

# **Mandatory Limits on Executive Remuneration A Comparative Analysis**

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*Annual Conference on European Company Law, March 2010*

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# EXECUTIVE REMUNERATION BEFORE THE CRISIS

## The EU context

### 2004 Recommendation on Pay

- Disclosure of company pay policy (detailed recommendations)
- Disclosure on individual pay
- Shareholder vote
- Prior approval of share-based scheme

### 2005 Recommendation on Independent Directors

- 'Sufficient' numbers of INEDs
- Guidance on independence
- Remuneration committee: exclusively NED, majority INEDs
- Functions of the RC

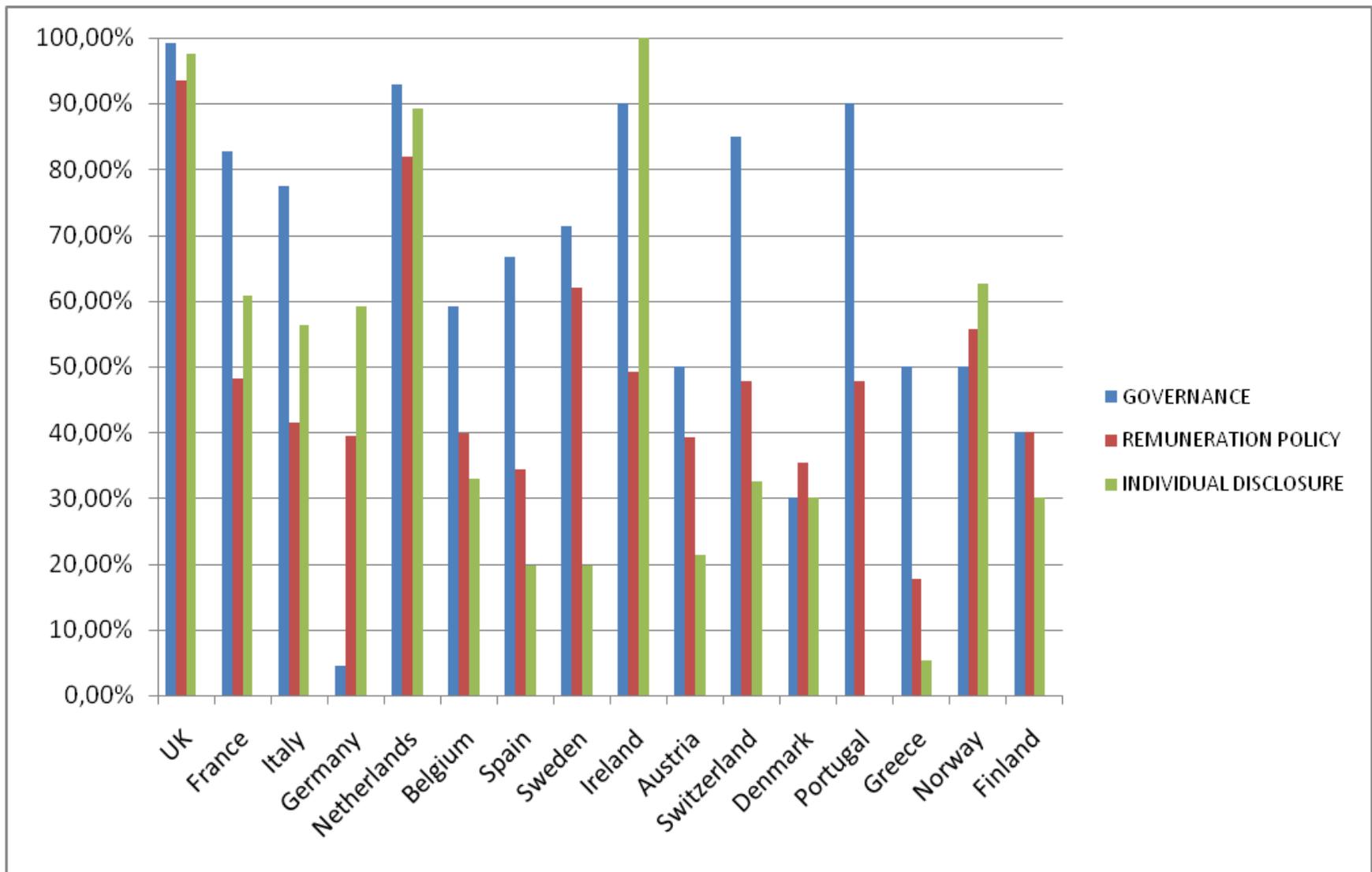
# EXECUTIVE REMUNERATION BEFORE THE CRISIS

