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Opinion

Title **Revised recommendation on directors' remuneration and new recommendation on remuneration in financial services**
Resubmission - (draft version of 8 April 2009)

Lead DG **DG MARKT**

1) Impact Assessment Board Opinion

(A) Context

The widespread opinion that inappropriate remuneration policies contributed to a short-term management focus, excessive risk-taking and, ultimately, the current financial crisis has renewed concerns about corporate governance and management incentives in the financial sector and beyond. Past Commission actions in this area notably include a Recommendation on directors' remuneration in listed companies - 2004/913/EC - and a Recommendation on the role of non-executive/supervisory directors and supervisory board committees - 2005/162/EC. However, the limited scope of these recommendations and their limited transposition by Member States raise doubts about their capacity to answer effectively current concerns. Accordingly, the Commission announced a new initiative on executive pay in October 2008 receiving the backing of the December 2008 ECOFIN Council. In March 2009, the Communication on Driving European Recovery (2009/114/EC) indicated that the Commission would strengthen Recommendation 2004/913/EC and table a new one specifically on remuneration in financial services.

(B) Positive aspects

The report has addressed several recommendations of the first opinion. The analysis of the problem and its underlying drivers are clearer and the choice of individual sub-components in the preferred options is better substantiated. Single market and international aspects are dealt with more extensively and the nature and scope of the initiative for the financial sector made clearer.

(C) Main recommendations for improvements

The recommendations below are listed in order of descending importance. Some more technical comments have been transmitted directly to the author DG and are expected to be incorporated in the final version of the impact assessment report.

General recommendation: While the report has been improved, there remain areas

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where further clarification is necessary:

(1) Provide further explanations for some suggested problem drivers. The revised report provides a clearer explanation of the problem and its underlying drivers. Some suggested drivers, however, still require further explanation and supporting evidence. For instance, the alleged downward rigidity in variable component payments (inter alia, page 9, 18, 29, 35 and annex 2) should be backed up by more than anecdotal evidence and the ultimate reasons behind this rigidity should be analysed in greater detail (for instance, by looking at any differential tax treatment of the variable and fixed components). The reasons why a greater variable share should lead to increased herd behaviour (p. 18) should also be more convincingly explained as the opposite can also be argued in theory. Cases of fraud should be distinguished from evidence of excessive but nevertheless legal risk-taking behaviour (page 18 and footnote 73). Finally, the implications of imperfect equity market pricing for remuneration based on shares or other stock market indicators should be more prominently flagged along with an indication of whether a further analysis of this issue is planned.

(2) Better substantiate certain sub-components in the preferred options. The revised report provides a better justification of some individual measures adopted under the preferred options. However, the discussion on proportionality should address the following issues: the tension between leaving decisions on the scope of application at the national level (see, for instance § 6.2.4) and the desire to avoid substantial differences in corporate governance rules across Member States (p. 21 and 23); the rationale for the expected improved implementation by Member States of the proposed Recommendations, given the unsatisfactory application of existing Recommendations on directors' remuneration (p. 49) and a first-mover disadvantage to the voluntary action; the value added of the additional recommendations proposed for the financial sector (like claw-back in the case of misstated data) compared to the FSF principles endorsed by the G20. More generally, the section 6.2.5 should motivate more and spell out more clearly the choice for the preferred options.

(3) Further clarify the analysis of single market aspects. While the analysis of single market aspects has been somewhat clarified, the exact nature of the concerns with regard to distortion of competition remains unclear. What is the reference market: goods and services (p. 21), executives (p.21 and footnote 90) or capital (p.23)? Also, the analysis of the impact of the preferred package of measures on the (relevant) single market remains partial, including with regard to the implications that Member States' application or not of the proposals would have on the supply of directors within the EU and between listed and unlisted companies or the financial sector and other sectors.

(4) More clearly justify a specific initiative for the financial sector. The revised report includes important clarifications with regard to the nature and scope of the recommendations for the financial sector as well as their role within a strengthened supervisory environment. There remains, however, a need to better justify the reasons for an additional initiative targeted to the financial sector by highlighting more explicitly the differences with the non-financial sector in terms of distribution of risk-taking responsibilities within firms, systemic importance of the sector and relevance of moral hazard concerns. The new references to the goal of restoring a level-playing field with financial institutions benefitting from national rescue packages should be clarified (p.32). Finally, in order to avoid possible misunderstanding on the planned use of the recommendations within a strengthened supervisory environment, the text under § 5.2.2.B

and §6.3 should be consolidated into one coherent whole. This should also clarify the effectiveness from a single market perspective of creating a legal obligation on supervisors to ensure compliance with the principle that remuneration policies should be consistent with effective risk management when the recommendations on how to implement this principle are not legally binding (and therefore could be transposed differently across Member States). Finally, the report should be clearer on the scope of the measure in terms of type of staff that would be covered (e.g. traders) (p.45).

(5) Consolidate the analysis of international aspects. The revised report has strengthened the analysis of international aspects and has integrated the results of the London G-20 meeting (accordingly, however, unnecessary references to preparatory meetings – see, inter alia, page 21 and 23 – should be updated/deleted where appropriate). Finally, while improved, the analysis of the implications of the proposed measures for the supply of directors in the EU should stress that what is uncertain is the size of the likely negative impact rather than the sign of such impact (given the assessed negative impact of individual measures such as claw-back clauses, limited severance pay etc.). It should also be consolidated in one single section to be referred to whenever relevant (rather than being repeated in each case).

(D) Procedure and presentation

While exceeding the standard 30-pages limit is justified in this case, the text could be shortened by avoiding repetition of the same text for the two recommendations (see, inter alia, § 5.1), reducing the text on the origins of the financial crisis (p. 16-17) and eliminating overlaps in §6. Also, it is suggested to limit the size and number of annexes by referring to web site addresses for background information.

An executive summary should be added to the report as a separate staff working document. Footnotes should be shifted to an annex and a bibliography added. Journalistic language should be avoided (page 21) and political messages put in more neutral language. The relevance of the (numerous) footnotes for the argument in the main text should be double-checked (see, for instance, footnote 23, 70, 71 and 73). The level of the sub-headers in section 2.1 should be adjusted.

While much improved, the presentation of the sub-options under Option C could still be improved using the same style for both recommendations (see p.26-27 vs. 28-30). Furthermore, the description of the "packages" under section 6.1 should be transferred to section 5, and each "package" should be clearly labelled as an option and presented as such (with its sub-option) in the impact tables of section 6. Similarly, there should be a better correspondence between the labelling of the sub-options of section 5.1.4 and their presentation in the impact tables of section 6.2. Finally, consideration should be given to the usefulness of moving forward parts of the § 6.3 (p.48) into the policy context section (§3.1).

2) IAB scrutiny process

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Author DG	MARKT
External expertise used	No
Date of Board Meeting	Written procedure
Date of adoption of Opinion	<p style="text-align: center;">22 AVR. 2009</p> <p>The present opinion concerns a resubmitted draft IA report. The first opinion was issued on 3 April 2009.</p>