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REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE AND THE COMMITTEE OF THE REGIONS

Report on the application by Member States of the EU of the Commission 2009/384/EC Recommendation on remuneration policies in the financial services sector (2009 Recommendation on remuneration policies in the financial services sector)

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Report on the application by Member States of the EU of the Commission 2009/384/EC Recommendation on remuneration policies in the financial services sector (2009 Recommendation on remuneration policies in the financial services sector)

(Text with EEA relevance)

1. OBJECTIVE OF THE REPORT

Whilst the level of remuneration in the financial services sector has been a much debated issue for some time now, until recently, little attention was paid to the short-term focus and lack of risk adjustment of annual bonuses/variable remuneration in the financial services industry[1].

There is, however, now a widespread consensus that annual bonuses' intrinsic philosophy encourages excessive risk-taking as, in the absence of any "malus" or "clawback" provisions, recipients can only cash part of profits they generate without bearing the consequences of any losses in case of materialisation of the risk.

These remuneration policy problems in the financial services sector are not limited to directors´ and managers´ pay, but also extend to remuneration schemes at other levels, notably to those persons whose work involves risk-taking (e.g. traders) and whose remuneration for a variable part is a function of performance.

In its Communication dated 4th March, "driving the European recovery"[2], the European Commission indicated that it 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 throughout firms.

In line with the G20 London Summit conclusions[3], the Commission Recommendation on remuneration policy in the financial services sector was adopted on 30 April 2009[4]. The

[1] In 2008, a Counterparty Risk Management Policy Group III (CRMPG III) formed in the US to analyse the credit market crisis concluded in its report that compensation schemes in the financial services were one of five primary driving forces of the financial crisis. CRMPG III stressed the need for properly aligning compensation incentives with the long term interests of the financial institution and for discouraging short-run excesses in risk taking. At EU level, de Larosière report came to the same conclusion when it recommended to focus on the structure of remuneration policy in the financial services sector and to *"re-align compensation incentives with shareholder interests and long-term, firm-wide profitability"*.

[2] Commission Communication of 4 March 2009 to the Spring European Council, "Driving European Recovery" - COM(2009) 114.

[3] G20 Summit conclusions, London, 2 April 2009, paragraph 15.

[4] Commission Recommendation 2009/384/EC on remuneration policies in the financial services sector (OJ L 120, 15.5.2009, p. 22).

Commission became the first G20 participant to implement G20 conclusions on remuneration policy in the financial services sector. The main objective of the new Recommendation is to ensure that remuneration policies of financial institutions do not encourage excessive risk taking and are in line with the long-term interests of financial institutions. The Recommendation invites Member States to adopt measures in four main areas: (i) structure of remuneration policy, (ii) governance, (iii) disclosure of remuneration policy, (iv) supervision[5].

The Commission wanted to act quickly and send a strong and immediate political signal to Member States and market operators that a substantial change in the way remuneration policies were designed and implemented had to take place.

The Commission was also of the view that the Recommendation should apply across the financial services industry, regardless of the legal status of the financial institution. The Commission considered that a limited application of the new principles (for instance only to banks and investment firms) would have left aside financial institutions which may also be of importance to maintain financial stability, and wrong incentive policies inducing excessive risk taking in these institutions could have the same consequences as in banks and investment firms. Furthermore, applying principles on sound remuneration practices only to a limited part of financial services industry could result in a distortion of competition between different sectors which compete for attracting similar talent on the same labour market.

The objective of this report, which the Commission committed to produce one year after adoption of its Recommendation, is to evaluate the extent to which Member States have put in place the necessary framework in order to give effect to the main principles of the 2009 Recommendation on remuneration policy in the financial services sector. Member States were invited to take the necessary measures to promote the application of the Commission Recommendation by 31 December 2009.

This report is based on the replies of Member States to a Commission questionnaire. This report is completed by a Commission staff working paper which accompanies this report and contains the tables that indicate the extent to which Member States have followed the requirements of the Recommendation.

2. MAIN FINDINGS OF THE EVALUATION

16 Member States (BE, BG, CY, DE, ES, FR, HU, IT, LT, LV, LU, MT, NL, RO, SE, UK) adopted national measures in accordance with the Commission Recommendation. Of the remaining 11 (AT, CZ, DK, EE, EL, FI, IE PL, PT, SI, SK) Member States, six indicated that they were in the process of preparing or adopting relevant national measures in this field.

In six Member States (DE, FR, IT, MT, NL, UK) principles on sound remuneration policies are already applicable to 2009 bonuses. In other Member States these principles are to be applied by relevant financial institutions in the course of 2010.

