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Corporate governance in financial institutions and remuneration policies

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(Text with EEA relevance)

1. INTRODUCTION

The scale of the financial crisis triggered by the bankruptcy of Lehman Brothers in autumn 2008 and linked to the inappropriate securitisation of US subprime mortgage debt led governments around the world to question the effective strength of financial institutions and the suitability of their regulatory and supervisory systems to deal with financial innovation in a globalised world. The massive injection of public funding in the US and Europe – up to 25% of GDP – was accompanied by a strong political will to learn the lessons of the financial crisis in all its dimensions to prevent such a situation happening again in the future.

In its Communication of 4 March 2009[1], effectively a programme for reforming the regulatory and supervisory framework for financial markets based on the conclusions of the Larosière report[2], the European Commission announced that it would (i) examine corporate governance rules and practice within financial institutions, particularly banks, in the light of the financial crisis, and (ii) where appropriate, make recommendations, or even propose regulatory measures, in order to remedy any weaknesses in the corporate governance system in this key sector of the economy. Strengthening corporate governance is at the heart of the Commission's programme of financial market reform and crisis prevention. Sustainable growth cannot exist without awareness and healthy management of risks within a company.

As highlighted by the Larosière report, it is clear that boards of directors, like supervisory authorities, rarely comprehended either the nature or scale of the risks they were facing. In many cases, the shareholders did not properly perform their role as owners of the companies. Although corporate governance did not directly cause the crisis, the lack of effective control mechanisms contributed significantly to excessive risk-taking on the part of financial institutions. This general observation is all the more worrying because corporate governance has been relied upon as one of the ways of regulating business life. Consequently, there is a need to address the fundamental question of whether the existing corporate governance regime is deficient as far as financial institutions are concerned or whether it has rather been poorly implemented.

In the financial services sector, corporate governance should take account of the interests of other stakeholders (depositors, savers, life insurance policy holders, etc), as well as the stability of the financial system, due to the systemic nature of many players. At the same time, it is important to avoid any moral hazard by not diminishing the responsibility of private stakeholders. It is therefore the responsibility of the board of directors, under the supervision

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1 COM (2009) 114 final.

2 Report of the High-Level Group on Financial Supervision in the EU published on 25 February 2009. Mr Jacque de Larosière was chairman of the group.

of the shareholders, to set the tone and in particular to define the strategy, risk profile and appetite for risk of the institution it is governing.

The options outlined in this Green Paper are likely to accompany and supplement the legal provisions implemented or planned for the purpose of strengthening the financial system, in particular in the context of the reform of the European supervisory architecture[3], the Capital Requirements Directive (the 'CRD')[4], the Solvency II Directive[5] for insurance companies, reform of the UCITS system and the regulation of Alternative Investment Fund Managers.

Corporate governance requirements should also take account of a financial institution's type (retail bank, investment bank) and size. The principles of sound corporate governance referred to in this Green Paper focus primarily on large financial institutions. These principles should be adapted so as to be applied effectively to smaller financial institutions.

This Green Paper should be read in conjunction with the Commission Staff Working Paper (COM(2010) XYZ) '*Corporate governance in financial institutions: the lessons to be learnt from the current financial crisis and possible steps forward*'. This document takes stock of the situation.

It is also important to point out that, since its meeting in Washington on 15 November 2008, the G20 has endeavoured to improve, amongst other things, risk management and compensation practices within financial institutions[6].

Lastly, the Commission will soon launch a broader review on corporate governance within listed companies in general and, in particular, on the place and role of shareholders, the distribution of duties between shareholders and boards of directors with regard to supervising senior management teams, the composition of boards of directors, and corporate social responsibility.

2. THE CONCEPT OF CORPORATE GOVERNANCE AND FINANCIAL INSTITUTIONS

The traditional definition of corporate governance refers to relations between a company's senior management, its board of directors, its shareholders and other stakeholders, such as employees and their representatives. It also determines the structure used to define a company's objectives, as well as the means of achieving them and of monitoring the results obtained[7].

