EU Recommendation

REMUNERATION POLICIES IN THE FINANCIAL SERVICES SECTOR

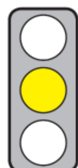
Status: 22.06.2009

cep Centrum für Europäische Politik

MAIN ISSUES

Objective of the Recommendation: The EU Commission wishes to prevent staff at financial undertakings from taking excessive risks due to certain remuneration practices representing an incentive to do so. Therefore, the Commission recommends establishing principles on sound remuneration policies in the financial services sector.

Parties affected: All financial service providers and their staff; supervisory authorities.



Pros: (1) The Commission is right in emphasising that certain remuneration practices of financial service providers can generate risks which are currently not taken into sufficient consideration.
(2) It is reasonable to incorporate through supervisory rules the risks emanating from remuneration practices into the requirements for own capital to be withheld.

Cons: The Commission does not explicitly reject a direct regulation of wages.

CONTENT

Title

Recommendation C (2009) 3159 of the Commission of 30. April 2009 on **remuneration policies in the financial services sector**

Brief Summary

- **Role of remuneration policies in the financial crisis**
  – The Commission holds the view that the financial crisis was partly induced by failed remuneration practices in the financial services sector.
  – The Commission recommends to Member States that the following principles for a "sound remuneration policy" be implemented into the financial services sector by the end of 2009.
- **Undertakings affected**
  – The Recommendation covers all financial undertakings seated in the EU or having their headquarters in the EU, and there specifically the staff members whose professional activities have an impact on the risk profile of the financial undertaking.
  – Regarding the remunerations and severance agreements of members of the managing board of listed companies, the Commission has submitted a separate Recommendation [C(2009) 3177].
  – Financial undertakings include banks, (re-) insurance undertakings, investment firms, pension funds, UCITS investment funds and undertakings with "similar" business activities.
  – The Commission wishes to apply the remuneration principles to all business areas of financial undertakings, including their subsidiaries in offshore financial centres outside the EU.
- **Principles of remuneration policies**
  – The Commission basically requires that the "remuneration policy" of financial undertakings be
    - consistent with a "sound and effective risk management" and does not provide staff with incentives for "excessive risk taking";
    - in line with the business strategy of the financial undertaking as well as with its objectives, values and long-term interests.
  – The Commission requires the following from the balance of fixed and variable remuneration components:
    - The fixed remuneration component should be sufficiently high in order to avoid staff "dependence" on bonus payments.
    - Each financial undertaking should set a maximum limit on variable remuneration.
    - Where "significant bonus" payments are due, the "major part" of it should be paid only after a "minimum" deferment period and take into account outstanding risks.
    - Severance agreements awarded on a contractual basis should be related to performance achieved and "not reward failure".
    - Supervisory boards should be entitled to require the repayment of bonuses awarded on a "manifestly misstated" performance assessment.

– The Commission requires that when measuring performance which is relevant for variable remuneration
  - the performance of the last three to five years be taken into account;
  - the performance of individuals and their business units be take into account, as well as the results of the whole financial undertaking;
  - non-financial criteria also be taken into account, such as compliance with internal rules and procedures and with the standards governing customer care.
– The supervisory board of a financial undertaking should be in charge of establishing the general principles for the remuneration policy and of determining the remuneration of managers. Control functions and, where appropriate, human resources departments and/or external experts should also be involved in the design of the remuneration policy and review its implementation at least once a year.

► **Transparency**
Financial undertakings should be obliged to disclose, in a clear and easily understandable way – e.g. in the annual financial statement – information on:
– the criteria employed to measure performance and the link between pay and performance;
– the decision-making process used for determining the remuneration policy, including the names of all persons involved;
– the parameters and rationale for variable remuneration, in particular where these are remunerated in the form of shares or share options.

► **Supervision**
The national supervisory authorities should monitor whether the recommended principles are followed, taking into account the size of the financial undertaking and the nature and complexity of its activities. Therefore, supervisory authorities should have access to all relevant information in all financial undertakings.

Changes Compared to the Status Quo

To date only the MiFID Directive on markets in financial instruments (2004/39/EC) and the Directive on insurance mediation (2002/92/EC) contain rules on remuneration in the financial services sector.

Statement on Subsidiarity

As is common practice with recommendations, the Commission does not give a formal statement on subsidiarity. However, it indicates that most financial undertakings are operating at cross-border level and thus only harmonised remuneration principles in all Member States can avoid distortion of competition.

Political Background

The public debate about bonus payments to staff members of the financial industry was characterised by single cases where high compensations were paid despite the financial crisis.
Prior to this Recommendation, in its Communication "Driving European Recovery" [COM(2009) 114], issued for the Spring Conference of the European Council, the Commission had announced legislative measures allowing for supervisory reviews of remuneration practices in the financial services sector. For the banking sector the Commission announced that it would be proposing in June 2009 amendments to the Directive on capital requirements for banks ("Basle II"), which should allow the inclusion of remuneration practices into capital requirements for financial service providers (press release IP/09/674 by the Commission of 29. April 2009).
In this context the Commission instigated a public discussion ("round table") on the remuneration of managers (also of financial undertakings) in March 2009.

Options for Influencing the Political Process

Leading Directorate General:	DG Internal Market and Services
Consultation procedure:	From 29. April until 6. May 2009 the Commission held a public consultation on the consideration to integrate remuneration policies for banks into the capital requirements to be withheld ("Basle II").

