

The Theory and Practice of Directors' Remuneration

New Challenges and Opportunities

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Introduction from Editors

Dear readers and friends! We are happy to present to you our new book *The Theory and Practice of Directors' Remuneration: New Challenges and Opportunities*. Corporate governance faced critical new challenges during and after the world financial crisis and this book focuses on one of these: remuneration practices. Both practical and theoretical fundamentals needed urgent review. International organizations, researchers, and practitioners have all pointed out the necessity for reform and change. The excessive remuneration of executive directors and the ineffective remuneration of non-executives are seen as key problems and reasons for the financial crisis.

The main objective of this book is to outline the practical and theoretical issues and discuss and analyze new approaches to directors' remuneration due to changes made in corporate governance practices during the post-crisis period. Its secondary purpose is to ignite a new debate on the issue. The book is divided into three parts to give readers a full understanding of remuneration issues – the theoretical foundations, a cross-sectoral view, and a cross-national analysis of current practice.

The book is the result of a great deal of work done by our international network of corporate governance professionals, many colleagues, and friends. We are pleased to deliver our warm regards to Markus Stiglbauer (Germany). His contribution to editing the book adds great value to our project. We would also like to thank Philip J. Weights (Switzerland), who is a well-known expert in corporate governance and banking in Europe and worldwide. The academic outlook written by our colleague Rado Bohinc (Slovenia) sheds light on the scholarly discussions around the topic as well as debates among practitioners.

Our contributors are, of course, worthy of special thanks. But the most important words of acknowledgment should be addressed to our families who consistently supported us in undertaking this major work.

Alexander Kostyuk
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The recent financial crisis has led to a loss of trust in the quality of corporate governance and the balance of the European financial market. Banks play a key role in modern economies and perform integral functions. These issues have also affected Germany especially as financial companies play a major role in the German corporate governance system (“German bank-based system”). This is made apparent by a traditionally dominant creditor protection within commercial law accounting, which by its nature undervalues assets and overvalues debt in financial accounting. A sound banking and financial system is critical for the performance of the German economy, particularly in the wake of the financial crisis that began in 2007. Since then, remuneration issues and practices in combination with extraordinary appetite for risk have been much criticized and the implementation of the “pay for performance” principle without any doubt represents a basic standard for “good” corporate governance.

Thus, the German government passed two laws concerning remuneration. The first was the Act Regarding the Disclosure of Management Board’s Remuneration. Its main purpose is to provide companies an incentive toward establishing appropriate, performance-based management compensation. Nevertheless, against all expectations, management salaries have been leveled and, unfortunately, even boosted. Companies commonly argue that one cannot separately evaluate the performance of individual board members, said Müller, Head of the German Corporate Governance Code Commission, in a heavy criticism. Consequently, the German government passed the act regarding the Appropriateness of Management Board’s Remuneration in 2009. It aims to link the variable remuneration of the management board to the company’s development based on several years’ assessment data, as well as the implementation of a “cooling off period” for former members of the management board before they are able to become members of the supervisory board. As a result, for example, Allianz SE, now assesses the short-, middle- and long-term elements of managers’ variable remuneration equally and enforces its malus system in case of bad performance, as does Deutsche Bank AG.

Despite these positive reactions, one must differentiate the argumentation when examining general empirical findings on German listed companies’ reaction toward these new regulations. Between 2007 and 2009, German companies reduced overall management reward (–16 percent) and approximately 55 percent pay less than €500 tsd. to a member of the management board, and only 19 percent pay over 1 million euro to an individual board member – this limit is psychologically important. Nevertheless, with regard to the payment structure, we rate the development as negative. We found that companies in general, and particularly those in the financial

sector, increased fixed managerial pay within the payment structure and reduced variable bonus pay. Moreover, considering the economic upswing in Germany in 2010, we are observing that the current structure and overall management compensation is comparable to the beginning of the financial crisis, with a slight increase in long-term incentives.

