European Economic and Social Committee

INT/527
Corporate governance in financial institutions and remuneration policies

Brussels, 20 January 2011

OPINION

of the
European Economic and Social Committee
on the
Green Paper - Corporate governance in financial institutions and remuneration policies
COM(2010) 284 final

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Rapporteur: **Mr Smyth**

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On 2 June 2010 the European Commission decided to consult the European Economic and Social Committee, under Article 304 of the Treaty on the Functioning of the EU, on the:

> *Green Paper - Corporate governance in financial institutions and remuneration policies*
> COM(2010) 284 final.

The Section for the Single Market, Production and Consumption, which was responsible for preparing the Committee's work on the subject, adopted its opinion on 6 January 2011.

At its 468th plenary session, held on 19 and 20 January 2011 (meeting of 20 January), the European Economic and Social Committee adopted the following opinion by 173 votes with four abstentions.

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1. **Conclusions and recommendations**

1.1 In this opinion the EESC sets out its considered responses to the lengthy list of questions posed in the Commission's Green Paper. The questions deal with eight key aspects of the governance of financial institutions ranging from the performance of boards of directors, the performance of supervisory authorities, through the management of risk, conflicts of interest, the role of shareholders through to the vexed question of the remuneration of directors.

1.2 The EESC welcomes the intent behind the Commission's Green Paper but notes some definitional shortcomings in its content, particularly on the precise definition of corporate governance which the Committee believes should be more robust, and on the differences in board structures between the British and Continental systems. It also considers that it would be helpful to define the concept of "financial institution" more clearly so that the recommendations should focus in particular on credit institutions.

1.3 In its consideration of the Green Paper, the EESC has found that the differences between the British and continental models of corporate governance are irreconcilable at the structural level because the organizational concepts are so different. Accordingly the EESC recommends that the Commission give consideration to the principles which should underlie corporate governance practice in the EU. For example, the British model is built on the principle of competent independence which facilitates the independent role of key board committees. Should independence be a key principle throughout EU corporate governance? If so, how should it be achieved in the continental model?

1.4 The Green paper is also relatively parsimonious in its treatment of the needs of consumers. Consumers of financial services have also been hit very hard by the effects of poor governance across the financial system.

1.5 In terms of remuneration policy the EESC has already expressed its general views in a number of recent opinions. In short, the Committee believes that remuneration policy should not just be about those at the top of financial institutions but also about remuneration at all levels.

1.6 The broad thrust of the opinion is that there is scope for a tightening up of certain aspects of the governance of financial institutions but that while governance codes remain voluntary, the onus is upon the supervisory authorities to ensure that as far as possible, these codes are adhered to across the European Union.

2. Introduction and Background to the Opinion

2.1 The aim of the Green Paper is to address perceived deficiencies in the system of corporate governance, whether in substance or in implementation. In the context of the financial and economic crises the strengthening of corporate governance lies at the heart of the Commission's reform programme. The proposals outlined in the Green Paper should be seen in the context of wider reforms of the European supervisory architecture, the Capital Requirements Directive (CRD), the Solvency II Directive, the reform of the Undertakings for Collective Investment in Transferable Securities (UCITS) and the regulation of Alternative Investment Fund Managers. They should also be taken in the broader context of a review by the Commission of corporate governance within listed companies dealing with the role of shareholders, the appropriate supervision of senior management teams, the composition of boards of directors and corporate social responsibility.

2.2 The Commission defines corporate governance as the relations between a company's senior management, board of directors, shareholders and other stakeholders such as employees and their representatives. It also concerns the setting of a company's objectives, the means of achieving them and the monitoring of the outcomes of the corporate effort. Within the financial sector governance takes on an even greater significance because the failure of a (large) financial institution brings with it a systemic risk to the entire financial sector as evidenced in the recent financial crisis, when governments had to shore up the banking system with public funding.

2.3 The EESC is surprised to note that the Green Paper does not make any distinction between the structure of boards in British and continental European economies. In the former there is only one board comprising executive and non-executive directors, although it is customary for there to be an executive board working under the CEO. In the continental model there are two boards - a managing board, and a supervisory board. In the rest of this opinion and to avoid confusion, reference to the "board" is normally in terms of the British model unless specifically stated otherwise.