## Implementation national rules

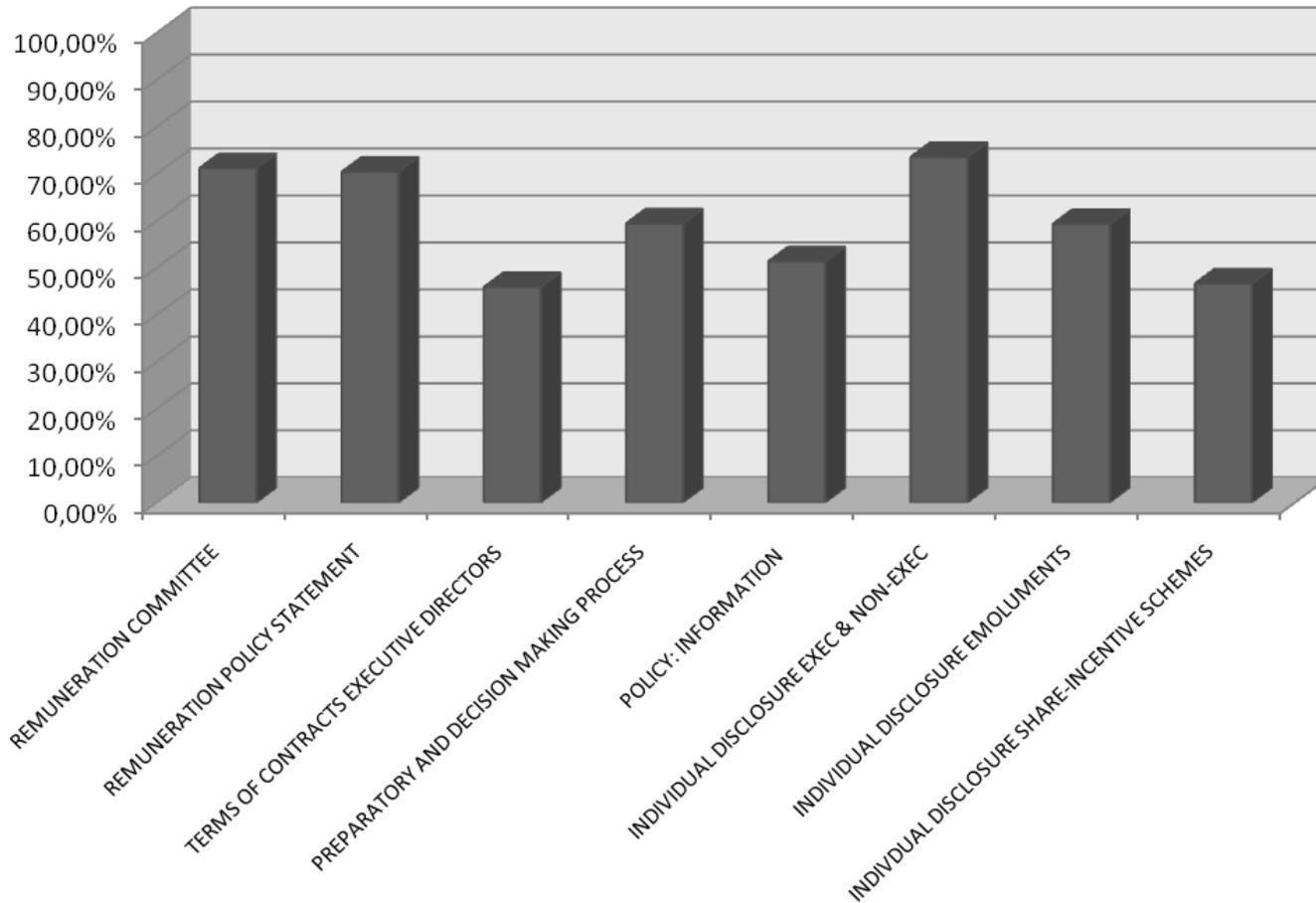
- Primarily corporate governance codes
- Divergences across Member States

## Implementation by firms (Research FTSEurofirst 300)

- Divergences; firms tend to follow national corporate governance principles, without going beyond these guidelines
- Focus on core disclosure requirements
- Low levels of disclosure of details
- Remuneration policies scattered throughout annual reports



## 8 Categories



# CRISIS & POST-CRISIS REFORMS

## Scope

- Firms across sectors
- Financial sector (primarily)

