2 (see the retained suboptions in the table above), could have a positive effect on reducing excessive risk-taking by staff and on linking pay and performance. The general principles on remuneration policy consistent with effective risk management should align incentives with prudent risk-taking by staff. The possible principles regarding the deferment of variable component, the linking of termination payments to the real performance and adjusting of profits for risk and cost of capital could have a strong positive effect on aligning the interests of staff with the long term interests of the company, since they allow the company to assess the real performance over a longer period of time. All the options are considered to be proportionate to the objective they aim to achieve. They do not aim at setting a limit on the level of pay nor to impose a determined structure of individual remuneration and should leave enough flexibility to financial institutions for putting in place remuneration policies consistent with effective risk management adapted to their particular situation. The principles remain general in nature and provide guidance as to what is necessary to reach the objectives set. This could be reinforced by making clear that their application is subject to a proportionality test, depending on the size of a financial undertaking and the nature and complexity of its activities.Regarding the impact on supply of talented people, the options could make employment in the relevant financial services sector relatively less attractive compared to other sectors of the economy in the EU and compared to employment, including in the financial services sector, outside the EU, as the options could (indirectly) affect the level and modalities of remuneration negatively. The extent of the potential negative effect is uncertain. There are arguments indicating that the effect might not be that significant: the discounted value of the affected part of the remuneration would be known to the employee/director, when negotiating the contracts, which is likely to mean they will negotiate higher fixed salaries. Moreover, other factors such as tax, language, culture and social considerations also influence executive mobility. Furthermore, the risks are such that application of the principles require effective monitoring and efforts to ensure that they are applied as widely as possible internationally to avoid regulatory arbitrage. Similar principles on the structure of remuneration are already recommended by FSF (and endorsed by G20), which should further limit the risks for EU companies compared to companies situated in other financial centres.

The most contentious suboption under Option D is introducing a clawback of the variable component. It would be difficult to include into employment contracts, problematic to enforce and could result in law suits for the financial institution. But the ultimate threat of

clawback could be useful to send a clear political message and as a last resort solution to restore pay for performance, if necessary.

6.2.2. *Governance*

	Aligns interests of recipient with long term company interests	Reduces incentives to excessive risk taking	Strengthens link between pay and performance	Improves governance on remuneration policy	Supply of talented directors/employees	Efficiency
Option A	n.a.	n.a.	n.a.	=	=	=
Option B	n.a.	n.a.	n.a.	=	=	=
Option D (*governance)*	n.a.	n.a.	n.a.	++	=	+
Responsibility of the board for oversight and operation of the remuneration policy	n.a.	n.a.	n.a.	++	=	+
Board members able to reach independent judgement	n.a.	n.a.	n.a.	++	=	+
Internal control functions, and human resources and shareholders involved in the process	n.a.	n.a.	n.a.	++	=	+
Remuneration policy updated over time	n.a.	n.a.	n.a.	++	=	+
Internal transparency	n.a.	n.a.	n.a.	+	=	=/+
3 suboptions on external disclosure (see below):						
Yearly mandatory disclosure in a separate statement	n.a.	n.a.	n.a.	+	n.a.	+
A single mandatory external disclosure at first, followed by updates if future modifications	n.a.	n.a.	n.a.	=/+	n.a.	=/+
A disclosure in annual financial statements as part of internal control description	n.a.	n.a.	n.a.	+	n.a.	+

Magnitude of impact as compared with the baseline scenario: ++ strongly positive; + positive; – – strongly negative; – negative; = marginal/neutral; ? uncertain; n.a. not applicable

On governance of the remuneration process, option A and option B would probably have a neutral effect. Option D, including the retained suboptions as set out in section 5.1.4 and Annex 2 (see the retained suboptions in the table above), could have a strong positive effect on governance of the remuneration policy. The possible principles included in option D address and could improve several aspects of corporate governance on the remuneration policy, namely possible conflicts of interest of the members of the board,

the role of the internal control functions and internal transparency. Ensuring that the board has overall responsibility for the design and operation of remuneration policy backed by expertise of human resources and internal control functions, increases the likelihood of having remuneration policies consistent with effective risk management and non-biased by undue influence of business units. Giving a role to shareholders and other stakeholders and making remuneration policy internally transparent further strengthens the objectivity of the process.

These options on the governance considered to be proportionate with regard to the objective they aim to achieve. As further described in Annex 2, the costs of these options are assessed to be relatively limited compared to their effectiveness.

External disclosure of remuneration policy is necessary in order to adequately inform the relevant stakeholders. Nonetheless, disclosure will entail costs and may pose problems of confidentiality of business information. Disclosure for stakeholders should be clear and easily understandable so as to allow them to form a view on whether the financial undertaking has adopted remuneration policies consistent with sound risk management practices. Adequate additional disclosure where appropriate is also necessary in order to provide information to supervisors so that they can effectively review remuneration policies of financial institutions. On disclosure of the remuneration policies Option D could have a positive effect on improving governance on remuneration policy. Each of the three suboptions has its costs and benefits as compared to the objective. Whilst annual mandatory disclosures in a separate statement or in annual accounts are overall considered to be slightly more efficient in achieving better governance, the differences between the three suboptions are not important enough to single out a preferred option. Each of them could therefore be retained as a preferred policy option on external disclosure.