2.4 The Green Paper does not formally note that each Member State has its own corporate governance system and that there is no distinction made in the case of the corporate governance of financial institutions. The Commission's definition of corporate governance is also somewhat partial in nature and so should be made more robust. The EESC suggests a stronger, more comprehensive definition of corporate governance. The main objective of corporate governance is to ensure that the company survives and thrives. To do this the board must meet the reasonable expectations of shareholders while ensuring the reasonable satisfaction of the stakeholder community – consumers, partners, contractors, suppliers and employees. When the board cannot ensure the survival of the company, it should dispose of the assets for optimum value.

2.5 The Green Paper outlines a range of deficiencies and weaknesses in corporate governance within financial institutions and seeks responses to a set of eight general questions dealing with:

1. issues with boards of directors;
2. deficiencies in risk management problems with conflicts of interest;
3. the role of auditors;
4. deficiencies in the supervisory authorities;
5. problems with the role of shareholders;
6. the lack of effective implementation of corporate governance principles;
7. the remuneration of directors of financial institutions;
8. conflicts of interest.

3. Answering the Green Paper questions

3.1 The EESC considered responses to the specific questions emerging from the Green Paper are as follows:

3.2 Issues with boards of directors

3.2.1 Specific question 1: *Should the number of boards on which a director may sit be limited (for example, no more than three at once)?*

Setting a precise number is arbitrary. It would be better to ensure that on appointment, and thereafter, a director can commit and subsequently spend the time in the company which his or her role requires. The time needed should be specified and divided between formal board and committee meetings and less formal visits to and reviews of departments, divisions and regions. In some cases an appointment could be virtually full time. There is always a benefit from at least two appointments for cross company comparisons.

3.2.2 Specific question 2: *Should combining the functions of chairman of the board of directors and chief executive officer be prohibited in financial institutions?*

This is already best practice in some jurisdictions. The division of roles should be mandatory in financial institutions because of the tension between the operational role of the executives and the stewardship role of the board.

3.2.3 Specific question 3: *Should recruitment policies specify the duties and profile of directors, including the chairman, ensure that directors have adequate skills, and ensure that the composition of the board of directors is suitably diverse? If so, how?*

It is fairly common practice in some jurisdictions to analyse the skills and experience needed within the board and then to recruit accordingly. For example, for a major financial institution one might expect a successful retired banking executive, perhaps as Chairman, senior partners of legal and accounting firms with finance industry experience, a CEO from a major commercial company as a counterpoint to the CEO and to bring a corporate customer perspective and someone with a consumer background as a core group around which a larger team could be built. This might include credit, actuarial, economic, industrial and commercial experience at the highest level. Ideally the ratio would be no less than 60% non-executive directors: 40% executive directors. Between them, the executives and non executives also need to incorporate an understanding of the major geographies in which the business operates. In some jurisdictions the Supervisory Authority now carries out an in depth review of the skills, experience and record of candidate before an appointment is authorised. This is to be welcomed.

3.2.4 Specific question 4: *Do you agree that including more women and individuals with different backgrounds in the board of directors could improve the functioning and efficiency of boards of directors?*

In the context of question 3 above, gender and ethnic balance is desirable if it does not dilute experience and expertise. It can bring different and valuable perspectives. There has to be a practical limit to the size of boards.

3.2.5 Specific question 5: *Should a compulsory evaluation of the functioning of the board of directors, carried out by an external evaluator, be put in place? Should the result of this evaluation be made available to supervisory authorities and shareholders?*

Supervisory authorities should mandate all Chairman to audit their governance arrangements in the context of the above four factors. At the same time the Authorities should undertake an audit to certify any directors whom they did not certify on appointment. The on-going responsibility for board performance must rest with the Chairman. It would be appropriate for Chairmen to commission a periodic external evaluation of board effectiveness for their own use. In the continental model, it is the duty of the supervisory board to take action if the business is not going well or if the auditor's report alerts the board to some important issues.