State-aided financial institutions

All financial institutions

Systemically important financial institutions

# CRISIS & POST-CRISIS REFORMS

## Sources

- Global Principles
- European Regulations
- National Corporate Governance Codes
- National Legislation
- Banking Associations / Supervisory Authorities  
(following the G20 and FSB rules)

# GLOBAL LEVEL

- FSF Principles
- FSB Implementation Standards
- Basel Committee: Assessment Methodology
- Others (e.g. OECD)

# FSB Principles and Implementation Standards

- Apply to “significant financial institutions”
- Focus on areas in which especially rapid progress is needed
- Aim to ensure a level playing field, therefore must be consistently implemented across jurisdictions
- Reinforced through supervisory examination and intervention at national level
- Not used as a pretext to impede market entry

# FSB Principles and Implementation Standards (cont.)

- **Effective governance of compensation**
  - Corporate governance reforms to ensure appropriate board oversight of compensation and risk
  - Greater independence and accountability of boards and RC
- **Effective alignment of compensation with prudent risk-taking**
  - Global standards on pay structure which provide for:
    - Balanced compensation (fixed and variable, cash and equity)
    - Deferral
    - Clawback
- **Effective supervisory oversight and engagement by stakeholders**
  - Greater disclosure and transparency of level and structure

# EU LEVEL

- Recommendation as regards the regime for the remuneration of directors of listed companies
  - Complements & strengthens previous 2 Recommendations
- Recommendation on remuneration policies in the financial sector
- CEBS Principles on Remuneration Policy
- Proposal for the revision of the Capital Requirements Directive

# RESTRICTIONS STATE-AID

- European Commission's Communications:  
Banking Communication, Recapitalization Communication, Impaired Asset Communication
- UK: limits imposed on Lloyds and RBS
- France: Decree on rules of compensation for senior corporate executives
- Germany: SoFFin (Special Fund Financial Market Stabilization) limits
- Netherlands: limits on recapitalization measures

# UNITED KINGDOM

- Financial Reporting Council: Review of the Combined Code
- Financial Services Authority: Code of Practice on Remuneration Policies
- Walker Review
- Financial Services Bill
- ABI Guidelines on Executive Remuneration

# Review of the Combined Code

## The FRC's Final Report on its Review of the Combined Code

- Proposed changes are quite far-reaching
- A new "supporting principle" (previously a Code provision and a recommendation on pay design)
  - Performance targets should be stretching to promote the long-term success of the company
- Design:
  - Deferral of bonuses
  - Clawback clause
- Incentives subject to challenging performance criteria, including non-financial performance metrics (e.g. strategic performance)

# FSA Code on Remuneration Policies

- ✓ August 2009
- ✓ Limited scope: specific UK financial institutions, most of which banks, broker dealers or building societies
- Compatibility with the implementation of the plans of supervisory authorities in other major financial centres
- Proposals to incorporate the Code into FSA's Handbook
- FSA: increasing the focus on remuneration within its supervisory programme

# FSA Code on Remuneration Policies (cont.)

- FSA intervention is principle-based, avoiding excessive detail
- No specific requirements as to levels of remuneration
- Focuses on the processes for determining remuneration
- Eight principles - “evidential provisions”
  - if breached, would have evidential value in showing that the overriding general principle has not been met
- The overriding principle: the firm should ascertain its risk tolerance level and operate within this level
- Additional risk may have to be offset by making provision for increased capital

# FSA Code on Remuneration Policies (cont.)

## Remuneration structure

- Fixed component: a sufficient proportion of total remuneration
- Non-financial performance metrics: a significant part of the performance assessment process
- Bonus pool assessed by reference to net profit (rather than revenue)
- At least two thirds of bonus deferred
- Deferred piece: provision for clawback
- Guaranteed bonuses running for more than 1 year- prohibited

# Walker Review

- ✓ November 2009
- ✓ Principles may significantly impact on remuneration practices within the UK financial services industry
- ✓ FRC finds that Walker's measures are largely restricted to the financial sector
  - More power for RC to scrutinize firm-wide pay
  - Significant deferred element in bonus schemes
  - Greater disclosure of pay beneath board level
  - Chairman of RC to face re-election if the remuneration report gets less than 75% approval

# ABI Guidelines on Executive Remuneration and an accompanying Position Paper

- Encourage a focus on risk management in executive remuneration
- Remuneration policy and practices to take risks fully into account
- Performance conditions to take account of risk
- “Boards should consider disclosure of these risks and how they are managed in accordance with the obligations under the Enhanced Business Review”

