

REFORMING COMPENSATION

THE LATEST FACTS FROM EUROPE



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*Transatlantic Corporate Governance Dialogue
Securities and Exchange Commission, Washington DC, 17 September 2009*

EU Regulations on directors' remuneration

- European Commission
- Member States
 - All public companies
 - Financial industry
 - State-aided financial institutions (FI)
- Recent global coordination

EC Regulation: Public Companies

Apr 09: Recommendation as regards the regime for the remuneration of directors of listed companies

Complements & strengthens previous 2 Recommendations
(2004/2005)

Additional principles:

- Structure of directors' remuneration
- Process for determining remuneration
- Control of process

Objectives:

- Long-term sustainability of the remuneration policy
- Incentives based on measurable performance criteria
- Avoiding rewards for failure

EC Regulation: Financial Sector



Feb 09: Report by High-Level Group of Financial Supervision in the EU chaired by Jacques de Larosière

IIF Principles:

- Transparency
- Alignment with shareholder interests and long-term profitability

Proposals:

- Bonuses set in a multi-year framework
- No guaranteed bonuses
- Applying to bankers and to traders and asset managers

Apr 09: CEBS Principles on Remuneration Policy (banks)

- Transparency towards internal and external stakeholders
- Governance with respect to oversight and decision-making
- Performance measurement
- Forms of remuneration (proportionality, deferral, consideration of risk)

Apr 09: Recommendation on remuneration policies in the financial sector

Structure of pay

- Appropriate balance core pay – bonus levels
- Bonus deferred to take into account risks
- Adjust underlying performance for risk, cost of capital and liquidity
- Provisions for clawback

Governance

- Remuneration policy: transparent externally & internally
- Board independence and increased responsibilities
- Involvement of internal control and HR functions

Recommendation on remuneration policies in the financial sector (cont.)

Disclosure

- Accounting for the nature, size and scope of activities
- All core elements of the remuneration policy, design & operation

Supervision

- Increased role of the supervisory authorities
- Take account of the nature and scale of the FI

Proposal: Revision of the Capital Requirements Directive (effective end of 2010)

Imposes capital sanctions on banks with remuneration policies found to generate unacceptable risks

EC Regulation: State-aided Financial Institutions



EU State aid schemes - financial sector

- State guarantee schemes for bank deposits and newly issued debt securities
- Recapitalisation measures
- Asset relief measures
- Nationalisations
- Ad hoc state interventions

- ✓ Coordination through common principles

Oct 08: **Banking Communication** for rescue operations

- Management should not retain undue benefits – governments may have, *inter alia*, the power to intervene in remuneration

Jan 09: **Recapitalisation Communication**

- Limitation of executive remuneration and distribution of bonuses

Feb 09: **Impaired Asset Communication**

- Caps on executive remuneration should be considered

Member States Regulation: State-aided Financial Institutions

✓ Coordination among Member States (MS)

Conditions for FI applying for State aid schemes:

- Reporting requirements
- Restoring borrowing capacity
- Dividend policy
- Adoption of specific business strategies
- Financing the real economy
- Government board representation
- ***Limitations on remuneration of directors***

Limitations on remuneration

Sustainable remuneration policy

Taking account of risks

Avoiding rewards for failure

Restrictions on:

- salary increases
 - bonus payments
 - award of stock / shares
 - executive severance packages
- ✓ To be extended to the overall financial sector

United Kingdom

Government conditions - recapitalisation of RBS & Lloyds

- For 2008: no cash bonuses to board members
- Remuneration policy for subsequent years:
 - Incentive schemes to be reviewed
 - Linked to long-term value creation
 - Taking account of risks
 - Reducing the potential for rewards for failure

APS (Asset Protection Scheme):

- To implement a remuneration policy consistent with the principles of the FSA Code of Practice on Remuneration

Germany

SoFFin (Financial Markets Stabilisation Fund)