Overall, these measures don't seem to be appropriate to motivate managers to act in companies' and shareholders best interest because such remuneration structure lowers managers' individual consequences in the event of a severe financial/economic situation by reducing their personal income risk on one hand and fires "normal" workers or reduces their working time (and consequently their income) on the other hand. Additionally, higher fixed managerial pay makes companies less flexible in a further crisis and generally does not lower company risk, but rather possibly increases managerial risk taking. Further, the regulatory requirements of an appropriate management board's remuneration are not yet well implemented. Bonus pay and share-based pay are still short-term oriented in many cases. Further, in the case of negative firm development, bonus programs often do not involve managers sufficiently. With regard to the act regarding the Disclosure of Management Board's Remuneration, there are only few listed companies that choose to "opt out" and not publish management and supervisory board members' remuneration individually. A company may use this option for five years when 75 percent of the shareholders represented at the shareholder's meeting vote for this exception. Shareholders are able to renew the decision to opt out after five years.

In summary, this is a clear mandate for a thorough and critical discussion of existing remuneration structures for management board members by supervisory boards and remuneration committees.

Markus Stiglbauer

Professor at Friedrich-Alexander-Universität Erlangen-Nürnberg (Germany); German Association of University Professors (DHV); European Academy of Management (EURAM); Association of University Professors of Management (VHB); Virtus Global Center for Corporate Governance (VGCCG)

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Practitioners' Outlook

It was with great pleasure that I accepted the invitation from Dr. Alexander Kostyuk, Chairman of the Board of the International Center for Banking and Corporate Governance, to write a Foreword to this important new book *The Theory and Practice of Directors' Remuneration: New Challenges and Opportunities*. This topic is of interest to many people, including employees, investors, executives, auditors, regulators, and politicians. We have witnessed the devastating effect of the global financial crisis which began in 2007–2008. This evolved into a Sovereign Debt Crisis by 2010, and caused the loss of millions of jobs worldwide. The effect is still felt today, as illustrated by the collapse of one of Portugal's largest banks, Banco Espírito Santo, as recently as August 3, 2014. Post-crisis analysis by the World Bank and the International Finance Corporation has identified Corporate Governance failures as the main contributing factor to the crisis. The failures are in four main areas: "Risk Governance"; "Remuneration and alignment of incentive structures"; "Board independence, qualifications and composition"; and "Shareholder engagement". This book addresses perhaps the most emotional and controversial of these, the remuneration issue.

The news headlines post-crisis routinely discussed "Corporate Greed", "Market Abuse", with Banks "Too Big to Fail", and bankers "Too Big to Jail". Public outrage led to the birth of the "Occupy Wall Street" protest movement in September 2011. The main issues raised were social and economic inequality, greed, corruption and the perceived undue influence of corporations on government, particularly from the financial services sector. Greed is reinforced in popular culture, as illustrated in the movie "Wall Street" where Gordon Gekko, a corporate raider played by the actor Michael Douglas, says "*The point is, ladies and gentleman, that greed, for lack of a better word, is good. Greed is right, greed works.*"

In the real world of business, politicians, voters, and investors want to control excessive greed. On October 13, 2014, Thomson Reuters published a press release from their subsidiary Incomes Data Services with the headline "FTSE 100 Directors' Total Earnings Jump by 21% in a Year." It explains that share-based

incentive payments and bonuses are driving the increase. IDS points out that the median total earnings for a FTSE 100 director is now £2.4 million. The median total earnings for FTSE 100 Chief Executives are £3.3 million. This is 120 times more than a full time employee in 2014, compared to 47 times more than a full time employee in 2000. Such an increasing gap is causing great concern, and measures are now being taken in the United Kingdom to make directors and executives more accountable, introduce Remuneration Governance, curb bonuses, and establish mandatory bonus claw-back periods.

