REFORMING COMPENSATION

THE LATEST FACTS FROM EUROPE

Guido Ferrarini
Maria Cristina Ungureanu

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 > 1 year
• For senior employees 2/3 of bonuses spread over 3 years
Mar 09: **Turner Review**

*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?
Contact

Prof. Guido Ferrarini  
E-mail: guidoferrarini@unige.it  
Tel: +39 010 5531814

Dr. Maria Cristina Ungureanu  
E-mail: mariacristina.ungureanu@unige.it  
Tel: +39 010 2099894

University of Genoa, Italy