MEMO/10/229

Brussels, 2nd June 2010

European Commission Green Paper on corporate governance in financial institutions and report on remunerations - frequently asked questions

Why has the European Commission decided to launch a public consultation on corporate governance in financial institutions?

The crisis highlighted that effective checks and balances within financial institutions did not work. Corporate governance rules were de facto stress-tested by the run-up to the crisis and the crisis itself and found wanting. Many financial institutions took risks that were not in their best long-term interests, and which society as a whole is now paying for.

The crisis highlighted that there was insufficient oversight by boards of senior management. This was often due to lack of time commitment and expertise in boards. Too often, risk management functions in financial companies lacked authority and independence. In many cases shareholders failed to exercise their control over companies' management and sometimes were themselves pushing financial institutions to take excessive risk to provide higher short-term returns.

In response to these numerous failings, the European Commission committed itself in its Communication to the Spring European Council "Driving European Recovery" of March 2009 to examine and report on current corporate governance practices in financial institutions, making recommendations including for legislative initiatives, where appropriate. Today's public consultation is the first step to the reform of the corporate governance mechanisms in the financial services sector.

The Green Paper is complemented by a staff working document which describes and analyses weaknesses in corporate governance revealed by the financial turmoil. The Green Paper is further accompanied by a report on the application by Member States of the Recommendation 2009/384/EC on remuneration policies in the financial services sector and a report on the application by Member States of the Recommendation 2009/385/EC on remuneration of directors of listed companies. These reports are completed with two staff working papers providing a detailed analysis of the measures taken by Member States.

What are the main suggestions covered in the Green Paper?

The Green Paper submits to public consultation the following suggested options to improve corporate governance in financial institutions:

- limit the number of directors' memberships in boards, for instance to 3;
- require more expertise on boards;
- widen the "fit and proper test" to include evaluation of expertise and individual qualities of candidates;
- enhance the role of supervisors in the review of corporate governance structures;

- mandate risk committees at board level tasked with setting policy on risk appetite to be disclosed publicly through a risk statement,
- strengthen the legal liability of directors via an expanded 'duty of care';
- strengthen the authority of the risk management function potentially giving the Chief Risk Officer equal standing to the Chief Financial Officer;
- regulate or restricts stock options and golden parachutes;
- separate the functions of the Chairman and of the Chief Executive Officer;
- put in place a stricter duty for auditors to flag anything serious to boards and supervisors, and to look at whether they should have an enhanced role to check the risk systems. This enhanced role would be in addition to the planned review by the Commission of auditors' existing role.
- mandate that institutional investors publish their voting and engagement policies and records and adhere to stewardship codes.

How does the Green Paper fit with other Commission initiatives in response to the financial crisis?

Improved corporate governance is at the core of the Commission's work on crisis prevention and a fundamental element of the regulatory reform package aimed at creating a safer financial framework. Crisis prevention and management must start from within the company. Effective supervision and the right financial regulation can only be effective if companies themselves are the first ones to act responsibly.

For example, improved oversight of risks by boards and enhanced authority and independence of the risk management function should ensure that financial institutions are able to manage more effectively their risks. Consequently, it should usefully complement stricter capital rules and the new arrangements for monitoring risk established by the new European supervisory structure.

Encouraging shareholders to assume more seriously their responsibilities as owners of the financial institution in which they invest could contribute to avoid future crisis situations. This would in turn mean that shareholders would not have to be deprived of their decision-taking powers by national authorities in crisis management situations and lead to greater long-term profits.

How does the Green Paper fit with the consultative document of Basel Committee on Banking Supervision on principles for enhancing corporate governance?

The ideas explored in the Green Paper are consistent with the proposals of the Basel Committee to enhance corporate governance and in particular with the principles regarding board practices, risk management, conflicts of interest and the role of the supervisors.

However, the Green Paper also explores the role of shareholders and of external auditors in corporate governance of financial institutions, which are not as such covered by the principles in the Basel consultative document.

In addition, in some areas, the Green Paper proposes more concrete options, such as limiting the number of mandates of board members, diversifying board composition (including more women on boards) or separating the functions of the Chairman and the Chief Executive Officer.

Does the financial crisis put in question the existing corporate governance model in financial institutions?

The question of the adequacy and appropriateness of the current corporate governance framework for financial institutions is a challenging one for stakeholders and public authorities. There is no straightforward answer. The current system of checks and balances must be significantly strengthened, duly applied and enforced so that all stakeholders will have a greater awareness of their accountability and liability, without undermining the spirit of entrepreneurship and appropriate risk-taking that is necessary to economic growth.