6.2.3. Supervision

	Aligns interests of recipient with long term company interests	Reduces incentives to excessive risk taking	Strengthens link between pay and performance	Improves supervisory oversight	Improves corporate governance on remuneration policy	Supply of talented directors/employees	Efficiency
Option A	=	=	=	=	=	=	=
Option B	=	=	=	=	=	=	=
Option D *(supervision)*	+	+	+	+	+	=	+
Ensure financial institutions have remuneration policies consistent with effective and sound risk management.	++	++	++	++	+	=	+

Use tools under Basel II Accord	+	+	+	+	+	=	+
Take account of nature/scale of financial institution and complexity of its activities	+	+	+	=	+	n.a.	=

Magnitude of impact as compared with the baseline scenario: ++ strongly positive; + positive; – – strongly negative; – negative; = marginal/neutral; ? uncertain; n.a. not applicable

On the supervisory oversight of the remuneration process, option A and option B would probably have a neutral effect. Option D, including the retained suboptions as set out in section 5.1.4 and described in more detail in Annex 2 (see the retained suboptions in the table above), could have a strong positive effect on the supervisory review of the remuneration policy. For the supervisors to effectively review remuneration policies of financial institutions, they need to have access to all necessary information and to dispose of supervisory tools which enable them to make financial institutions compliant with the principles on sound remuneration policies. This increased role of supervisors will have additional costs, but the supervisory oversight on the adequacy of financial institutions' compensation policies is an indispensable tool if the implementation of the principles on sound remuneration policies by financial institutions is to be effective. Supervisors could adopt a proportionate approach and the intensity of the supervision applied to financial institutions will vary according to the supervisor's estimate of the potential impact of their conduct and the risks run by them.

However, using only supervisory tools under the Basel II Accord on capital requirements would not be effective in achieving the objective of having sound remuneration policies across the whole financial services industry. Supervisory tools there apply only to banks and investment firms and will be irrelevant for financial institutions for which capital requirements do not exist.

6.2.4. The scope of application

First, the new principles on remuneration could apply only to credit institutions and investment firms. However, this option leaves outside the scope of the general principles all other sectors of financial services industry. Alternatively, general principles on sound remuneration policies could apply to all actors in the financial services industry, regardless of the legal status of the financial institution. This option would avoid any possible loopholes and prevent a distortion of competition between different sectors. However, some of the general principles on sound remuneration practices may be of more relevance to certain categories of financial institutions than others. Therefore, in order to avoid unjustified costs and to ensure proportionality, Member States may, when implementing the general principles, adapt and complement them according to the specific situation of given financial institutions.

Second, new principles could apply to significant, systemically important companies, whose failure has important consequences on the correct functioning of the financial services industry. However, this option could appear as insufficiently effective in achieving the objective of prudent risk-taking in the financial services sector. If there are unsound remuneration policies which induce excessive risk-taking in a large number of small financial institutions, together these financial institutions could generate a systemically important risk. Consequently, to limit the scope of the principles on sound remuneration policies to significant financial institutions only could undermine the reach of these principles. An alternative option would be to apply the new principles to all financial institutions, whatever their size. This option would better achieve the above-mention objective and avoid a possible distortion of competition between financial institutions of different sizes. However, for the sake of ensuring proportionality and in order to avoid unnecessary costs for the financial institutions of small size with a limited number of employees, Member States may take account of, its size, scope of activities and complexity.

Finally, new principles on remuneration policy could include all categories of staff within a financial undertaking, with special arrangements adopted with regard to directors, senior staff members, and other risk-takers whose remuneration is performance related. Alternative, their scope of application could be limited only to those categories of staff whose professional activities have an impact on the risk profile of the financial institution. Either approach could equally be retained as preferred option.

6.2.5. Conclusion on remuneration in financial services

	Aligns interests of recipient with long term company interests	Reduces incentives to excessive risk taking	Strengthens link between pay and performance	Improves corporate governance on remuneration policy	Improves supervisory oversight	Supply of talented directors/employees	Efficiency
Option A	=	=	=	=	=	=	=
Option B	=	=	=	=	=	=	=
Option D *(structure)*	+	+	+	n.a.	n.a.	?	+
Option D *(governance)*	n.a.	n.a.	n.a.	++	n.a.	=	+
Option D *(supervision)*	+	+	+	+	+	=	+

The overall preferred option is Option D which combines new principles on the structure of the remuneration, on the process of design and operation of the remuneration policy, on the disclosure of remuneration policy to external stakeholders and on the supervisory review. This balance between structure, governance, disclosure and supervision is the most efficient to achieve the objective of having sound remuneration policies in financial

institutions consistent with effective risk-management. Sound practices for remuneration policy in an individual financial institution should be adopted through an internal process which avoids conflicts of interest and ensures that the operation of the remuneration policy is consistent with its design and objectives. Adequate involvement of internal and external stakeholders in the process can only be achieved if these stakeholders are sufficiently informed. Supervisory review would further strengthen the effectiveness of risk management, especially where systemic risk is concerned, and ensure coherent implementation of sound remuneration policies across Member States.