5 For a detailed description of the content of the Recommendation, please see the Commission staff working document SEC(2010) 671 that supplements this Report.

Only seven Member States (BE, FR, HU, LT, LV, NL, SE) adopted national measures that apply to financial undertakings across the financial services sector. In the nine remaining Member States, the scope of the national measures varies substantially, although all cover credit institutions.

All 16 Member States adopted national measures to risk-adjust remuneration policies and align them with long term interest of the financial institutions. However, there are substantial differences on the content and level of detail of the national provisions dealing with the structure of the remuneration policy.

A limited number of Member States fully implemented important recommendations on governance, such as the role of (supervisory) boards or the qualification and expertise of members of remuneration committees.

The content of disclosure requirements varies between Member States. Upcoming legislation aiming at enhancing disclosure requirements is announced in several Member States.

3. ASSESSMENT OF THE IMPLEMENTATION OF THE RECOMMENDATION

3.1. Scope and general issues

16 Member States (BE, BG, CY, DE, ES, FR, HU, IT, LT, LV, LU, MT, NL, RO, SE, UK) adopted national measures in accordance with the Commission Recommendation. 11 Member States (AT, CZ, DK, EE, EL, FI, IE PL, PT, SI, SK) have not yet adopted any specific national measures by the time of drafting of this report. Out of these 11 Member States, six (CZ, DK, EE, FI, IE and PT) indicated nonetheless that they were in the process of preparing or adopting relevant national measures[6], in particular in the perspective of the future revision of the Capital Requirements Directive (CRD)[7].

Among Member States that did not take any specific measures yet and are not in process of doing so, AT and EL argued that they already have several national provisions on remuneration. However, these provisions relate to general company law or corporate governance and do not specifically address the issues raised by the Commission Recommendation on remuneration policies in the financial services sector.

SK estimated that regulating remuneration was not necessary, taking into account low levels of remuneration of managers in Slovak financial institutions, their limited impact on the stability, low expansion of investment banking sector and investment services.

PL did not find justifiable to intervene at this stage into the remuneration schemes of private companies, leaving it to the prudence and responsibility of relevant corporate bodies to include principles of the Recommendation in their rules on corporate governance and best business practices. PL is however planning to implement national principles regarding

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6 For the purpose of this report, only Member States that adopted national measures in accordance with the Commission Recommendation will be analysed.

7 COM(2009) 362. For more details see Section 4 of this report.

remuneration policy of credit institutions and investment firms following the revision of the CRD.

With the exception of six Member States (DE, FR, IT, MT, NL, UK) for which principles on sound remuneration policies are already applicable to bonuses awarded in 2009, principles on sound remuneration polices in most Member States are to be applied by relevant financial institutions in the course of 2010.

Whilst all 16 Member States that adopted specific national measures in accordance with the Commission Recommendation cover credit institutions, only seven Member States (BE, FR, HU, LT, LV, NL, SE) adopted national measures that apply to financial undertakings across the financial services sector. In the nine remaining Member States, the scope of the national measures varies substantially:

- Six Member States (BU, CY, ES, IT[8], MT, RO) only cover credit institutions;

- One Member State (UK) also covers investment firms;

- One Member State (DE) also covers the insurance sector and investment firms;

- One Member State (LU) covers all financial undertakings except the insurance sector.

In several Member States, a threshold or a size condition is in place to trigger application of all or certain more stringent rules. In IT, the October 2009 Bank of Italy provisions have identified the six major banking groups which, in addition to the rules applicable to all banks, have to be compliant with the September 2009 FSB Implementation Standards. In the UK, the FSA’s Remuneration Code incorporated into the FSA’s Handbook applies to around 26 of the larger banks, building societies and broker dealers incorporated in the UK.

In two Member States (DE, ES), financial institutions covered are being asked to determine themselves to what extent they should be covered (self-assessment). In DE, all covered financial institutions should comply with general requirements linking remuneration policies with sound risk management and long term objectives. However, the relevant financial institution shall determine on its own, on the basis of a risk analysis, whether special requirements should apply. According to DE, "the analysis must be plausible, comprehensive and transparent for third parties".

All 16 Member States apply the principles to those categories of staff whose professional activities have a material impact on the risk profile of the financial undertaking. However, several Member States (BG, CY, HU, IT, MT, NL, RO, SE, UK), in line with CEBS guidelines, went further and captured all categories of staff with a special emphasis on senior employees and other risk takers. Some Member States (BE, DE, IT[9], SE) asked financial institutions themselves to draw a list of categories of staff that have a material impact on the risk profile of their institution. Apart from giving examples (such as senior management or

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[8] IT indicated that they have some general principles on compensation related to the provision of investment services and activities that would apply to investment firms and asset management companies (joint Bank of Italy and Consob Regulation, issued on October 2007).