What categories of financial institutions are covered by the Green Paper? Does the Green Paper take account of different corporate models? Why does the Green Paper not cover listed companies more generally?

The solutions explored in the Green Paper are of relevance for all regulated financial institutions. Nonetheless, the primary focus of the Green Paper is on banks and life insurance companies. When the Commission brings forward specific initiatives, they will need to be applied in a proportionate manner, according to the size, nature and complexity of activities of the financial institution concerned and, where relevant, taking account of the specificities of the different corporate models existing in the European Union.

Whilst lessons learnt from this crisis are probably also of relevance for corporate governance in listed companies in general, the scope of the Green Paper is essentially limited to financial institutions. Given the particular role they play in the economy and potential impact of their activities on financial stability, corporate governance in financial institutions present specific features which differentiate them from listed companies in general. In addition to their responsibilities towards shareholders, financial institutions have responsibilities towards depositors or policy holders and also to the public.

However, the Commission recognises that issues relating to corporate governance of listed companies more generally also deserve to be addressed and has started work to this end. A further Green Paper will follow in the autumn.

What be the follow-up to the public consultation? Will there be any legislative proposals?

The consultation is open for responses until 1st September 2010. Following the results of the public consultation which should be available in Autumn this year the Commission will decide in the first quarter of 2011 on the need for any non-legislative and legislative proposals to tackle the failures of corporate governance in financial institutions.

In particular, with regard to remuneration practices, the Commission has already committed to come up with legislative proposals to regulate pay in all sectors of the financial services industry. The first legislative proposal to modify the Credit Requirements Directive was adopted by the Commission in July 2009. Other legislative measures will follow.

Why does the Green Paper include remuneration issues when the Commission has already made legislative proposals in that area for the financial services industry?

The Commission Recommendations of 2005 and 2009 on remuneration of directors in listed companies also apply to directors of listed financial institutions. These Recommendations contain specific provisions, for example on disclosure of individual remuneration, which go beyond the existing legislative proposals for the financial services sector. Since these Recommendations have a wider scope of application, the Commission deems appropriate to use this opportunity to consult on the need for legislative measures as regards directors' remuneration more generally.

What are the Commission reports on the 2009 Recommendations on Remuneration?

In April 2009, the Commission adopted two Recommendations on remuneration policy in the financial services sector and on directors' remuneration. The Commission committed to publish an evaluation report one year later on Member States' application of both Recommendations, which they had been invited to implement by 31 December 2009. The two reports of the Commission respond to this commitment.

What are the main conclusions of the two Reports on Recommendations on remuneration?

Under the Recommendation on remuneration policy in the financial services sector (IP/09/674), Member States were invited to ensure that financial institutions have remuneration policies for risk-taking staff that promote sound and effective risk-management. The Recommendation set out guidelines on the structure of pay, on the process of design and implementation of remuneration policies and on the role of supervisory authorities in their review. The evaluation report concludes that only 16 Member States – Belgium, Bulgaria, Cyprus, Germany, France, Hungary, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Romania, Spain, Sweden and the United Kingdom – have taken measures to fully or partially promote the application of the Recommendation at national level. The remaining 11 have not yet adopted any national measures, but the Czech Republic, Denmark, Estonia, Finland, Ireland and Portugal have indicated that they are in process of doing so.

The Recommendation on directors' remuneration (IP/09/673) set out best practices for the design of an appropriate remuneration policy for directors, focusing on certain aspects of the structure and determination of their remuneration, including shareholder supervision. The evaluation report concludes that 10 Member States – Austria, Belgium, Denmark, Germany, Italy, Lithuania, the Netherlands, Portugal, Slovenia, and the United Kingdom – have implemented at least half of the recommendations. However, most recommendations have been implemented only by a minority of Member States.

What will be the next steps on remuneration?

As regards remuneration in financial services, the Commission has already adopted in July 2009 a legislative proposal to modify the Capital Requirements Directive for remuneration in credit institutions (i.e. banks) and investment firms. Provisions on remuneration are also now part of the draft AIFM Directive under negotiations in Council and Parliament. Other legislative measures for remaining sectors of financial services (i.e. UCITS and insurance companies) are under preparation and should be adopted by the Commission in the course of next year.

As regards the remuneration of directors of listed companies, the Commission report on the implementation by Member States of measures to promote the application of existing recommendations shows that this application is neither uniform nor satisfactory. For this reason, the Commission gives consideration in this Green Paper to the need for and content of relevant legislative measures. Following the outcome of the pubic consultation, the Commission will decide on the need and the content of these legislative proposals.