The preferred option on structure of remuneration policies introduces new principles on the structure of the remuneration. This option consists of a general principle on sound remuneration policies which should be consistent with sound and effective risk management. For this purpose, financial institutions should strike an appropriate balance between fixed and variable components of remuneration with a sufficiently high level of fixed component so as to ensure that staff do not rely exclusively on bonus payments. This option also requires that the variable component should be linked to performance and that a major part of it should be deferred in order to take into account the risk horizon of the underlying performance. Variable payments should be subject to performance measurement criteria which should privilege longer-term performance of financial institutions and adjust the underlying performance for risk, cost of capital and liquidity. Possibility for clawback in cases of payments awarded on the basis of data that are manifestly misstated could be considered although this is legally complex and its likely impact uncertain.

The preferred option on the governance of remuneration policies introduces new principles on the governance of decision-making on remuneration policies in financial institutions. This option consists of a general principle that remuneration policy should be transparent internally, should be clear and properly documented and contain measures to avoid conflicts of interest. This option also implies that the (supervisory) board should have the responsibility for the oversight of the operation of the remuneration policy for the financial institution as a whole with an adequate involvement of internal control functions and human resources departments or experts as well as shareholders. Board members and other staff involved in the design and operation of remuneration policies should be independent. Nonetheless, it does not seem proportionate to have a remuneration committee composed exclusively of non-executives. To ensure that remuneration policy achieves its objectives, it should be updated over time to meet the financial institution's changing situation and staff members should know in advance the criteria which will be used to determine their remuneration and have access to their appraisal process.

The preferred option with respect to disclosure introduces new principles on the disclosure of remuneration policies in financial institutions. This option consists of a general principle that remuneration policy should be adequately disclosed to external stakeholders in a clear and easily understandable way. The different ways to achieve this transparency are relatively equivalent in efficiency so they could consist either of a yearly mandatory disclosure in a separate remuneration policy statement, a single mandatory

disclosure at first, followed by an update in case of future changes or a disclosure in annual financial statements.

The preferred option includes new principles on the supervisory review of remuneration policies in financial institutions. This option 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. In order to address the question of proportionality, this option also provides for supervisors to take account of the nature and scale of the financial institution and the complexity of its activities in order to assess its compliance with the principles on sound remuneration policies.

Finally, on the scope of the new principles, a financial institution could adopt a remuneration policy which includes all levels of the organisation and all categories of staff limit the remuneration policy only to those categories of staff whose professional activities have an impact on the risk profile of the financial institution. As explained in section 6.2.4. above, the two options seem comparable as to their costs and benefits and as to their effectiveness in achieving the main objective of the new policy. Both of them could equally be retained as preferred option.

There is a risk that application of the principles might have an adverse effect on the supply of talented employees and directors in the EU. This argues in favour of effective monitoring of their application and efforts to ensure they are applied effectively and as widely as possible to avoid regulatory arbitrage.

6.3. Discussion of coherence and future developments.

The preferred options for directors' remuneration and remuneration policy in financial services are consistent with each other. In any event and for greater clarity, given the overlap (i.e. for directors of listed companies in the financial services industry), the Recommendation on remuneration policy in financial services should clearly state that the provisions of the (existing and forthcoming) Recommendations on directors' remuneration are applicable to directors in the financial services industry. The proposed Recommendation on remuneration policy in financial services would be applicable without distinction to privately or publicly owned financial institutions.

Furthermore it will specify that its content is without prejudice to specific national measures on remuneration in the context of national rescue packages for the financial sector. As mentioned above, the Commission acknowledged, when examining state aids for financial institutions that "Restrictions on dividend policy and caps on executive remuneration should also be considered". These were considered to be behavioural constraints to ensure that beneficiary (public or privately owned) financial institutions do not engage in aggressive expansion against the background of the state guarantee to the detriment of competitors not covered by such protection. However they are exceptional measures and can not substitute for general guidelines to be applied outside national rescue packages for ailing banks. In fact, the proposed Recommendation would introduce

new principles to be applied by all financial institutions. These recommendations are to be viewed as part of a wider package.

As indicated earlier, the Commission also 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, in the first instance, with remuneration policy in banks and investment firms (this is where the clearest market failure has occurred on the basis of the evidence available to date) and will be included in the package of modifications of the Capital Requirements Directive which is now planned for mid-June 2009. The primary purpose of the legislative instrument will be to bring remuneration policies and their link with risk management clearly within prudential oversight. The legislative amendment might establish a general principle that remuneration policies should be consistent with effective risk management. Supervisors should review compliance with this principle and, where necessary, ensure that covered financial institutions take remedial action, where necessary and have adequate capital to cover the risks they take. Similar legislative initiatives in other financial sectors (such as insurance) may also be needed and will be considered. Meanwhile the Recommendation on financial services could already provide a 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 although their positions in this respect are coordinated to a certain extent though existing committees which bring together 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, then 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 betweens supervisors as regards 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. It will be important in order to ensure a global level playing field to monitor what is being done at international level and how (and if) the FSF principles are implemented in other countries/geographical areas. The G20 agreed to strengthen the role of the FSF to become a Financial Stability Board and its expansion, inter alia, to the European Commission will facilitate monitoring of the implementation of its principles by others.

The financial crisis has stressed-tested Corporate Governance regimes in banks and investment firms and they have been found to be sorely wanting. There is a need to address more issues related to risk management within financial institutions. This will be the subject of a more wide-ranging report also announced in the 4th March Communication which is to be produced for the end of this year.