The same reaction to corporate greed is felt in Switzerland. In March 2013, Swiss voters approved a plan to severely limit executive compensation. This national referendum, commonly referred to as the “Initiative against rip-off salaries” was prompted by the public outrage against the executives of Swissair, the flagship airline that collapsed in 2001, and the political storm when Novartis, the pharmaceutical company, agreed to a \$78 million severance pay-out for its departing chairman. The intense criticism from investors forced Novartis to scrap the pay-out. The Swiss vote gives shareholders of companies listed in Switzerland a binding say on the overall pay packages for executives and directors. Swiss companies are no longer allowed to give bonuses to executives joining or leaving the business or to executives when their company is taken over. Violations can result in fines equal to up to six years of salary and a prison sentence of up to three years.

In the United States, executive remuneration is also a major concern. It is reported that by 2006, CEOs made 400 times more than average workers, a gap 20 times bigger than it was in 1965. To address this situation, on January 25, 2011, the SEC adopted rules for Say-on-Pay and Golden Parachute Compensation as required under the Dodd-Frank Wall Street Reform and Consumer Protection Act. Say-on-Pay votes must occur at least once every three years, and Companies must disclose on an SEC Form 8-K how often it will hold the Say-on-Pay vote. Under the SEC’s new rules, companies are also required to provide additional disclosure regarding “golden parachute” compensation arrangements with certain executive officers in connection with merger transactions. Despite the new rules, a report titled “2013 CEO Pay Survey” produced by Governance Metrics International Ratings grabs attention when it states that the first two executives named in their Top Ten List of Highest Paid CEOs earned more than \$1 billion in a single year, and all 10 CEOs made at least \$100 million. Historically, Oracle has one of the highest paid US executives. For the past two years, shareholders voted down the CEOs pay package. However, the resolution is non-binding. Most of the votes “for” were cast by the CEO himself as he owns a quarter of the company (CNNMoney (New York),

2013). This illustrates two Corporate Governance issues, one being that shareholders in the United States do not yet have the right to “approve” the remuneration of top executives. The second issue is that a Chairman (who may also be the CEO) can vote in favor of a compensation issue, despite the obvious conflict of interest.

The European Union has taken significant measures to deal with the remuneration issue. This includes issuing “*Directive 2013/36/EU of 26 June 2013 on Access to the Activity of Credit Institutions and the Prudential Supervision of Credit Institutions and Investment Firms.*” In point 53 of the introductory text, there is a clear statement that weaknesses in corporate governance contributed to excessive and imprudent risk-taking in the banking sector which led to the failure of individual institutions and systemic problems in Member States. The Directive also recognizes that the general provisions on governance and the non-binding nature of a substantial part of the corporate governance framework, based essentially on voluntary codes of conduct, did not sufficiently facilitate the effective implementation of sound corporate governance practices. Articles 92–96 cover the specific new rules regarding Remuneration. Of particular interest from a transparency and reporting perspective is Article 96 titled “Maintenance of a website on corporate governance and remuneration.” Here the Directive requires Financial Institutions to explain on their website how they comply with Articles 88–95 dealing with all the “Governance Arrangements” including the new remuneration rules.

Corporate Governance is of universal importance. Remuneration Governance is one of the key challenges to ensure the correct balance between risk and reward, and ensure that Directors’ compensation is equitable to all parties and stakeholders. It seems clear that the trend is to enhance the Remuneration Governance. Increasingly, this is via a formal and transparent policy and procedure for implementing executive remuneration and for fixing the remuneration packages of individual directors. Many countries are introducing regulations for Companies to include the remuneration figure for top executives and directors in their annual financial report, along with the introduction of binding shareholder votes on boardroom remuneration.

It is therefore timely and relevant that this new book *The Theory and Practice of Directors’ Remuneration: New Challenges and Opportunities* has been written. The book examines the current theories, practices, and regulations and explains them in detail.

Section I, Theory of Corporate Governance and Directors’ Remuneration, is written by Prof. Udo Braendle of the American University in Dubai, UAE, and covers in Chapter 1 the key topic of “Corporate Governance and Remuneration,” followed by Chapter 2 (co-written with Prof. John E. Katsos of the American

University in Sharjah) covering “Directors’ Remuneration and Motivation.” Professors Braendle and Katsos suggest that the failure of Remuneration Governance can be remedied by switching the balance of compensation packages from extrinsic motivators such as pay-for-performance bonuses and stock options, to intrinsic motivators such as firing and prestige.