(The "Enhanced Business Review" - the requirement, under section 417 of the Companies Act 2006, for directors to report to members and help them assess the directors' performance of their duty to promote the success of the company)

# Bank Payroll Tax

- ✓ UK Pre-Budget Report (2009)
- ✓ Legislation in the Financial Services Bill 2010 to introduce a new bank payroll tax
- ✓ Targeted at UK financial institutions, as well as UK branches of foreign financial institutions
- A one-off charge of 50% on any bonuses in excess of £25,000 awarded to individual banking employees
- Employees' tax position is unaffected by the levy

# FRANCE

- AFEP / MEDEF Corporate Governance Code of Listed Corporations
- Government Decree (Financial Institutions)
- French Banking Federation: Professional Rules
- Draft Bill for Amended Finance Act (Taxation of traders' bonuses)

# AFEP / MEDEF Corporate Governance Code of Listed Corporations

- ✓ December 2008
- ✓ Particular attention to a “balanced” and “appropriate” compensation

Some specific recommendations:

- Benchmarking compensation with the business sector and the European & global market (in contrast with other recent reforms)
- Fixed compensation may only be reviewed at relatively long intervals, e.g. every 3 years
- Variable compensation: a maximum percent of the fixed part

# AFEP / MEDEF Corporate Governance Code of Listed Corporations (cont.)

- Award of options and shares: taking into account the level of dilution
- Exercise of shares related to performance conditions met over a multi-year period
- Termination payments:
  - conditional upon performance requirements
  - should not exceed 2 years' payments (fixed and variable)
  - only paid for forced departures

# **Government Decree regarding compensation of employees whose actions may have a material impact on the risk exposure of credit institutions and investment firms**

✓ 3 November 2009

- Specific recommendations:
  - Variable remuneration taking account of risk (liquidity, capital)
  - Deferral of variable remuneration
  - Deferred part based on performance
  - A significant part of the variable remuneration paid in shares
  - Grant of shares subject to a retention period

# **French Banking Federation: Professional Rules for the Governance and Variable Compensation of Financial Markets Professionals**

- ✓ November 2009
- ✓ Derive from the commitments made at the meeting held on 25 August 2009 between the FBF and the French President
- ✓ Based also on the Ministerial Decree of 3 November 2009
- ✓ Apply to French banking firms from 2009, on compensation to be paid on 2010

## French Banking Federation: Professional Rules (cont.)

Variable remuneration:

- Based on net profit
- Deferred over at least 3 financial years
- The amount of deferred variable varies according to the level of variable compensation:
  - generally minimum 50%
  - min 60% for the highest variable compensation
- At least 50% of the deferred part to be paid in shares
- Award of shares: minimum retention period of 2 years
- Malus of deferred element
- Payment of guaranteed bonuses is prohibited

# **Draft Bill for Amended Finance Act (Taxation of traders' bonuses)**

- Emulates UK bonus tax
- Banks operating in France
- A one-off supertax of 50% on any bonuses in excess of € 27,000 (based on performance realised in 2009)
- Employees' tax position is unaffected by the levy

# GERMANY

- Corporate Governance Code
- Law on the Adequacy of Remuneration of Executive Board Members (VorstAG)
- Federal Financial Supervisory Authority (BaFin) Guidelines on Minimum Requirements for Risk Management (MaRisk)

# Corporate Governance Code (2009)

Main reforms:

- Increasing the role of the Supervisory Board in determining compensation of the management board members
- Compensation oriented towards long-term sustainable performance, not encouraging risk-taking
- No rewards for failure

# Act on the Appropriateness of Management Board Compensation (VorstAG)

- ✓ August 2009
- ✓ Applies to all stock corporations irrespective of industry sectors
- Criteria for determining the ***appropriate*** level of remuneration:
  - Based on director's performance
  - Accounting for company's position
  - Not exceeding the "*usual*" remuneration without good reasons
    - sector & market standards (horizontal comparability)
    - salaries paid within the company (vertical comparability)
- Remuneration structure oriented towards sustainability

## VorstAG (cont.)

- Increased responsibility and liability of the Supervisory Board
  - decide on the Management Board remuneration  
(assigns only a preparatory function to the RC)
  - apply a possible reduction in remuneration
- Members of the SB held liable for the difference between determined remuneration and the appropriate remuneration
- Non-binding vote on the remuneration structure