Lastly, the relative unsatisfactory application of the existing Recommendations on directors' remuneration, including the lack of accountability of directors towards shareholders and the relative inactivity of (even institutional) shareholders on these issues may raise serious questions on the effectiveness of corporate governance rules. The European Commission's services have launched a study on this issue and results are expected for the end of 2009.

7. MONITORING AND EVALUATION

7.1. Monitoring

Directors' remuneration

Given the unsatisfactory application of the existing Recommendations, the new Recommendation 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 EU rules on directors' remuneration. An annual scoreboard on the effectiveness of the EU rules on directors' remuneration in Member States, in particular on the linkage between performance and level of directors' remuneration in each Member State will be established in 2010 together with a data gathering study to this end.

A peer review by Member States on their respective application of EU Recommendations on directors' remuneration is also being considered. Furthermore, to improve quality and comparability of European data on companies' disclosure of directors' remuneration, the Commission will explore possibilities to standardise the disclosure.

Finally, the result of an ongoing study on the effectiveness and monitoring of existing corporate governance rules in Member States will be available by the end of this year and provide up to date information of the situation in Member States.

Remuneration in financial services

The new Recommendation would include a provision inviting Member States to notify the Commission of measures taken. Furthermore, the Commission intends to carry out on online visits of financial institutions to check whether remuneration policy is in line with the new Recommendation. The Commission will work closely with CEBS and relevant national authorities to ensure convergent and consistent application within the EU.

7.2. The evaluation reports

After one year, the Commission will examine both Recommendations in the light of the experience acquired and outcome of the above-mentioned monitoring. The evaluation will be based on the data gathered from the monitoring exercises, complemented with information collected from companies, Member States and stakeholders.

[1] Please see list of articles below

[2] E.g. Berle and Means (1932), Jensen and Meckling (1976), O'Reilly et al (1988), Garen (1994), Murphy (1999), Oxelheim and Randoy (2005)

[3] Declaration of the Washington DC Summit on Financial Markets and the World Economy". White House.

[4] Commission Recommendation of 14 December 2004 fostering an appropriate regime for the remuneration of directors of listed companies (2004/913/EC). OJ L385/55, 29.12.2004.

[5] After the European Council of October 2008, President Barroso reported to the European Parliament that the Commission would come forward with an initiative on executive pay based on a review of the 2004 Recommendation. Later the ECOFIN Council, in its conclusions of 2 December 2008, invited the Commission "to update its recommendation so as to promote a more effective control by shareholders, and encourage a stronger link between pay and performance, including on leaving pay ("golden parachutes")".

[6] COM(2009)114 final of 4.03.2009

[7] Cadbury Report, December 1992. For a more comprehensive definition, see for example the OECD Principles of 1999: "Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined."

[8] See Directive 2006/46/EC. The "comply or explain" approach means that to the extent a company, in accordance with national law, departs from a corporate governance code to which the company is subject, or voluntarily has decided to apply, it shall explain which parts of the code it departs from and the reasons for doing so.

[9] Commission Recommendation of 15 February 2005 (2005/162/EC). Some countries use a one-tier board structure. This board structure is characterised by an administrative board consisting of a mix of executive and non-executive directors. In the countries using a two-tier board structure, a management board consists entirely of managing directors and a supervisory board consists entirely of supervisory directors. Of particular importance for the non-executive or supervisory directors is their role in overseeing executive or managing directors and dealing with situations involving conflicts of interest.

[10] Commission Recommendation of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board. OJOEU (2005/162/EC) dated 25th February 2005 L52/51.

[11] See references above.

[12] OJ C270, 25/10/2008, p 8

[13] OJ C10, 15/1/2009, p 2

[14] In its analysis of avoidance of the undue distortions of competition in the context of state aid, the Commission assesses, among others, whether the aid package foresees sufficient behavioural rules to prevent an abuse of the state support. Restriction on executives' remuneration is one of these behavioural rules positively assessed. A number of cases of aid to the financial sector approved until now by the Commission, both in the form of guarantees and recapitalisation (individual or national schemes), include restrictions on executives' remunerations as behavioural safeguard.

[15] Please see problem trees in Annex 11.

[16] In agency theory, the company is a nexus of contracts; it focuses on executives directors as they take the strategic decisions: resources allocation decision, new market entries, etc.

[17] See Annex 10.

[18] See Annex 10.

[19] See e.g.: http://www.ft.com/cms/s/0/275553dc-046f-11de-845b-000077b07658.html ("War of words breaks out over Goodwin's retirement pot"), http://www.ft.com/cms/s/0/ad9a97fa-085b-11de-8a33-0000779fd2ac.html ("Former N Rock director paid nearly £1m"), http://www.ft.com/cms/s/0/8676422a-d7b4-11db-b218-000b5df10621.html ("Trichet calls for executive pay restraint"), http://cachef.ft.com/cms/s/0/f17f27ee-945f-11dd-953e-000077b07658.html ("Paris warns on executive pay"), http://www.ft.com/cms/s/0/f201e98c-2799-11dd-b7cb-000077b07658.html ("Merkel ally backs curbs on executive salaries"), http://www.irishtimes.com/newspaper/finance/2009/0212/1233867933323.html ("Contrite bankers starting to pay for past excesses"), http://www.ft.com/cms/s/0/d0e1fb46-db69-11dd-be53-000077b07658.html