In Section II, Cross-industrial Remuneration Practices Analysis, Regina W. Schröder provides an analysis of the practices in the Financial Services sector. She argues that attention has not been paid to the present value of remuneration, and the discounting method by which this value should be calculated. The discounting method and its disclosure are important elements of the corporate governance, allowing stakeholders to anticipate the amount of the incentives and rewards paid, and evaluate the associated risk. The Industrial Sector analysis is provided by Dr. Yusuf Mohammed Nulla who explores the energy, metal, mining, and health industry’s effects on Directors’ remuneration in Canada and the United States.

Section III, Cross-country Remuneration Practices Analysis, provides an analysis of Director’s Remuneration in various countries. The US perspective is covered by Dr. Andrew J. Felo, Associate Professor of Accounting, Nova South-Eastern University in Florida who highlights the two main challenges regarding Directors Remuneration. The first is that directors have significant input into their own pay packages, while the second challenge is to make the remuneration package attractive enough to attract quality directors to the board. Prof. Jean J. Chen provides an excellent analysis of the regulations, challenges for Directors’ Remuneration in the United Kingdom. She notes that two problems in UK remuneration practices have been highlighted in recent scrutiny, the divergence of executive pay from firm performance and decreased clarity and transparency caused by increasingly complex remuneration reporting. She explains that in response to the failings in the corporate governance framework for executive remuneration, the UK government has announced a comprehensive package of reforms including binding shareholder votes and greater transparency in the directors’ remuneration reports. Prof. Dr. Markus Stiglbauer and his Corporate Governance team at the University of Erlangen-Nuremberg present a comprehensive analysis of the German remuneration regulations and how the system functions within the two-tier Board framework of a management board and a supervisory board. One of the key challenges is noted as the failure in 2013 of the German Government to pass a proposed new Act to improve the Supervision of Board Remuneration. This Act included empowering the annual general shareholder meeting to review and approve management board remuneration as proposed by the supervisory board. The remuneration situation in Italy is explained by

Dr. Marco Artiaco, Professor of Economy and Management at the Università di Roma Tre. He argues that the Italian Corporate Governance system still seems weak, and remuneration policies of Italian regulated firms, seem to be oriented to finding solutions in order to acquire and retain top managers. In his view, the solutions selected by authorities in order to regulate financial firms such as transparency, remuneration system structure, incentive mechanism control, and risk management should be extended to all the companies in which remuneration is a critical issue. Directors' remuneration in Spain is addressed by Prof. Montserrat Manzanegue, together with Elena Merino – Madrid and Regino Banegas – Ochovo of the University of Castilla-La Mancha in Spain. They mention the Spanish government is currently considering new measures to limit variable remuneration and allowances, and changing the advisory vote of the General Shareholders' Meeting regarding the remuneration of Directors to a binding vote. Dr. Hussein Ahmed Tura of the Ambo University in Ethiopia critically analyzes Directors' Remuneration in Ethiopia. He explains that the Ethiopian Commercial Code of 1960 is outdated, unchanged, and lacks rules and principles on many aspects of company governance including adequate provisions on directors' remuneration. He also mentions that National Bank of Ethiopia recently adopted a directive limiting the directors' remuneration in the banking industry to approximately US\$2500 per year. He argues this may have an adverse effect on the independence of directors, and the retention of talented experts. Chapter 12 deals with remuneration requirements from European legislation to German implementation. It is written by Professors Oliver Kruse, Christoph Schmidhammer, and Erich Keller at the Deutsche Bundesbank University of Applied Sciences. Their chapter analyzes the implementation of remuneration policies in German banking institutions starting from European legislation standards. They mention that BaFin surveys illustrate some institutions try to undermine regulatory requirements by not fully defining risk takers or implementing asymmetric variable remuneration components. It is suggested that some German institutions are investing significant efforts to avoid regulatory remuneration standards. Chapter 13 is written by Roberta Provasi from Bicocca Milan University, Italy and Patrizia Riva from Piemonte Orientale University, Italy and deals with European specifics of directors' remuneration regulation.