[9] Only for the 6 Italian major banks.

control functions), no Member State gave a definition of categories of staff that have a material impact on the risk profile[10,11].

Most Member States (except FR) adopted national provisions on remuneration in the financial services sector through a supervisory act. This can correspond to a recommendation or to a binding legal act where the supervisory authority has been empowered to issue mandatory rules and principles. In FR, a regulation (Arrêté) was adopted by the Ministry of finance. Several Member States specified that if a relevant financial institution does not comply with their requirements, national supervisors are entitled to take supervisory measures, e.g. to require rectification of the remuneration systems ("qualitative measures") or to ask for capital add-ons ("quantitative measures"). Recommendations dealing with supervision were in some Member States implemented through legislation as they are part of general powers/prerogatives granted to competent authorities. Disclosure requirements were sometimes implemented in a corporate governance code (when they typically concern directors of listed financial institutions).

Several Member States (BG, DE, ES, UK) specified that current supervisory measures were without prejudice to forthcoming national legislation. In three Member States (DE, FR and NL) national measures were accompanied by industry's extra commitments contained in a business code.

Where national measures were adopted, all Member States indicated that they would apply to relevant financial institutions on an individual and consolidated basis[12]. In line with EU requirements, branches of EEA institutions operating in the territory of an EU Member State are not captured.

All Member States that adopted national measures included a "proportionality test" to take into account the nature, the size as well as the specific scope of activities of the financial institution. Also, all 16 Member States excluded fees and commissions from the scope of application of their national measures, in accordance with the Commission Recommendation.

3.2. Structure of remuneration policy

All 16 Member States implemented the general requirements contained recommendations 3.1 and 3.2 of the Commission Recommendation. Recommendation 3.1 establishes the general requirement that remuneration policy should be linked to sound risk management and recommendation 3.2 aims at aligning remuneration policies with long term interest of the financial institution. However, ES limited the scope of application of recommendation 3.2 to

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10 SE nonetheless specified that *"An employee whose actions can have a material impact on the risk exposure of the firm is defined in the following way: An employee belonging to a personnel category that, as a part of its assignment, exercises or can exercise a not insignificant influence on the firm's risk exposure".*

11 In the UK, covered financial institutions are expected to include "People who perform a significant influence function for a firm (and should therefore have been approved to perform this function) and employees whose activities have, or could have, a material impact on the firm’s risk profile". Presumption is that an employee in the second category is a covered employee if their total expected compensation for 2009 is greater than £1million.

12 Subject, in some cases, to the specific labour and/or fiscal law rules of third country in which the firms of the group operate.

executive and board members[13]. UK indicated that it implemented "implicitly" recommendation 3.2 (because of its overall code).

Although all 16 Member States implemented recommendation 4.1 on the need for an appropriate balance between fixed and variable pay (with the exception of ES which included the same limitation as above), only four Member States (BE, LU, MT, NL) included a requirement that financial institutions should set a maximum limit on the variable component.

15 Member States (except RO) implemented the recommendation 4.2 on bonuses policy. HU only partially implemented the recommendation as it did not provide any rule on the possibility to withhold bonuses.

While all 16 Member States implemented the recommendation 4.3 on deferral of the variable component, six Member States (BG, CY, HU, LV, MT, and RO) did not include any reference to a minimum deferment period. IT included such a reference only for the six major banks. LT did not implement this provision for the insurance sector.

All 16 Member States implemented the recommendation 4.4 on the risk adjustment of the deferred variable pay but LT did not extent its scope of application to the insurance sector.

Out of the 16 Member States, two (RO and MT) did not implement the recommendation 4.5 on termination payment. LT limited the scope to exclude the insurance sector. FR limited the scope to directors and managers of listed companies.

Only six Member States (BE, DE, ES, LU, MT, NL) implemented the recommendation 4.6 on clawback and the possibility to reclaim part (or all) of the variable component. BG, CY and HU limited the clawback to cases of fraud. IT limited its scope to the six major banks. LT did not implement it for credit institutions. FR, LV, RO, SE, UK did not implement this recommendation.

Three Member States (BG, MT and RO) did not implement the recommendation 4.7 concerning the need to update over time the structure of the remuneration policy.

All 16 Member States implemented recommendation 5.1 on performance measurement.