("Companies warned over executive pay-outs"), http://www.ft.com/cms/s/d285337a-0ce1-11dd-86df-0000779fd2ac,dwp_uuid=ebe33f66-57aa-11dc-8c65-0000779fd2ac,print=yes.html ("BP shareholders criticise executive pay packages"), http://www.ft.com/cms/s/0/882d3a46-aa9f-11dd-897c-000077b07658.html ("North-south divide over excessive executive pay"), http://www.ft.com/cms/s/0/f3506d4a-b588-11dd-ab71-0000779fd18c.html ("Pressure mounts on executives to renounce incentives"), http://www.ft.com/cms/s/0/d54991b0-bb2c-11dd-bc6c-0000779fd18c.html ("Ex-UBS executives forfeit pay"), http://www.ft.com/cms/s/0/e312a89e-f3ef-11dd-9c4b-0000779fd2ac.html ("Mandelson warning to banks over bonuses"), http://www.ft.com/cms/s/0/9e078d7a-28fa-11dd-96ce-000077b07658.html ("Mail bosses defend ‘obscene’ bonus payouts"), http://www.ft.com/cms/s/2/712f3d9c-5245-11dd-9ba7-000077b07658.html ("The Lex Overpaid CEO Award"), http://www.ft.com/cms/s/0/e27ee73e-dac8-11dd-8c28-000077b07658.html ("Bellway pay-outs prompt concern"), http://www.ft.com/cms/s/0/b7c7ceb8-9be2-11dd-ae76-000077b07658.html ("High pay fails to boost performance, says report"), http://www.ft.com/cms/s/0/2da1c486-e95b-11db-a162-000b5df10621.html ("Threat of ban on 'golden parachutes'"). Also outside the EU public outcries over executive pay are taking place, especially in the US: http://www.ft.com/cms/s/0/c22ee8f6-f96b-11dc-9b7c-000077b07658.html ("Gentlemen, please empty your pockets"), http://www.ft.com/cms/s/0/799e4b5e-f325-11dd-abe6-0000779fd2ac.html ("Obama gets tough on pay for executives"), http://www.irishtimes.com/newspaper/finance/2009/0212/1233867933340.html ("US bankers questioned on use of bailout money").

[20] In a meta-analysis of some 137 studies of executive compensation, Tosi et al. (2000) found that changes in firm performance accounted for only some four per cent of the variation of CEO pay. In a meta-analysis of 229 empirical studies Dalton et al. (2003) reports that only a few studies find a systematic link between executive compensation and firm performance. As regards evidence from European countries a number of studies relating to the United Kingdom find a low pay-performance sensitivity (Gregg et al., 2005; Conyon and Murphy, 2000; Ozkan, 2007). Bruce et al. (2007) come to the same conclusion on bonuses within UK companies. For Germany, Haid and Yurtoglu (2006) report a weak relation between compensation and performance, whereas Conyon and Schwalbach (2000) find that the relation is positive in both Germany and the United Kingdom. By contrast, recent studies on Portugal (Fernandes, 2008) and the Netherlands (Dufhues et al., 2007) do not find any such relation.

[21] E.g. in a Financial Times article (http://www.ft.com/cms/s/0/58383be0-9a52-11dd-bfe2-000077b07658.html) the IDS Executive Compensation Review is quoted for saying that "bonus payments have continued to rise faster than inflation in spite of the deteriorating financial outlook" (the quote relates to bonuses in UK companies in 2008). In a Financial Times article (http://www.ft.com/cms/s/0/c22ee8f6-f96b-11dc-9b7c-000077b07658.html) relating to the US in 2007 it is informed that "The median income of an S&P 500 CEO nearly doubled while the average profit of their companies rose just 12%". An Associated Press study at http://www.shareholderforum.com/sop/Library/20080919_Deal.htm reports that the median CEO pay in S&P 500 companies was about USD 8.4 million in 2007 and had not come down at a time the economy was weakening.

[22] In particular they often receive social insurance and supplementary pension schemes. Supplementary pension schemes are often substantial and do not depend on performance. They normally depend on the level of pay. They are called supplementary because they are outside the national statutory social security to which the Directors might be rightfully entitled under Social Security law.

[23] There seems to be at least some anecdotal evidence that could support this argument. Bellway, the UKs fourth largest housebuilder paid more than 630,000 pounds to top executives in spite of a sharp fall in its share price in 2008. They were rewarded with bonuses worth 55 % of their salaries in a year when shares in the company lost 28% of their value, sales fell by 50% and house prices collapsed. Peter Montagnon, Director of Investment Affairs at the Association of British Insurers, commented: "Management had targets and abandoned them when it became clear they were not going to meet them. They decided to pay bonuses anyway." Available at: http://www.ft.com/cms/s/0/796b95d2-da7b-11dd-8c28-000077b07658.html.

[24] Main et al (2006), p. 27, Gabaix and Landier (2006), p. 3.

[25] "Executive remuneration in the EU: the context for reform" by Ferrarini & Moloney Oxford Review of Economic Policy, Vol. 21, N°. 2/2005.

[26] A study showed that missing quarterly earnings benchmarks are associated with higher risks of being fired and getting lower bonuses and lower equity based compensation. See http://www.hbs.edu/research/pdf/09-014.pdf

[27] A survey conducted by Graham et al. in 2005 in US listed companies .See graham, Harvey and Rajgopal, the Economic implication of corporate financial reporting, Journal of accountings and economics, vol 40.