Professor Alexander Kostyuk, Virtus Interpress, and the Global Center for Corporate Governance are to be commended for this comprehensive review and analysis of the international state of Governance and Directors' Remuneration.

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Academic Outlook

Remuneration, compensations, and other benefits of directors is rather new and not much publicly discussed and even not much researched topic. However it is, especially in times of crisis, very relevant for successful and efficient corporate governance. Without a doubt, it is a legitimate concern and expectations of the shareholders that directors' remuneration should not exceed the agreed levels and that it should be disclosed for public scrutiny.

This book makes more familiar the issues, related to remuneration, compensations, and other benefits of directors. It is very topical issue, relevant to a wide range of readers, like scholars from a variety of disciplines, professionals outside academia and also students for use in courses. The book is also recommended to general readers interested in the field of business, economy, law, corporate governance, finance, accounting, and management; it is on one hand of great theoretical interest and on the other currently needed to the practitioners in this field.

In the Section III of this book (Cross-Country Remuneration Practices Analysis), the presentation of practices analysis in some individual EU member states and in addition the EU regime for the remuneration of directors of listed companies is presented.

Director Remuneration is a Matter of Growing Importance in the EU

Director remuneration is a matter of growing importance in most of the EU countries and at the level of EU as well. According to European Commission, experience over the last years, and more recently in relation to the financial crisis, has shown that remuneration was focused on short-term achievements and in some cases led to excessive remuneration, which was not justified by performance. Also remuneration policies in the financial services sector showed inappropriate remuneration practices in the financial services industry and also induced excessive risk.

EU Commission Recommendation of April 30, 2009, complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies and Commission Recommendation on remuneration policies in the financial services sector SEC(2009) 580 SEC(2009) 581, Brussels, 30.4.2009 C(2009) 3159 imposed several approaches and practices.

Legislation on Directors' Remuneration

Legislation and corporate governance codes mostly apply to all types of companies; however, in some countries they apply only to listed companies. There are often stricter rules on transparency and disclosure for listed companies. Most of the rules on executive directors' remuneration apply only to domestically incorporated companies, whereas prospectus regulation and ongoing disclosure rules and regulations apply to all companies, the securities of which are listed on the Stock Exchange.

Directors' remuneration in EU countries is regulated by different Laws (Acts), Decrees, Supreme Court decisions, Case law, Regulations of the Ministries, Stock Exchange or Financial Services Authority rules and recommendations and best practices. As for laws, most often directors' remuneration would be regulated by Public Limited Companies Acts or Stock Corporations Acts (Austria, Germany, Spain) or just Companies Acts (Finland, UK, Ireland, Luxembourg, Portugal), Civil Codes (Italy, Netherland), Accounting Laws, Capital Markets Acts, Securities Trading Acts, Stock Exchange Acts and rules (like Disclosure Obligations for Issuers, Stock Exchange Admission Regulation, Listing Rules, etc.), Commercial Codes, like in France, etc.

Corporate Governance Codes

Best practices would normally be described in private ethical codes – mostly called Corporate Governance Codes or Principles of Good Governance and Code of Best Practice or Code of Ethics for Companies' Boards of Directors and different other non-binding recommendations. A so-called “comply or explain” principle is often applicable to compliance with the relevant provisions by companies.

Where the “comply or explain” principle applies, the evidence whether companies generally comply with best practices is in some countries available in companies' annual reports. However, there are countries where the Code is only applied if a company is ready to accept the rules, expressing that by way of declaration to accept

and to obey to the rules. In some other countries, there is a legal obligation to report on compliance of the companies' rules and behavior with the code.

It is recommended by most corporate governance codes that the Board create a Remuneration Committee with the powers to propose to the Board of Directors the amount of the Directors' annual remuneration to review the remuneration programs and consider their appropriateness and results, and to ensure transparency in remuneration. The Remuneration Committee's mission is also to assist the Board in setting and supervising the remuneration policy. In general, these committees' role is basically informative and consultative, although they may exceptionally be given decision-making powers.