3.2.6 Specific question 6: *Should it be compulsory to set up a risk committee within the board of directors and establish rules regarding the composition and functioning of this committee?*

There are three issues: audit, compliance and risk. The committee configuration should reflect the particular business mix. From a macro point of view, risk is inherent in the board’s strategic plans. This is where the risk appetite and risk profile should be established and measured. In a bank, this is where policies would be established for the risk acceptable in each business sector: domestic mortgages, credit cards, commercial property, industrial loans, fund management, foreign exchange and commodities, as well as the composition of reserves, counterparty limits, etc. It is not possible to have a risk committee inside the continental managing board which is composed of a few people (usually not exceeding 5-7 persons) who tend to be specialists in various activities.

3.2.7 Specific question 7: *Should it be compulsory for one or more members of the audit committee to be part of the risk committee and vice versa?*

Risks at the micro level, as opposed to the macro level discussed in 3.2.6 above, could actually form part of the audit committee’s brief.

3.2.8 Specific question 8: *Should the chairman of the risk committee report to the general meeting?*

Risk is a key component of any business strategy. Risk appetite and risk profile define how a business is likely to perform and how volatile its results may be. These are matters for the Chairman and CEO to explain and their statements will allow shareholders to increase or reduce their investment in the business according to their own risk appetite.

3.2.9 Specific question 9: *What should be the role of the board of directors in a financial institution's risk profile and strategy?*

Setting the strategy is the central task of a board. Since finance is, by definition, a risk business, the strategy must be developed within a risk envelope which defines the range of potential outcomes. The chosen strategy will be that which meets shareholders reasonable expectations and delivers stakeholder satisfaction. Whilst the responsibility of permanent executives for risk management must not be understated, the role of the board is fundamental to say the least. In the continental model the supervisory board approves the management board's strategy.

3.2.10 Specific question 10: *Should a risk control declaration be put in place and published?*

The answer is affirmative but only within the context of strategy communication to shareholders and stakeholders. Disclosure of commercial and confidential information should be avoided.

3.2.11 Specific question 11: *Should an approval procedure be established for the board of directors to approve new financial products?*

Yes, if they are material. Product introduction would normally be a function of strategy implementation and therefore a matter of considerable interest to the board.

3.2.12 Specific question 12: *Should an obligation be established for the board of directors to inform the supervisory authorities of any material risks they are aware of?*

It is to be expected that this would be a regular element in the on-going dialogue between the institution and the supervisory authorities.

3.2.13 Specific question 13: *Should a specific duty be established for the board of directors to take into account the interests of depositors and other stakeholders during the decision-making procedure ("duty of care")?*

In some jurisdictions there is already an obligation to take account of the interests of stakeholders. This should be routine. If stakeholders are dissatisfied, a business will not thrive. No given set of stakeholder interests should dominate. Board proceedings should record that all interests were considered when the strategy was set.

3.3 Deficiencies in risk management problems with conflicts of interest

3.3.1 Specific question 14: *How can the status of the chief risk officer be enhanced? Should the status of the chief risk officer be at least equivalent to that of the chief financial officer?*

This question implies that we know what a chief risk officer (CRO) is supposed to do. If risk is integral to business strategy, then the CFO *is* the chief risk officer. Risk at the micro level puts the CRO at the same level as the head of internal audit. Both report to a committee of the board and have unfettered access to the chairman of that committee. Both should report periodically to the full board.

3.3.2 Specific questions 15: *How can the communication system between the risk management function and the board of directors be improved? Should a procedure for referring conflicts/problems to the hierarchy for resolution be set up?*

This is covered by the response set out in 3.3.1 above. This procedure should already be part of the functioning of the committee and the board.

3.3.3 Specific question 16: *Should the chief risk officer be able to report directly to the board of directors, including the risk committee?*

This is also covered by the response set out in 3.3.1 above.