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3 See the Commission proposals creating three European Supervisory Authorities and a European Systemic Risk Board.

4 Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast), *OJ L 177 of 30.6.2006* and Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions (recast), *OJ L 177 of 30.6.2006*.

5 Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (recast) *OJ L 335 of 17.12.2009*.

6 It was confirmed at the Pittsburgh Summit of 24 and 25 September 2009 that compensation practices would have to be reformed in order to maintain financial stability.

7 See, for example, the OECD's Principles of Corporate Governance, 2004, p. 11. The Green Paper focuses on this limited definition of corporate governance and does not deal with some other important aspects, such as separation of functions within a financial institution, internal controls and accounting independence.

Due to the nature of their activities and interdependencies within the financial system, the bankruptcy of a financial institution, particularly a bank, can cause a domino effect, leading to the bankruptcy of other financial institutions. This can lead to an immediate contraction of credit and the start of an economic crisis due to lack of financing, as the recent financial crisis demonstrated. This systemic risk led governments to shore up the financial sector with public funding. As a result, taxpayers are inevitably stakeholders in the running of financial institutions, with the goal of financial stability and long-term economic growth.

Furthermore, the interests of financial institutions' creditors (depositors, life insurance policy holders or beneficiaries of pension schemes and, to a certain extent, employees) are potentially at odds with those of their shareholders. Shareholders benefit from a rise in the share price and maximisation of profits in the short term and are potentially less interested in too low a level of risk. For their part, depositors and other creditors are focused only on a financial institution's ability to repay their deposits and other mature debts, and thus on its long-term viability. As a result, depositors can be expected to favour a very low level of risk[8].

Largely as a result of the particularities relating to the nature of their activities, most financial institutions are strictly regulated and supervised. For the same reasons, financial institutions' internal governance cannot be reduced to a simple problem of conflicts of interest between shareholders and the management. Consequently, the rules of corporate governance within financial institutions must be adapted to take account of the specific nature of these companies. In particular, the supervisory authorities, whose mission to maintain financial stability coincides with the interests of depositors and other creditors to control risk-taking by the financial sector, have an important role to play in shaping best practices for governance in financial institutions.

Various legal instruments and recommendations at international and European level applicable to financial institutions and in particular banks, already take account of the particularities of financial institutions and the role of supervisory authorities[9].

However, the existing rules and recommendations are based first and foremost on supervisory considerations and focus on the existence of adequate internal control, risk management, audit and compliance structures within financial institutions. They did not prevent excessive risk-taking by financial institutions, as the recent financial crisis demonstrated.

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8 See Peter O. Mülbert, Corporate Governance of Banks, *European Business Organisation Law Review, 12 August 2008*, p.427.

9 Basel Committee on Banking Supervision, Enhancing corporate governance for banking organisations, September 1999. Revised in February 2006; OECD, Guidelines for insurers' governance, 2005; OECD, Revised guidelines for pension fund governance, July 2002; Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC, *OJ L 145 of 30.4.2004*; Solvency II Directive; Capital Requirements Directive; Committee of European Banking Supervisors, Guidelines on the Application of the Supervisory Review Process under Pillar 2 (CP03 revised), 25 January 2006, http://www.c-ebs.org/getdoc/00ec6db3-bb41-467c-acb9-8e271f617675/GL03.aspx; CEBS High Level Principles for Risk Management, 16 February 2010, http://www.c-ebs.org/Publications/Standards-Guidelines/CEBS-High-Level-Principles-for-Risk-Management.aspx

3. DEFICIENCIES AND WEAKNESSES IN CORPORATE GOVERNANCE WITHIN FINANCIAL INSTITUTIONS

The Commission considers that an effective corporate governance system, achieved through control mechanisms and checks, should lead to the main stakeholders in financial institutions (boards of directors, shareholders, senior management, etc.) assuming a higher degree of responsibility. Conversely, the financial crisis and its serious economic and social consequences have led to a significant loss of confidence in financial institutions, particularly with regard to the following.