Remuneration is a key aspect of corporate governance where conflicts of interest may arise and a strong control right for shareholders can significantly improve the accountability of boards. Unlike in other areas of corporate governance for which soft-law measures remain appropriate, the Commission's efforts to improve governance on pay through soft-law measures (three Recommendations on directors' remuneration, in 2004, 2005, and 2009) have not led to significant improvement in this area. It is therefore necessary to proceed with a more prescriptive approach involving binding rules on remuneration.

Remuneration Should Be Guided by Market Demands and Linked to the Company's Results

Generally, the company is free to establish the remuneration; yet it should be guided by market demands and having regarded to the responsibility and commitment of the role which each Director plays. Director remuneration should be set so as to offer sufficient incentives to dedication by the Director while not compromising his independence.

On the other hand, Directors' remuneration, should be linked to the company's results, since this will bring the Directors' interests more into line with those of the shareholder, which it is sought to maximize. It is recommended that remuneration comprising shares of the company or group companies, stock options or options referenced to the share price be limited to executive or internal directors. There are different advantages or disadvantages of the various forms of remuneration (incentives, payments in stock, stock options, etc.), some of which face tax obstacles in some countries, which do not exist in other countries.

It is the responsibility of the Boards' directors to adjust the remuneration to each company's individual circumstances. It is important to review remuneration policies periodically in order to ensure that the amounts and structure are commensurate with the Directors' responsibilities, risks, and duties. Accordingly, it is advisable for the Board itself, with the help of reports drafted for this purpose by the Remuneration Committee, to evaluate these matters at least once per year and disclose information on this area in the annual report.

EU Commission Recommendation

According to EU Commission Recommendation of April 30, 2009,¹ experience over the last years, and more recently in relation to the financial crisis, has shown that remuneration was focused on short-term achievements and in some cases led to excessive remuneration, which was not justified by performance. That is why the existing regime for the remuneration of directors of listed companies should have been strengthened by principles which are complementary to those contained in Recommendations 2004/913/EC and 2005/162/EC. The structure and level of executive pay is a key tool to ensure that directors' incentives on how to run a company are aligned with those of the company and its owners. In the past years, there were repeated cases of mismatch between executive pay and performance of the company. Shareholders often face difficulties in being properly informed and in exercising control over directors' pay (i.e., the management of the company).

Transparency on pay and oversight thereof is insufficient; only 15 EU Member States require disclosure of the remuneration policy and 11 Member States require disclosure of individual directors' pay. In addition, only 13 Member States give shareholders "a say on pay" through either a vote on directors' remuneration policy and/or report. Shareholders need information and rights to challenge pay, particularly when it is not justified by long-term performance. The lack of proper oversight on remuneration leads to unjustified transfers of value from the company to directors.²

¹Commission Recommendation of April 30, 2009, complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies (Text with EEA relevance) (2009/385/EC) (Recommendation of 2009).

²As it is shown in the Commission's impact assessment accompanying the Recommendations 2004/913/EC, 2005/162/EC and 2009/385/EC proposal.

An increase of the transparency on pay was therefore needed. It would have also given shareholders a right to approve the remuneration policy of the directors every three years and a right to vote annually on the remuneration report explaining the pay packages of directors in an advisory manner.

Some of the Experience of Member States³

The experience of Member States demonstrates that there is often an insufficient link between pay and performance where shareholders do not have a “say on pay.”

For instance, in France and Austria, where shareholders do not have a say on directors’ pay, the average remuneration of directors in the years 2006–2012 increased by 94% and 27% respectively, although the average share prices of listed companies in these countries decreased by 34% and 46% respectively. While executive pay should not depend only on short-term share price fluctuations, such fundamentally divergent trends are one indicator for a mismatch between pay and performance.

In Italy and Spain, before the introduction of an advisory say on pay in 2011, the average share price in the years 2006–2011 went down by 130% and 40% respectively, while the average remuneration of directors of listed companies increased by 29% and 26%. However, since the law was adopted in 2011, the average share price of listed companies has increased by 10% and decreased by 5% respectively, but the remuneration of directors has also increased by 1% and declined by 10%.