ASSESSMENT

Economic Impact Assessment

Ordoliberal Assessment

Variable remuneration practices (bonus schemes) are widespread in the financial industry. The Commission's assumption that many of these schemes are not designed in an optimal way as far as risk management is concerned does not only apply to individual cases.
In fact these **remuneration systems** can, in their concrete design, increase a staff member's tendency to take risks where only success is rewarded and failure insufficiently sanctioned, and when the integration with risk

management is inadequate. The incentives set by such a remuneration policy **can create risks not only for single financial service providers but for the overall financial system**.

This applies particularly to banks – which often lend each other money – and for insurance companies affiliated to banks through financial conglomerates. For pension funds and UCITS investment funds such system-relevance cannot be assumed. The supervision of their remuneration schemes is therefore not necessary.

With its Recommendation the Commission's commendable aim is to neutralise these risks. However, it remains unclear how the Recommendation will contribute to the achievement of this goal.

In as far as the aim of the Recommendation is to arrive at a direct **regulation of the remuneration of financial managers** through Member States, it **is not convincing**.

Such an option is implied by the Commission when it argues that "self-regulation and international standards are not sufficient to achieve an effective and durable change of practices on remuneration in financial institutions". (SEC (2009) 581, p. 4)

Such **a direct, legislative provision on the maximum amount of bonuses, detailed rules on** severance agreements **or the definition of criteria according to which "performance" is measured** are all problematic. They represent an extreme **disregard** for **the freedom of contract**. In contracts concluded under private law the contract parties concerned should be free to agree on these issues themselves.

However, it is more likely that the Commission will prefer another, indirect way of regulation. Regarding banks and insurance companies, in particular the Directive on capital requirements for banks ("Basle II") and the Directive on solvability ("Solvency II") are suitable for such indirect regulation. With these Directives risks taken by banks or insurance companies are gathered and evaluated by means of a risk-mathematical approach and finally priced in – through the capital to be withheld.

Amendments of the Directives on capital requirements and solvability should ensure that the remuneration policy is taken into account in the form of an "operational risk": **remuneration schemes leading to excessive risk should lead to a correspondingly high level of own capital requirements**. Thus the risks of a one-sided remuneration policy could be taken into account without intervening in the details of single remuneration.

Since the Commission has already announced legislative proposals in this regard – for banks as a start – the present Recommendation is to be regarded above all as a political signal: Unlike a Proposal which amends existing Directives, the recommendation facilitates a statement from the Commission that is quick and has public appeal. However, the Recommendation also sets the course for the technical implementation measures which, in the case of an amendment to the capital and solvability Directive, prescribe how supervisory authorities should evaluate the risks induced by remuneration schemes.

The transparency recommended by the Commission for the use of remuneration schemes can complement this indirect regulation in a meaningful way. The financial crisis has raised shareholders awareness of the risk-taking of financial undertakings. A higher degree of **transparency enables owners to pay more attention that remuneration schemes do not represent incentives for taking unintended risks**.

Impact on Efficiency and Individual Freedom of Choice

The national regulation of remuneration policy in the financial sector suggested by the Recommendation reduces the competitiveness of this industry and thus causes loss of efficiency, since talented managers will turn towards less regulated industries. This drain of human capital equals a discrimination of the financial industry.

Impact on Growth and Employment

Insignificant.

Impact on Europe as a Business Location

Insignificant.

Legal Assessment

Legal Competence

To ensure the sound operation and development of the common market the Commission is entitled to give Recommendations to Member States (Art. 211 TEC).

Subsidiarity

Recommendations by the Commission do not constitute binding measures (Art. 249 (5) TEC). It is left to the Member States' to decide whether or not and by which measures to follow them. Therefore the issue of subsidiarity is not relevant.

Proportionality

Does not apply.

Compatibility with EU Law

Unproblematic.

Compatibility with German Law

In Germany, parliamentary groups from the CDU/CSU and SPD have submitted a draft law on the "Adequacy of the remuneration of managers" in corporations (BT-Drs-16/12278 of 17 March 2009). It is to set incentives for

remuneration structures which strengthen corporate governance that is sustainable and aims at long-term profitability. However, this draft does not make any distinction between financial undertakings and other commercial enterprises.
In Germany the special rules recommended by the Commission for the financial services sector would require amendments to the German Banking Act (*Kreditwesengesetz*), all the more so as they cover all financial service providers, even those which do not trade under the legal form of an "Aktiengesellschaft".
Unlike the draft law currently being discussed in Germany, the Commission's Recommendation envisages the regulation not only of managers' wages: it affects all staff members whose activities have an impact on the risk profile of financial undertakings.

Alternative Policy Option

The Commission should integrate an indirect, risk-based regulation into the capital requirements and solvability Directives as soon as possible. For with its rapidly produced but legally non-binding Recommendation with public appeal, the Commission is actually sending a political signal that might induce Member States to intervene directly in the remuneration structures of the financial sector.

Possible Future EU Actions

The Commission has announced legislative proposals to ensure that remuneration practices in banks become subject to a supervisory review. It is expected that the Commission will propose amendments to the Directive on capital requirements for banks already in June 2009, according to which own capital to be withheld is also to cover risks of remuneration policy.
Whether the Commission will also propose amendments to the solvability Directive or even the MiFID Directive on markets in financial instruments (2004/39/EC) and the Directive on insurance mediation (2002/92/EC) remains to be seen.

Conclusion

The Commission should not recommend the direct regulation of remunerations to Member States but should overcome the risks by means of supervisory rules and standards instead. With higher demands on the own capital to be withheld, risks can be appropriately priced without having to intervene extensively into the remuneration policies of financial institutes. The Commission's announcement to follow this path, at least for banks, is to be welcomed. This goal should also be pursued for insurance companies.