3.3.4 Specific question 17: *Should IT tools be upgraded in order to improve the quality and speed at which information concerning significant risks is transmitted to the board of directors?*

It depends on what exists at the moment in each institution. Not all risks can be routinely monitored by IT. In many cases an email alert can suffice. The larger and more complex the organisation, in terms of divisions, geographies and products, the more sense it makes to install an IT based active risk manager.

3.3.5 Specific question 18: *Should executives be required to approve a report on the adequacy of internal control systems?*

Yes. In certain jurisdictions this is already mandatory. It will usually be managed through the audit committee.

3.4 **The role of external auditors**

3.4.1 Specific question 19: *Should cooperation between external auditors and supervisory authorities be deepened? If so, how?*

Audit firms must work for the members of the company. However, if they find serious issues of risk or non-compliance, which have systemic implications, supervisors should be alerted. Issues which can be corrected by the company and which do not have external ramifications should be left to the company to correct. In the continental governance system, the supervisory board appoints the auditors and meets them annually without the presence of the management board and the chief executive officer.

3.4.2 Specific question 20: *Should their duty of information towards the board of directors and/or supervisory authorities on possible serious matters discovered in the performance of their duties be increased?*

It depends on the status quo. In certain jurisdictions, the provisions are already adequate. In the continental European system it should be decided by the contractual basis between supervisory board and auditor.

3.4.3 Specific question 21: *Should external auditors' control be extended to risk-related financial information?*

Auditors are required to confirm that a company's accounts give a true and fair view on a going concern basis. In this context, any material risk should already be shown as a provision or a note to the accounts. No extension would appear to be needed.

3.5 Deficiencies in the Supervisory authorities

3.5.1 Specific question 22: *Should the role of supervisory authorities in the internal governance of financial institutions be redefined and strengthened?*

Yes, in jurisdictions where that has not already taken place.

3.5.2 Specific question 23: *Should supervisory authorities be given the power and duty to check the correct functioning of the board of directors and the risk management function? How can this be put into practice?*

As already outlined in 3.5.1 above.

3.5.3 Specific question 24: *Should the eligibility criteria ("fit and proper test") be extended to cover the technical and professional skills, as well as the individual qualities, of future directors? How can this be achieved in practice?*

This is custom and practice in the continental system to ensure this. The UK Financial Services Authority (FSA) has put in new procedures to give effect to this.

3.6 Problems with the role of shareholders

3.6.1 Specific question 25: *Should disclosure of institutional investors' voting practices and policies be compulsory? How often?*

Yes, in relation to the agenda of general meetings.

3.6.2 Specific question 26: *Should institutional investors be obliged to adhere to a code of best practice (national or international) such as, for example, the code of the International Corporate Governance Network (ICGN)? This code requires signatories to develop and publish their investment and voting policies, to take measures to avoid conflicts of interest and to use their voting rights in a responsible way.*

Yes, on a voluntary basis initially.

3.6.3 Specific question 27: *Should the identification of shareholders be facilitated in order to encourage dialogue between companies and their shareholders and reduce the risk of abuse connected to "empty voting"? Empty voting refers to a situation in which there is a vote by a shareholder with no corresponding financial interest in the company for which they are voting, with potentially negative consequences for the integrity of the corporate governance of listed companies and the markets on which their shares are traded.*

The issue of shareholders should be examined by the Commission because they are not the same as they were in the past. Today shareholders can be global companies, global shareholders, hedge funds etc. and as such are just traders in shares. They do not fulfil the role traditionally associated with the term "shareholders".

3.6.4 Specific question 28: *Which other measures could encourage shareholders to engage in financial institutions' corporate governance?*

One possible measure might be the creation of a proxy organisation to represent the private shareholders in each company. Alternatively there could be pressure from supervisory institutions, from politicians, from the media on institutional investors to become more active.

3.7 More effective implementation of corporate governance principles

3.7.1 Specific question 29: *Is it necessary to increase the accountability of members of the board of directors?*

Not if we want good candidates to come forward. It would be helpful for many institutions to better define their expectations of board members.