Such links between pay and performance are even stronger in Member States where shareholders have a binding say on pay on remuneration policy, since their opinion cannot be overruled by the board of directors.

In Sweden and Belgium, before the adoption of a binding say on pay in 2010 and 2011 respectively, the average share price from 2006 to 2009 and from 2006 to 2011 went down by 17% and 45%, while average pay of directors of listed companies increased by 18% and 95%. However, since the laws were adopted in 2010

³Communication From The Commission To The European Parliament, The Council, The European Economic And Social Committee And The Committee Of The Regions Action Plan: European company law and corporate governance – a modern legal framework for more engaged shareholders and sustainable companies (Action Plan 2012).

and 2011, the share price has increased by 16% and 18% but the remuneration of directors has also increased by 18% and decreased (as a correction) by 10%.

To conclude, currently, not all Member States give shareholders the right to vote on remuneration policy and/or the report, and information disclosed by companies in different Member States is not easily comparable. The Commission will propose in 2013 an initiative, possibly through a modification of the shareholders' rights Directive, to improve transparency on remuneration policies and individual remuneration of directors, as well as to grant shareholders the right to vote on remuneration policy and the remuneration report.⁴

Three Recommendations on Disclosure of Remuneration Policy

The main recommendations related to remuneration are disclosure of remuneration policy and the individual remuneration of executive and non-executive directors, the shareholders' vote on the remuneration statement, an independent functioning remuneration committee and appropriate incentives which foster performance and long-term value creation by listed companies. Commission reports show that a number of Member States have not adequately addressed these issues.⁵

In 2009, the European Corporate Governance Forum (EUCGF) recommended that disclosure of remuneration policy and individual remuneration be made mandatory for all listed companies. It also recommended a binding or advisory shareholder vote on remuneration policy and greater independence for non-executive directors involved in determining remuneration policy.⁶

According to EUCGF, disclosure of the remuneration policy of listed companies and of the individual remuneration of directors (executive and non-executive) and any material change to it should

⁴Communication From The Commission To The European Parliament, The Council, The European Economic And Social Committee And The Committee Of The Regions Action Plan: European company law and corporate governance – a modern legal framework for more engaged shareholders and sustainable companies.

⁵Commission Recommendations 2004/913/EC, 2005/162/EC and 2009/385/EC.

⁶The Commission also consulted on this issue in the 2010 Green Paper on Corporate Governance in Financial Institutions.

be mandatory for all listed companies in the EU.⁷ Disclosure of the remuneration policy, its structure and individual director pay is necessary in order for shareholders to have an appropriate level of control over director remuneration.⁸

In 2004, the Commission issued a Recommendation⁹ to Member States dealing with remuneration disclosure and the role of shareholders and non-executive directors. According to the remuneration Recommendation, listed companies would have to disclose a remuneration policy statement that could include details about performance criteria. The remuneration policy statement should include among other things information related to the importance of fixed and variable remuneration, information on performance criteria and the parameters for annual bonus schemes.

Remuneration Should Promote the Long-Term Sustainability

The remuneration of executive directors is an important element of the governance regime of companies. In the last two decades, a fundamental shift has occurred to introduce and increase the level of variable pay, both in cash and in shares and rights to acquire shares.¹⁰

As stipulated in this recommendation, the structure of directors' remuneration should promote the long-term sustainability of the company and ensure that remuneration is based on performance. It is necessary to ensure that termination payments, the so-called "golden parachutes," are not a reward for failure and that the

⁷EUCGF, Statement – March 23, 2009 Statement of the European Corporate Governance Forum on Director Remuneration; According to EUCGF, currently only about 60% of Member States require disclosure of the remuneration policy and about two thirds of Member States require disclosure of individual director pay (see the Commission Working Staff Document referred to above).