[28] See Annex 10.

[29] HayGroup (2008).

[30] The HayGroup study finds that UK companies pay the highest base salaries, with a median of €1.4m. German companies pay the highest bonuses, with a median 85% of salary. French companies provide the largest long term incentive opportunities and have the highest median total compensation (salary, bonus plus fair value of long-term incentive award). Another study (See Ferrarini & al. article mentioned in 51) reports that the proportion of variable cash bonuses range from 27 % of pay in Finland to 47 % in France. When share-based compensation is included, total variable pay, including share options and long-term incentive plan awards, represents 78 % of total pay in the UK, and 60 % in France.

[31] Return On Equity (ROE) 10%, Total Shareholder Return (TSR) 13%, Economic Value Added (EVA) 18%, Cashflow 21%, Individual targets 36%, Other 49%.

[32] The UK finding is supported by the OECD report "Corporate Governance lessons from the financial crisis" (2009), p. 12: "*70 per cent of FTSE companies now defer some part of annual bonuses. For an example of such plans, Ladipo et al note that at one bank 75 per cent of the annual bonus is delivered as cash. The remaining 25 per cent is delivered as a provisional allocation of shares which are not normally released for at least three years and are subject to potential forfeit if the individual resigns and commences employment with a competitor.*"

[33] Also the FSF principles for Sound Compensation practices (p. 13) says in relation to clawback systems in the financial sector, that "*such provisions have not been common practice*".

[34] Out of 48 European companies 32 used Performance Share Plans, 31 Share Option Plans, 4 Matching Bonus Plans and 3 Cash Plans. Practices differ between countries; for example French companies use mostly share option plans whereas UK companies use mostly performance share plans.

[35] Jack Welch, who is regarded as the father of the "shareholder value" movement that has dominated the corporate world for more than 20 years, has said it was "a dumb idea" for executives to focus so heavily on quarterly profits and share price gains. The former General Electric chief told the Financial Times the emphasis that executives and investors had put on shareholder value, which began gaining popularity after a speech he made in 1981, was misplaced. See http://www.ft.com/cms/s/0/294ff1f2-0f27-11de-ba10-0000779fd2ac.html

[36] US Supreme Court. Schreiber v. Burlington Northern, 472 US.1 (1985)

[37] See for instance remarks made by Nicolas Sarkozy reported in a Financial Times article http://www.ft.com/cms/s/0/2da1c486-e95b-11db-a162-000b5df10621.html.

[38] Depending on the Member State, directors may be considered as employees and subject to labour law.

[39] In many Member States (e.g Austria, Germany, Italy, Portugal Ireland) severance payments are treated on a special basis – mostly in order to reduce the tax burden. Often, severance payments are taxed on basis of average earnings

[40] e.g. Cyprus and Spain

[41] e.g. Germany, Belgium and Ireland

[42] In Europe there are several examples. "*Antoine Zacharias, ousted in 2006 as chairman of the construction group Vinci, got a €13m severance package, supplemented by an estimated €250m of stock options*" http://www.ft.com/cms/s/0/8676422a-d7b4-11db-b218-000b5df10621.html (FT article 21.3.07 "Trichet calls for executive pay restraint"), "*The prospect of large severance payments to the outgoing chief executives of Dexia, the bank rescued in a government-led bailout last week, and Alcatel Lucent, the loss-making telecoms equipment supplier, has caused outrage in France. The French government last week effectively forced Axel Miller, the Dexia chief, to give up his golden parachute as a condition for injecting capital into the bank.*" http://cachef.ft.com/cms/s/0/f17f27ee-945f-11dd-953e-000077b07658.html. (FT article 7.10.08 "Paris warns on executive pay"), "*A pension arrangement giving Sir Fred Goodwin, former CEO of the ailing bank Royal Bank of Scotland, 693.000 pounds a year for the rest of his life, has caused a public out cry in UK*" http://www.ft.com/cms/s/0/275553dc-046f-11de-845b-000077b07658.html (FT

article 27.2.09 "War of words breaks out over Goodwin's retirement pot"). In Schwitzerland 3 former UBS executives have renounced severance payments of respectively around €21m, €14m and €7.5m after public pressure http://www.ft.com/cms/s/0/d54991b0-bb2c-11dd-bc6c-0000779fd18c.html (FT article 25.11.08 "Ex-UBS executives forfeit pay"). In the US, golden parachutes of mediocre performing executives have also caused outcry. OECD ("Corporate Governance lessons from the financial crisis (2009), p. 12) report, that Mudd (from Fannie May) got a payment of 9.3 m USD (but renounced it), Syron (from Freddie Mac) got 14.1 m USD (but renounced it), Prince (from Citibank) got 100 m USD and O'neal (from Merril Lynch) got 161 m USD. Robert Nardelli (from Home Depot) got a 210 million dollar golden parachute in spite of an 8 % drop in share price during his six years in charge http://www.ft.com/cms/s/0/c5698f48-abd4-11db-a0ed-0000779e2340.html. (FT article 24.1.07 "Home Depot slashes new CEO Blake's pay").