Eight Member States (BE, DE, ES, FR, IT, LU, NL, UK) implemented the recommendation 5.2 setting a multi-year framework for the assessment of performance. LV implemented it but added derogation for employment contracts that were shorter than the performance period. RO did not implement the recommendation. BG, CY, HU, LT, MT and SE partially implemented it to the extent that they do not foresee a specific multi-year framework but only request to take into account the longer term performance and current and future risk.

All 16 Member States implemented the recommendation 5.3 on risk adjustment of the performance measurement. However, NL did not specify that the risk adjustment should take

[13] Spain argued that taking into account that i) remuneration policy has not shown to be a problem in Spain, and ii) the need to guarantee coherence with European legislative developments, they are waiting for the adoption of the relevant European Directives to implement them.

into account the cost of the capital employed and the liquidity required. LT did not implement the recommendation for the insurance sector.

All 16 Member States implemented recommendation 5.4 relating to the insertion of non financial criteria in the individual performance assessment.

The substantial differences of national implementation on an element as fundamental as the structure of the remuneration policy are worrying. The differences even widen where the Member States (FR, DE, IT, NL, SE, UK) have also implemented the more stringent rules contained in the FSB Implementation Standards[14].

3.3. Governance

Concerning recommendation 6.1 on the need to include measures to avoid conflicts of interest and setting requirements on procedures determining remuneration, only ES did not implement it. Furthermore, MT and NL only partially implemented it as they either did not include at all any specific provisions on conflicts of interest (MT) or limited the scope to board members with a limitative list of potential conflicts of interest (NL).

All 16 Member States adopted national measures implementing the recommendation 6.2 on the role of the board. However, two Member States (BE and MT) only partially implemented it to the extent that there is no determination by the (supervisory) board of directors' remuneration. Furthermore, FR the board determines directors' remuneration only in firms having received public assistance.

Only RO did not implement it recommendation 6.3 on the involvement of control function and, where appropriate, human resources departments or external experts in the design of remuneration policy. However, DE and LT did not implement it for the insurance sector. LT further excluded banks from its scope.

Out of 16 Member States, only seven (BE, FR, LV, LU, NL, SE, UK) fully implemented the recommendation 6.4 on the expertise and qualification of (supervisory) board and remuneration committee members. LT did not implement it for banks and insurance companies. Other Member States (BG, CY, DE, ES, IT) only have general provisions on qualifications and independence of the remuneration committee members or control functions.

Concerning recommendation 6.5 on the review of the remuneration policy’s implementation by control functions, only ES did not implement it.

13 Member States (BE, BU, CY, ES, FR, IT, LV, LU, MT, NL, RO, SE, UK) implemented the recommendation 6.6 on staff members engaged in control processes. DE implemented it for credit institutions and investment firms but only partially for the insurance sector (no provisions on remuneration of control staff). LT did not fully reflect content for the insurance sector. HU did also only partially implement it as it does not provide for specific rules on remuneration for control functions, other than with regard to non-involvement of business units.

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14 There are other differences due to specific national provisions or in case of bailed financial institutions but they are more specific and limited in scope.

Overall, the level of implementation of recommendations 6.2 and 6.4 is unsatisfactory and, given their importance, is problematic.

3.4. Disclosure of remuneration policy

On recommendation 7 containing a general disclosure requirement, only ES did not implement it but informed of upcoming legislation on this issue. LT partially implement it as it did not adopt specific provisions for the insurance sector.

Recommendation 8 further specifies the content of disclosure requirements. Seven Member States (BE, FR, IT, LV, LU, SE, UK) fully implemented it. DE fully implemented it for credit institutions and investment firms but partially for the insurance sector (no detailed disclosure is required). BG, CY, LT, MT, NL and RO partially implemented it as either some requirements are missing or the scope is incomplete in terms of financial institutions covered or in terms of categories of staff (i.e. only directors)/type of legal forms (i.e. only listed companies) covered. ES and HU did not implement it.

3.5. Supervision

Recommendation 11 invited Member States to ensure that all relevant information is communicated by financial institutions to competent authorities, including an indication of compliance. Out of 16 Member States, only ES did not comply with this recommendation. LT did not foresee any specific rule for insurance companies.

Recommendation 12 invited Member States to ensure that competent authorities may request and have access to all information they deemed necessary to evaluate compliance by financial institutions. Out of 16 Member States that adopted national measures, only HU did not implement this recommendation.

4. ONGOING DEVELOPMENTS

In the Communication[15] accompanying the aforementioned Recommendations, the Commission acknowledged the latter were only the first stage in the Commission's strategy to address this issue and that legislation at EU level would also follow.