- Re-examination of compensation systems
- EUR 500,000 (USD 670,000) annual salary cap for top executives for the financial years 2008 and 2009
- No payout of compensation upon termination
- No bonus payments that are not legally required

Banks that only tap credit guarantees are exempt

France

Reform of the rules of compensation for senior corporate executive of State-aided or State-supported companies

- Bonuses authorized for a period not exceeding 1 year
- No bonuses if “large scale lay-offs” are necessary
- Prohibiting the allocation of stock options and free shares
- Severance pay max. 2 years’ compensation

Italy

Banks to adopt a Code of Ethics providing for, among other things, rules governing the remuneration of top management

Most other MS: adopted measures curbing executive pay

Member States Reforms: Financial Sector



United Kingdom

Oct 08: FSA - “Dear CEO” letter

- CEOs to review remuneration policies against a set of criteria

Feb 09: FSA - draft Code of Practice on Remuneration Policies (effective from 1 January 2010)

- Main principle: Remuneration policies consistent with effective risk management
- Quantum: a matter for boards and shareholders
- No contracts providing guaranteed bonuses for > 1year
- For senior employees 2/3 of bonuses spread over 3 years

Mar 09: Turner Review

a Regulatory Response to the Global Banking Crisis

- Remuneration policies to avoid incentives for undue risk-taking
- The development and enforcement of the UK and global codes

Jul 09: Walker Review

Consultation Paper on Bank Corporate Governance

- Power for Remuneration Committees to scrutinize firm-wide pay
- Significant deferred element in bonus schemes
- Greater disclosure of pay, also beneath board level
- Chairman of RC to face re-election if the remuneration report gets less than 75% approval

May 2009: Treasury - Banking Crisis: Reforming Corporate Governance and Pay in the City

- Clear failings in the remuneration process in the banking sector
- Concerns that the Turner Review downplays the role that remuneration played in causing the banking crisis
- Questions whether the FSA had attached sufficient priority to tackling remuneration
- Proposed reforms:
 - Enhanced disclosure, also below board level
 - Remuneration committees more open and transparent
 - Code of Ethics for remuneration consultants

France

Aug 09: Meeting with representatives of the French banking and finance sector – President's Communiqué

International initiative to increase oversight of bonuses

- Policy applying to bankers and traders
- 2/3 of bonuses deferred over a period of time to take account of results
- 1/3 of the deferred part of the bonus paid in stock
- Bonus malus: applying within a 2-year period

Netherlands

Sep 09: Provisional Banking Code (Association of Dutch Banks)

- ✓ Voluntary; to be written into law
- Variable remuneration: related to bank's long-term objectives
- Annual variable pay not exceeding 100% of annual fixed pay
- Variable remuneration based on performance of:
 - Individual
 - Division
 - Bank as a whole
- Financial performance adjusted for estimated risk & capital cost
- Supervisory board: discretionary power to adjust variable pay
- Provisions for clawback
- Severance pay not exceeding 1 year's fixed salary

EU & Global Coordination



3 Sep 09: Joint letter UK, France, Germany

- ✓ Binding rules (financial sector)
- Improve governance: role of the compensation committees, risk controllers; discretion for the supervisory board
- Enhance transparency
- Risk awareness
 - Link the size of bonus to fixed pay and to performance
 - Retaining stock options
 - Restricting guaranteed bonuses
 - Deferring awards
 - Clawback

5 Sep 09 (G20, London): Declaration on further steps to strengthen the financial system

- Global standards on pay structure

Conclusive Remarks



Nearly all MS that adopted State aid schemes implemented limits on executive remuneration

Initiatives have an unprecedented global scope

✓ Effectiveness still to be proven

Most FI receiving State aid did not award annual variable pay

Several FI that not received State aid also waived annual bonuses

✓ “Crisis” measures or long-term commitments?

Global coordination: binding rules

Corporate Governance still matters

✓ Prescriptive or principle-based rules?

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