[43] *Experience has shown that variable pay schemes have become increasingly complex and that in certain instances this has led to excessive remuneration and manipulation. This has raised questions of appropriate disclosure of director remuneration and of the role of shareholders and non-executive directors in the process of determining director remuneration*" [European Corporate Governance Forum statement, March 2009]

[44] Commission Staff Working Document dated 13 July 2007 SEC (1022)

[45] There are still substantial differences in the degree of disclosure between Member States: for example in Greece, it is only required to disclose the remuneration of board of directors' non-executive board members, whereas in other countries all board members' payment have to be disclosed. In the UK, for example, detailed, individualised disclosure on the remuneration packages of all executives (including salary, bonuses, share options, and long-term incentive schemes) as well as on remuneration policy is available in the Annual Report.

[46] For instance NL, UK.

[47] See RiskMetric report in Annex 6.

[48] See "Fixing Directors' Remuneration in Europe Governance, Regulation and Disclosure" Prof. Guido Ferrarini and Dr. Maria Cristina Ungureanu in Annex 7.

[49] Dissent on this issue was typically driven by the absence of any cap on executive variable remuneration or retention payments and the lack of stringent performance criteria thereon. Leading in Dissent: France – 6.2% dissent on average (vs 4.8% for Europe) – 2 rejected items and Netherlands – 4.4% dissent on average – 1 rejected and 2 withdrawn items – RiskMetrics.

[50] See examples of refusal on remuneration issues from shareholders in RiskMetrics presentation in Annex.

[51] See Gaspar, Massa, Matos (2005), Shareholder Investment Horizon and the Market for Corporate control, Journal of Financial economics, vol 76, pp. 135-16

[52] On the New York Stock Exchange, the average share is currently held for less than a year, as compared to about five years in 1960 and two years in 1990. Article by By Rakesh Khurana and Andy Zelleke, Washington Post, 8 February 2009.

[53] They tend to undervalue firms with good earning prospects in the long term but low current profitability. Ref Article. However there are also studies showing that institutional and block holding ownership can have a significant and negative impact on CEO compensation, which shows an existence of active monitoring by institutional and block holding ownership (Neslihan Ozkan (2005): "Do Corporate Governance Mechanisms Influence CEO Compensation? An Empirical Investigation of UK Companies").

[54] According to Jenson and Murphy: "*Remuneration committees routinely lack the information, expertise and negotiating skills necessary for hard-nosed contract negotiations with incumbent and incoming executives" Remuneration:" Where we've been, how we got here, what are the problems and how to fix them"* Jenson M and Murphy K, European Corporate Governance Institute Working Papers in Finance 2004, p22

[55] "The Remuneration Committee and Strategic Human Resource Management" Brian G M Main, Calvin Jackson, John Pymm and Vicky Wright. 24 December 2007.

[56] "Compensation Consultants and Executive Pay: Evidence from the United States and the United Kingdom" by Martin J. Conyon. May 2008. The study yields a number of findings. First, CEO pay is generally greater in firms that use compensation consultants. Second, the amount of equity used in the overall compensation package, such as stock options, is greater in firms that use consultants.

[57] See Lord Myners comments at House of Lords*: "From my perspective, one of the things that it should address is the insidious influence of external benchmarking and comparators by so-called benefit consultants. There needs to be much more awareness of internal comparators and perceived fairness".*
[58] http://business.timesonline.co.uk/tol/business/industry_sectors/support_services/article5864154.ece
[59] See Association of British Insurance (ABI) previous article
[60] OECD Report on Corporate Governance Lessons from the Financial crisis.ISSN1995-2864.
[61] The High Level Group on Financial Supervision chaired by J. de Larosière 25 February 2009.
[62] G20 Working Group 1 conclusions
[63] List of Members: *E. Gerald Corrigan* Goldman, Sachs & Co. Co-Chairman , *Douglas J. Flint* HSBC Holdings plc Co-Chairman, *Madelyn Antoncic* Lehman Brothers, *Craig W. Broderick* Goldman, Sachs & Co. , *Ken deRegt* Morgan Stanley *Andrew Feldstein* Blue Mountain Capital Management, *Peter Fisher* BlackRock, Inc., *Adam Gilbert* JPMorgan Chase & Co. *Christian Lajoie,* BNP Paribas, *Gary Lynch,* Morgan Stanley, *J. Chandler Martin* Bank of America ,*Edmond Moriarty,* Merrill Lynch *Gavin O'Connor,* Goldman, Sachs & Co., *Edward J. Rosen, Esq.*Cleary Gottlieb Steen & Hamilton LLP , *Zion Shohet,* Citigroup, *Barry L. Zubrow,* JPMorgan Chase & Co.
[64] Later this view was shared by many others. See for instance FSF's principles for Sound Compensation practices (draft 26.09), p. 4: "*Multiple surveys find that over 80 % of market participants believe that compensation practices played a role in promoting the accumulation of risks that led to the current crisis. Experts agree*."
[65] The IIF recommendations of 17 July 2008: http://www.iif.com/press/2008+press/press+75.php
[66] See de Larosière Report.
[67] See state of European banks following their exposure to risky investments: http://www.ft.com/cms/s/0/a26c6f02-cc74-11dd-acbd-000077b07658.html]
[68] http://cachef.ft.com/cms/s/1/3b0f594e-b7ae-11dd-ac6d-0000779fd18c.html
[69] http://www.cnbc.com/id/21819441
[70] The financial services industry has already witnessed a 16 percent decline in bonuses in UK financial institutions (from £8.8bn in 2006 to £7.4bn in 2007). Similarly, these figures have been mirrored on Wall Street. As the turbulence in the financial markets continue, in May 2008 the Centre for Economic and Business Research (CEBR) predicted that 2008 bonuses – to be paid in early 2009 – would total £5.07 billion, a fall of 42 percent from 2006's near record £8.8 billion payout. Even more striking is the prediction that bonus levels will not recover to 2006/07 levels until 2011 at the earliest.
[71] A significant portion of bonuses are paid in stock. That varies between banks, but a rule of thumb might be about 25-35 per cent in aggregate, with most of it locked up for three to five years. Junior staff receives virtually everything in cash. The heavier the hitter, the bigger the proportion paid in stock
http://www.ft.com/cms/s/1/570ac08c-5799-11dc-8c65-0000779fd2ac.html
[72] Report of the Board of Directors to the General Shareholders Meeting. 22May 2008 Société générale. http://www.ifa-iaf.be/v1/frontEnd/libraryIfa/index.php?action=spawnFile&id=50
[73] Other examples of bonus scandals: Caisse d'épargne: http://www.ft.com/cms/s/0/4daa03fa-9cac-11dd-a42e-000077b07658.html **-** Carnegie scandal in Sweden: http://www.ft.com/cms/s/0/e485dbe4-7504-11dc-892d-0000779fd2ac.html
[74] IIF Report, BCBS paper, OECD Report, SSG Report
[75] See Senior Supervisor Group, observations on risk management practices during the recent market turbulence.2008.
[76] See ACCA discussion paper
[77] Société Générale, 2008 Report of the Board of Directors to the General Shareholders Meeting, company website
[78] FSA Final notice to Credit Suisse first Boston, 13 August 2008, London
[79] See "The Moore Memo" at http://ftalphaville.ft.com
[80] SEC's Oversight of Bear Stearns an d Related Entities, Report N° 446-A
[81] Guerra and Thal-Laresen report, 2008
[82] Idem
[83] See policy context for references (CRD, Insurance, UCITS, MiFID, IORP)

