COMMISSION OF THE EUROPEAN COMMUNITIES

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COMMUNICATION FROM THE COMMISSION

accompanying

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

and

Commission Recommendation on remuneration policies in the financial services sector

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COMMUNICATION FROM THE COMMISSION

accompanying
Commission Recommendation complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies and Commission Recommendation on remuneration policies in the financial services sector

I. Introduction

The financial crisis has exposed serious weaknesses in the way financial markets are regulated and supervised. The Commission is leading a wide-ranging reform to apply the lessons of the crisis and deliver responsible and reliable financial markets for the future. In the present context, remuneration policies have been a particular focus of attention from the public, media, academics and policy makers alike.

There is broad consensus that compensation schemes based on short-term returns, without adequate consideration for the corresponding risks, contributed to the incentives that led to financial institutions' engagement in overly risky business practices. Wider concerns have also been voiced about recent substantial increases in executive remuneration and the constantly growing importance of variable pay in the composition of directors' remuneration across all sectors of the economy.

The two Recommendations that accompany this Communication are the first stage in the Commission's strategy to address this important issue. As announced in its Communication on 'Driving European Recovery'[1], the objective is to improve risk management in financial firms and align pay incentives with the sustainable performance of companies in general.

In this first stage the Commission is recommending a series of principles and best practices that Member States should ensure companies apply in the design and implementation of pay policies which reward long-term sustainable performance. A successful reform in this area depends on a real culture change in the businesses concerned. By bringing forward its Recommendations now, the Commission seeks to encourage companies to implement the principles of sustainable remuneration policy when reviewing staff contracts for the year 2010.

The Commission will follow up these Recommendations with legislative proposals to bring remuneration schemes into the scope of prudential oversight. In June the Commission will present proposals to revise the Capital Requirements Directive to ensure that regulatory capital adequately covers the risks inherent in banks' trading books, securitisation positions and remuneration policies. The Commission is prioritising legislative measures in the banking and investment banking sector since this is where the evidence of the negative impact of misaligned incentives is greatest. At a further stage, the Commission will examine additional measures in relation to non-banking financial services.

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

The Commission's existing Recommendations on directors´ remuneration in listed companies (2004/913/EC) and on the role of non executive/supervisory directors and supervisory board

[1] COM(2009)114 final of 4 March 2009.

committee (2005/162/EC) do not cover all the relevant issues exposed in recent months. In particular, the Recommendations do not require executive remuneration to be aligned with the long term interest of companies.

Following several recent high-profile cases and mounting evidence that executive pay structures need to be improved, the Commission's new Recommendation on the structure of directors' remuneration and on the process of design and operation of the remuneration policy for directors in listed companies sets out a series of new principles complementing the existing Recommendations. This is in line with the ECOFIN Council's conclusions of 2 December 2008, which 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")"*.

The scope of the new Recommendation is the same as the existing Recommendations, namely applying to directors of all listed companies.

An appropriate remuneration policy ensures pay for performance and stimulates directors to ensure the medium and long term sustainability of the company. Whilst the existing 2004 recommendation is based on the idea of pay for performance through disclosure of the remuneration policy, the new Recommendation gives further guidance in order to attain this goal based on best practices for the design of an appropriate remuneration policy. It focuses on certain aspects of the structure of directors' remuneration and the governance of directors´ remuneration, including shareholder supervision.

On the structure of remuneration policy, the new Recommendation introduces the principle of proportionality of remuneration within the company, namely by benchmarking directors' remuneration to the other executive directors in the board and the (senior) employees in the company. Severance pay (golden parachutes) should be subject to quantified limits and should not be payable in case of failure. In addition, in order to reinforce the link between pay to performance, the new Recommendation requires a balance between fixed and variable pay and subjects the award of variable pay to predetermined and measurable performance criteria.

In order to promote the long term sustainability of the company, the new Recommendation provides for a balance between long and short term performance criteria; for a deferment of variable directors' remuneration; for a minimum vesting period for stock options and shares; and for the minimum holding of part of shares until the end of employment. As a last resort, companies should reclaim variable components of remuneration that were paid on the basis of data which later proved to be manifestly misstated.

On governance of directors' remuneration policy, the new Recommendation includes principles aimed at improving shareholders' oversight of remuneration policies. It is crucial that shareholders, especially institutional investors, exercise their voting rights on directors' remuneration. To mitigate conflicts of interest, non-executives should not receive share options as part of their remuneration.

Remuneration committees play a key role in responsible pay policy. To strengthen the operation and accountability of the remuneration committee, the new principles state that at least one member of the committee should have sufficient expertise in the field of remuneration. In addition, the new principles contain an obligation for the members of the remuneration committee to be present at the general meeting where the remuneration statement is discussed in order to provide explanations to shareholders. Finally, in order to mitigate situations of conflict of interests of remuneration consultants, remuneration consultants who advise the remuneration committee should not advise other organs of the company at the same time. The new Recommendation clarifies the operation and composition of remuneration committees to improve their efficiency but within the existing role and functions as set out in the 2005 Recommendation. So the balance of power and relations with boards (or with a supervisory board structure, where applicable) remain unchanged. Any board, being set up only of non executive members of a listed company and deciding on the remuneration of executive members may also be considered equivalent to a remuneration committee.