In July 2009, the Commission adopted a proposal to revise the Capital Requirements Directive (CRD)[16] tackling, inter alia, remuneration policies of credit institutions. The Commission, in a context of crisis, prioritised legislative measures in the banking and investment firms sector since this was where the evidence of the negative impact of misaligned incentives was the greatest.

In its proposal, Commission aimed at translating into EU legal requirements the principles contained in its Recommendation on remuneration policy in the financial services sector. Banking supervisors are required to oversee remuneration policies and are given the power to sanction banks which do not comply with the new requirements. They will have several measures at their disposal to sanction non-compliance, such as requiring the institution to

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15 COM(2009) 211, 30.4.2009.
16 COM(2009) 362.

reduce the risk inherent to particular remuneration systems, impose fines or, as a last resort, capital add-ons.

The general agreement adopted in the ECOFIN Council meeting of November 2009 proved the EU determination to act on this issue. Taking into account the FSB additional Implementation Standards on pay adopted in September 2009, Member States further agreed to strictly reflect them in the CRD proposal[17].

Meanwhile, similar provisions on remuneration policy were also introduced by Member States in the proposal for a directive on Alternative Investment Fund Managers ("hedge funds")[18].

Both proposals are currently being discussed in the Council and European Parliament.

5. CONCLUSION

Notwithstanding the momentum to engage a substantial reform in the area of remuneration policies provided by the crisis, only 16 Member State fully or partially applied the Commission Recommendation. Whilst six Member States are in process of adopting measures to promote the application of the Recommendation, there is still a relatively high number of Member States that did not initiate any measures or took unsatisfactory ones. Only seven Member States apply relevant measures across the financial services sector. The substantial differences of national implementation on an element as fundamental as the structure of the remuneration policy are worrying.

Further efforts are thus needed to deal with this problem. No successful reform can be engaged without a real culture change in the way the financial services sector decides to incentivise its staff (from employees to executives). Some financial institutions already expressed their opposition to a reform in this area and continue to perceive short term bonus culture as a distinctive competitive edge and the most profitable manner to incentivise their staff. In fact, financial institutions have a keen interest in perpetrating a short term bonus culture in order to maintain a highly flexible workplace[19]. Financial services employees will only change their risk behaviour if they know they will be assessed over a sufficiently long period of time and that their level of pay will be effectively reduced if they take excessive risks.

Notwithstanding the forthcoming legislation, supervisory guidance will be necessary to ensure a common approach within the EU. To ensure a global level playing field, supervisory convergence will also be required in the context of the Basel Committee.

As regards practices in financial institutions themselves, at this stage, it is difficult to assess if and to what extent financial institutions have, in practice, put into place sound remuneration policies. It is too early and most of the regulatory changes are still ongoing. Though financial institutions have started to modify their remuneration practices, given their concerns about

[17] See agreement found on 10 November 2009 during ECOFIN Council.

[18] COM(2009) 207, 30.4.2009.

[19] Short-term bonuses imply short tem employment contracts. Being able to reduce the number of employees any times a year, financial institutions enhance competition amongst staff and preserve the level of bonus pools as part of this culture of mobility.

first-mover disadvantages, it is unlikely that they will commit to a long term overall remuneration policy reform until adoption of pending legislation in this area[20]. Although financial institutions are communicating externally and "tactically marketing" some remuneration policy changes, in particular for their directors[21], very little or no information is yet available or disclosed on individual remuneration at a lower level and on its structure.

On its side, the Commission intends to:

– propose similar legislative measure on remuneration in the non banking financial services sector (insurance, UCITS) in the course of 2010/early 2011;

– ensure that Member States and the European Parliament find a swift agreement on the pending legislative proposals that deal with remuneration issues and commit to a strict monitoring of their future implementation by Member States;

– ensure that, through its participation to the FSB and G20, an effective application of similar rules on remuneration policy in the financial services sector is taking place at global level to provide a level playing field on this issue;

– re-examine the situation regularly and reserve the right to come with any additional measures, as required.

[20] The recent IIF report states that though *"Progress toward aligning compensation with the IIF/FSB Principles also was being made, much more work needed to be done. While a majority of the firms surveyed linked compensation to performance and used deferrals in compensation payouts, most faced challenges in aligning compensation to the risk time horizon of the revenue and in incorporating cost of capital and risk factors into the assessment of performance"*.

[21] This includes self limitations or caps on bonuses or golden parachutes for top executives, substantial amount of money given to charity, etc.