[84] "Principles for sound compensation practices in the financial industry" adopted by the FSF on 12 March 2009. See Annex 5.
[85] See the tender documentation of the study in Annex 9.
[86] See for instance the EFC document in Annex 4.
[87] In 2007, the French Government already made it legally compulsory to subordinate any exit remuneration packages for executives to performance requirements. The French Government is also expected to pass a new legislation to ensure that stock options could only be awarded to top executives if they or some other form of profit-share scheme are also in place for the rest of a company's workforce. Lastly, President Sarkozy threatened to legislate on these issues if the new recommendations are not applied by the industry.
[88] The use of tax facilities on disproportional pension payments over the past, are discouraged by introducing a new employers' tax on back service payments regarding wages in excess of €500,000. These back service payments are taxable at a rate of 15%. Secondly, a new employers' tax at a rate of 30% is introduced on disproportional exit bonus payments. These payments are considered to be disproportional if and insofar as the payments exceed the employee's annual wage. This extra tax is only applicable if the annual wage of the employee exceeds €500 000.
[89] Adopted in March 2009. See Annex 5.
[90] The Rise of an International Market for Executive Labour by Winfried Ruigrok, Peder Greve. SCALA Discussion Paper No. 7/2007. Though the authors explain there are many barriers to the movement of executives in Europe, recent data suggest that an international market for executive labour in Europe is at best emerging very gradually. However, the international market for executive labour is not emerging in the same way and at the same pace across Europe.
[91] See above.
[92] See *OECD Principles of Corporate Governance*, revised April 2004, originally issued June 1999. The OECD principles constitute one of the twelve key standards of the Financial Stability Forum for sound financial systems.
[93] They suggested:

- Compensation incentives should be based on performance and should be aligned with shareholder interests and long-term, firm-wide profitability, taking into account overall risk and the cost of capital;
- Compensation incentives should not induce risk-taking in excess of the firm's risk appetite; and
- Firms should take into account the performance realized for shareholders over time in determining severance pay.

[94] Public consultation is ongoing. See Annex for the principles.
[95] In particular Italy, the UK, the Netherlands and Germany. The Bank of Italy issued a regulation on banks' organisation and corporate governance, requiring that remuneration schemes be consistent with risk management policies and long-term strategies.
[96] Please see EFC Report in Annex 4.
[97] Please EFC Report.
[98] See for instance work done by the Bank of Italy, the FSA and the French Commission bancaire. See Annex 8.
[99] Basel II is the second of the Basel Accords, which are recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision. The purpose of Basel II, which was initially published in June 2004, is to create an international standard that banking regulators can use when creating regulations. The second pillar provides, inter alia, a framework for dealing with all the other risks (not covered in Pillar 1) a bank may face, such as systemic risk, pension risk, concentration risk, strategic risk, reputation risk, liquidity risk and legal risk, which the accord combines under the title of residual risk. It gives banks a power to review their risk management system. Remuneration policy would fall under the second Pillar.
[100] See FSA Recommendation Annex 8.
[101] For instance, the French recommendations (code of conduct) which have been adopted this week only relate to banks' investment arm (i.e. ''banque de financement et d'investissement'). In contrast, the CEBS guidelines are addressed to all staff members of banks. See Annex 8.

[102] This issue will be part of the forthcoming legislative proposal on remuneration policy and prudential authorities announced on 4th March 2009.