It should be noted that nothing in the Recommendation affects the autonomy of the social partners in collective bargaining.

III. Commission Recommendation on remuneration policies in the financial services sector

In addition, the Commission is also tabling a new Recommendation on remuneration in financial services to address perverse incentives and excessive risk-taking throughout firms active in this area. The Recommendation puts the EU in the vanguard in implementing the commitments made at the G20 Summit in London on 2 April 2009. The G20 agreed to *"endorse and implement the Financial Stability Forum (FSF) tough new principles on pay and compensation and to support sustainable compensation schemes and the corporate social responsibility of all firms"*. The second Recommendation on remuneration in financial services is consistent and complementary to the FSF principles.

In terms of scope, it covers all sectors in the financial services industry, regardless of the size of the financial institution or whether or not it is a listed company. This avoids any possible loopholes and prevents a distortion of competition between different sectors and financial institutions. The principles apply to all categories of staff whose professional activities have an impact on the risk profile of the financial institution.

The new Recommendation includes 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 stakeholders and on supervisory review. This balance between structure, governance, disclosure and supervision should have a positive impact on sound remuneration policies in financial institutions, in particular to ensure such policies are consistent with effective risk-management and long-term viability.

Remuneration policies in the financial services sector should be consistent with and promote sound and effective risk management. For this purpose, financial institutions should strike an appropriate balance between fixed and variable components of remuneration.

The fixed component should be sufficiently high so as to ensure that staff do not rely exclusively on bonus payments. The variable component should be linked to performance and 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. Further, financial institutions should claim back variable components of remuneration that were paid on the basis of data which are subsequently proven to have been manifestly misstated.

The new Recommendation also introduces important new principles on the governance of decision-making on remuneration policies in financial institutions. Remuneration policy should be transparent internally, clear and properly documented and contain measures to avoid conflicts of interest. This 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. To ensure that the remuneration policy achieves its objectives, it should be updated over time to reflect 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 disclosure of remuneration policies in financial institutions is an essential condition for effective oversight. Remuneration policy should be adequately disclosed to stakeholders in a clear and easily understandable way.

The new Recommendation also sets new principles on the supervisory review of remuneration policies in financial institutions. Supervisors should 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, supervisors should 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.

Indeed, 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, it is foreseen that Member States, when implementing the general principles, may adapt and complement them according to the situation of the financial institutions concerned.

IV. Next steps

These Recommendations represent the first stage in a series of proposals to realign pay incentives with sustainable long-term performance of companies. In a second phase the Commission will present legislative proposals to empower national supervisors to compel financial institutions to implement remuneration policies that are consistent with effective risk management.

In June the Commission will address 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) through the package of modifications of the Capital Requirements Directive. The legislative changes that will be proposed will bring remuneration policies and their link with risk management clearly within prudential oversight in the supervisory review process under that Directive. Credit institutions and investment firms will be legally obliged to have remuneration policies that are consistent with effective risk management, and supervisors will be able to take measures to address any failures by credit institutions and investment firms in this regard.

The principles set out in the Commission new Recommendation on remuneration policies in the financial sector will be highly relevant to compliance with this obligation. They will provide further guidance as to how the binding obligation can be met, and a framework for regulators when assessing firms' remuneration structures in the course of the 'Pillar 2' supervisory review.

The forthcoming amendments of the Capital Requirements Directive will not supersede the Recommendation, but will complement it. The Recommendations have a clear ongoing added value, both in terms of signalling clearly to the markets the best practices that the Commission considers appropriate, pending the adoption of legislative requirements, but also since a legislative approach will need to focus on principles and will not be appropriate for setting out best practices in the level of detail that is possible in the Recommendations.

Similar legislative initiatives in other financial sectors (such as insurance) might have to be considered. Meanwhile, the Recommendation on remuneration policies in financial services will provide guidance on the principles to be applied in these sectors too and a starting point for dialogue between financial institutions and relevant supervisors in these sectors too.

The evaluation reports of 2007 of the previous Recommendations showed both strengths but also some weaknesses. The Commission intends to increase monitoring mechanisms to enhance effective application of both Recommendations. After one year, the Commission will examine both Recommendations in the light of the experience acquired and the outcome of the aforementioned monitoring and submit an evaluation report on the application by Member States of both Recommendations.

Finally, it should also be noted that the Recommendations are without prejudice to specific national measures on remuneration in the context of national rescue packages for the financial sector. The Commission has welcomed such national measures in the context of its state aid decision-making. But these measures are exceptional, serving to compensate for the distortive effects of state intervention. They can not substitute for general guidelines to be applied by all financial institutions in normal as well as exceptional market conditions.