⁸According to EUCGF, the effective impact of the Recommendation has been minimal: see the Commission Working Staff Document SEC (2007) 1022 of July 13, 2007. 527 68 Remuneration, Compensations and Other Benefits of Directors non-cash benefits. It should also explain the company's policy on the terms of executive directors' contracts. Information about the way the remuneration policy has been drawn up should also be made available.

⁹Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies.

¹⁰EUCGF, Statement – March 23, 2009 Statement of the European Corporate Governance Forum on Director Remuneration.

primary purpose of termination payments as a safety net in case of early termination of the contract is respected. Schemes under which directors are remunerated in shares, share options or any other right to acquire shares or be remunerated on the basis of share price movements should be better linked to performance and long-term value creation of the company.¹¹

In order to facilitate the shareholders' assessment of the company's approach to remuneration and strengthen the company's accountability toward its shareholders, the remuneration statement should be clear and easily understandable. Moreover, further disclosure of information relating to the structure of remuneration is said to be necessary.¹²

Remuneration Policy

A remuneration policy also includes a maximum amount of remuneration. This should ensure that companies make a conscious choice as to what is the value of good management for their company. For new recruitments, the company will be able to deviate from the maximum, but only subject to prior or ex post approval by the shareholders.

The remuneration policy approved by shareholders should explain how the pay and employment conditions of employees of the company were taken into account when setting the policy or directors' remuneration by explaining the ratio between the average remuneration of directors and the average remuneration of full time employees of the company other than directors and why this ratio is considered appropriate.

This ensures that companies make a conscious choice and reflect on the relative value of good management for the company and on the interaction between executive pay and a company's general working environment. The policy may exceptionally be without a ratio in case of exceptional circumstances. In that case, it shall explain why there is no ratio and which measures with the same effect have been taken.

The remuneration policy should be submitted to shareholders for a vote every three years. Executive remuneration can only be awarded or paid if it based on an approved remuneration policy. In view of the significant differences of Member States' company law, it will be for Member States set out in detail how these principles

¹¹Recommendation of 2009.

¹²Recommendation of 2009.

will be complied with and what procedures would need to be followed if shareholders reject the remuneration policy.

Remuneration Policies in the Financial Services Sector

According to the Commission Recommendation on remuneration policies in the financial services sector,¹³ inappropriate remuneration practices in the financial services industry, also induced excessive risk¹⁴.

Creating appropriate incentives within the remuneration system itself should reduce the burden on risk management and increase the likelihood that these systems become effective. Therefore, there is a need to establish principles on sound remuneration policies. The recommendation on remuneration in the financial services sector is presented in order to improve risk management in financial firms and align pay incentives with sustainable performance.

The recommendation sets out general principles applicable to remuneration policy in the financial services sector and should apply to all financial undertakings operating in the financial services industry. Remuneration policy covers those categories of staff whose professional activities have a material impact on the risk profile of the financial undertaking. The governing body of the financial undertaking should have the ultimate responsibility for establishing the remuneration policy for the whole financial undertaking and monitoring its implementation.

The framework is not the same as for credit institutions and investment firms. Directive 2013/36/EU, part of the CRD IV package (MEMO/13/690), has introduced, *inter alia*, a maximum ratio

¹³Commission Recommendation on remuneration policies in the financial services sector SEC (2009) 580 SEC(2009) 581, Brussels, 30.4.2009 C (2009) 3159. Remuneration, Compensations and Benefits in the German AktG 68.2 taking and thus contributed to significant losses of major financial undertakings.

¹⁴Financial undertaking' according to the recommendation, means any undertaking, irrespective of its legal status, whether regulated or not, which performs any of the following activities on a professional basis: (a) It accepts deposits and other repayable funds; (b) It provides investment services and/or performs investment activities within the meaning of Directive 2004/39/EC; (c) It is involved in insurance or reinsurance business; (d) It performs business activities similar to those set out in points (a), (b) Or (c). A financial undertaking includes, but is not limited to, credit institutions, investment firms, insurance and reinsurance undertakings, pension funds and collective investment schemes.

of 1:1 between the fixed and the variable component of the total remuneration, with some flexibility provided for shareholders to approve a higher ratio, up to 1:2.

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