3.7.2 Specific question 30: *Should the civil and criminal liability of directors be reinforced, bearing in mind that the rules governing criminal proceedings are not harmonised at European level?*

In certain jurisdictions the provisions are already adequate. The greatest risk to director is usually the reputational risk of being associated with a business that fails. Recently there have been calls for automatic bans from similar roles for directors who fail to warn about undue risks. This is arguably a more precise and promising policy tool.

3.8 **Remuneration of directors of financial institutions**

3.8.1 Specific question 31: *What could be the content and form, binding or non-binding, of possible additional measures at EU level on remuneration for directors of listed companies?*

The provisions of CRD3 appear to be adequate. This will engage the supervisory authorities. Publication of institutional voting policies on remuneration will also be a good move, see 3.8.4 above.

3.8.2 Specific question 32: *Do you consider that problems related to directors' stock options should be addressed? If so, how? Is it necessary to regulate at Community level, or even prohibit the granting of stock options?*

CRD3 appeared to address this. The issues relating to time, hurdles and quantum are covered in that directive.

3.8.3 Specific question 33: *Whilst respecting Member States' competence where relevant, do you think that the favourable tax treatment of stock options and other similar remuneration existing in certain Member States helps encourage excessive risk-taking? If so, should this issue be discussed at EU level?*

The Commission should be encouraged to examine this issue, but, as things stand, taxation is a Member State matter.

3.8.4 Specific question 34: *Do you think that the role of shareholders, and also that of employees and their representatives, should be strengthened in establishing remuneration policy?*

In certain jurisdictions, the remuneration report is subject to shareholder approval. Publication of institutional shareholder votes will make the system more transparent. The problem of the leverage/ratchet effect of the remuneration consultants needs to be addressed by the Commission. The system of shareholder representative organisations in the Netherlands may be a useful template for the Commission to consider.

3.8.5 Specific question 35: *What is your opinion of severance packages (so-called "golden parachutes")? Is it necessary to regulate at Community level, or even prohibit the granting of such packages? If so, how? Should they be awarded only to remunerate effective performance of directors?*

Severance packages are not service rewards. Service rewards are earned in service. Severance packages are the contractual obligations when a company releases an executive director. They are usually granted as a lifeline to give a new recruit some security in the event that his appointment does not work out. Dismissal does not necessarily equate to failure. A strategy change can make a perfectly good performer redundant. Therefore the packages are needed. In some circumstances they may be too rich, especially with respect to pensions. They could be contractually set up to reduce over time and also to be discounted where there has "clearly" been failure. Increasing CEO packages in service should also be discouraged. Rewards should be earned by performance. In the continental system, employees are represented on the supervisory board and they can influence such remuneration practices.

3.8.6 *Specific question 36: Do you think that the variable component of remuneration in financial institutions which have received public funding should be reduced or suspended?*

This question refers principally to the remuneration of high level positions in financial institutions. It is less relevant to ordinary employees. There have been some extraordinary remuneration packages for individuals and such abnormal situations should be avoided. It is up to the government owners of institutions that have received public funding to do as they see fit.

3.9 **Conflicts of interest**

3.9.1 Specific question 37: *What could be the content of possible additional measures at EU level to reinforce the combating and prevention of conflicts of interest in the financial services sector?*

The concept of "Chinese walls" refers to the procedures enforced within a securities or investment firm to prevent the exchange of confidential information between the firm's departments so as to avoid the illegal use of inside information. It has been relied upon within the financial and other sectors to prevent damaging conflicts of interest. In practice, however, Chinese walls are far from infallible because they rely on the honour system. Information is only restricted by the discretion and meticulousness of the parties involved. It may be that regulations that specify legal requirements for information security would lead to an improvement in compliance in this regard.

3.9.2 Specific question 38: *Do you agree with the view that, while taking into account the different existing legal and economic models, it is necessary to harmonise the content and detail of Community rules on conflicts of interest to ensure that the various financial institutions are subject to similar rules, in accordance with which they must apply the provisions of MiFID, the CRD, the UCITS Directive or Solvency 2?*

Yes.

Brussels, 20 January 2011.

The President
of the
European Economic and Social Committee

Staffan Nilsson

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