# Minimum Requirements for Risk Management (MaRisk)

- ✓ The Federal Financial Supervisory Authority (BaFin): refined and extended its MaRisk for financial institutions
- ✓ August 2009
- Compensation practices aligned with long-term risk, profitability and stakeholder interests
- Variable compensation of employees with activities impacting on risk to be based on the profitability of the unit and the firm
- Deferment of variable remuneration
- No link to short-term profits in the variable remuneration of staff involved in high risk positions
- Clawback provision

# THE NETHERLANDS

- Corporate Governance Code Monitoring Committee:  
Corporate Governance Code
- Netherlands Bankers' Association: Banking Code

# Corporate Governance Code

- ✓ December 2008
- The level and structure of remuneration to be determined with due regard to the pay differentials within the enterprise
- Link remuneration with long-term objectives
- Options granted dependent on the achievement of challenging targets specified beforehand
- Options vesting period: minimum 3 years
- For shares granted without financial consideration: retention period min. 5 years / until the end of the employment
- Remuneration in the event of dismissal: 1 year's fixed salary
- Bonus malus, clawback

# Banking Code

✓ Netherlands Bankers' Association, September 2009

- Total remuneration of individual executives slightly below the median level for comparable positions in the relevant markets, both inside and outside the financial sector
- Variable remuneration: deferment within at least 3 years
- Annual variable remuneration not exceeding 100% of the individual's fixed salary
- Greater responsibility for Supervisory Boards:
  - To reclaim variable remuneration based on inaccurate data
  - To adjust the variable remuneration if results undesirable

# ITALY

- Corporate Governance Code – under review
- Bank of Italy: Supervisory provisions concerning banks' organization corporate governance
- Bank of Italy: Remuneration and incentive systems

# Bank of Italy: Supervisory Provisions Concerning Banks' Organization Corporate Governance

✓ March 2008

- Remuneration schemes do not conflict with a bank's prudent risk management
- Non-binding shareholder vote on remuneration policies
- Importance of the RC and its independence
- Provisions for disclosure

# Bank of Italy: Remuneration and Incentive Systems

- ✓ October 2009
- Banks are required to align their remuneration policies to international standards, adjusting them according to size, complexity, type of activity etc.
- Incorporates most FSB provisions for the variable remuneration:
  - Deferment
  - Based on multi-annual performance
  - Bonus malus
  - Severance payments based on achieved performance

# BELGIUM

- Corporate Governance Code
- CBFA: Recommendation Regarding Sound Remuneration Policies in Financial Institutions

# Corporate Governance Code

✓ March 2009

“The Company shall remunerate directors and executive managers fairly and responsibly”

Main provisions:

- Focus on disclosure (although still on a global basis for executive directors)
- Share vesting: minimum 3 years
- Severance pay
  - Not exceed 12 months' basic and variable salary
  - Increase to 18 months exceptional circumstances
  - Based on performance criteria

# Recommendation Regarding Sound Remuneration Policies in Financial Institutions

- ✓ Belgian Banking Finance and Insurance Commission (CBFA), October 2009
- ✓ Banks, insurance companies, brokers & investment companies
- Appropriate balance fixed-variable pay: fixed component a sufficiently high proportion
- A maximum limit should be set on the variable component of remuneration
- The major part should be deferred with a minimum, reasonable, deferment period
- Bonus malus, clawback
- Failure to fulfill standards will result in greater Commission scrutiny and could lead to an increase in capital requirements

# SWITZERLAND

- Finma: Compensation Regulations Issued for Swiss Banks and Insurance Companies

# Compensation Regulations Issued for Swiss Banks and Insurance Companies

- ✓ Swiss Financial Market Supervisory Authority (FINMA), October 2009
- ✓ Banks, insurance companies and other financial institutions
  - Compensation schemes to increase employees' risk awareness
  - Disclosure of remuneration structure for all employees
  - Variable remuneration to be paid only if the financial institution realized an added value over a long period of time, after deducting risk capital costs
  - Deferred remuneration varies in value during specific holding periods in order to increase risk management and sustainability awareness

# Remarks

## Main new provisions:

- Increased importance of remuneration governance
  - Disclosure
  - Process
  - Design
  - Stakeholder view
- Risk management as a factor in remuneration policy
- Application of remuneration policy to a wider pool of employees
- Benchmarking salaries against compensation levels internally
- Alignment with real, long-term performance through deferral, clawback

# Remarks

## Further issues

- International coordination of regulation
- Extending regulations to all financial institutions
- Extending some provisions to all sectors
- A one-size-fits-all approach should be avoided:  
flexibility in the application of certain principles

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