3.1. The question of conflicts of interest

The questions raised by the issue of conflicts of interest and management of such conflicts are nothing new. Indeed, the issue arises in every organisation or company. Nonetheless, given the systemic risk, the volume of transactions, the diversity of financial services provided and the complex structure of large financial groups, the issue is particularly pressing in the case of financial institutions. Potential conflicts of interest can arise in a variety of situations (for example, exercising incompatible roles or activities, such as providing advice on investments while managing an investment fund or managing for one's own account, incompatibility of mandates held on behalf of different clients/financial institutions). This problem can also arise between a financial institution and its shareholders/investors, particularly where there is cross-shareholding or business links between an institutional investor (for example through the parent company) and a financial institution in which it is investing.

At Community level, the MiFID[10] is a step forward for transparency, devoting a specific section to certain aspects of this issue. However, the asymmetric information between investors and shareholders on the one hand, and the financial institution concerned on the other (an imbalance compounded by the ever-increasing complexity and diversity of the services provided by financial institutions), calls into question the effectiveness of market identification and supervision of various conflicts of interest involving financial institutions. Furthermore, as the CEBS, CEIOPS and CESR committees note in their joint report on internal governance[11], there is a lack of consistency in the content and detail of the conflict of interest rules to which the various financial institutions are subject, depending on whether they need to apply the provisions of MiFID, the CRD, the UCITS Directive[12] or Solvency 2.

3.2. The problem of effective implementation by financial institutions of corporate governance principles

The general consensus[13] is that the existing principles of corporate governance, namely the OECD principles, the recommendations of the Basel Committee, and Community legislation[14], already cover to a certain extent the problems highlighted by the financial crisis. In spite of this, the financial crisis revealed the lack of genuine effectiveness of corporate

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10 Directive 2004/39/EC on markets in financial instruments, (OJ L 145 of 30.4.2004).

11 'Cross-sectoral stock-take and analysis of internal governance requirements' by CESR, CEBS, CEIOPS, October 2009.

12 Directive 2009/65/EC.

13 See the OECD's public consultation 'Corporate governance and the financial crisis' of 18 March 2009 and in particular the section entitled 'Implementation gap'.

14 Directive 2006/46/EC obliges financial institutions listed on regulated markets to draw up a corporate governance code to which they are subject, and to indicate any parts of the code from which they have departed and the reasons for doing so.

governance principles in the financial services sector, particularly with regard to banks. Several theories have been put forward to explain this situation:

– the existing principles are too broad in scope and are not sufficiently precise. As a result, they gave financial institutions too much scope for interpretation. Furthermore, they proved difficult to put into practice, in most cases leading to a purely formal application (i.e., a box-ticking exercise), with no real qualitative assessment.

– the lack of a clear allocation of roles and responsibilities with regard to implementing the principles, within both the financial institution and the supervisory authority.

– the non-binding nature of corporate enterprise principles: the fact that there was no legal obligation to comply with recommendations by international organisations or the provisions of a corporate governance code, the problem of the neglect of corporate governance by supervisory authorities, the weakness of relevant checks, and the absence of deterrent penalties all contributed to the lack of effective implementation by financial institutions of corporate governance principles.

3.3. Boards of directors[15]

The financial crisis clearly shows that financial institutions' boards of directors did not fulfil their key role as a principal decision-making body. Consequently, boards of directors were unable to exercise effective control over senior management and to challenge the measures and strategic guidelines that were submitted to them for approval.

The Commission considers that their failure to identify, understand and ultimately control the risks to which their financial institutions were exposed is at the heart of the origins of the crisis. Several reasons or factors contributed to this failure:

– members of boards of directors, in particular non-executive directors, devoted neither sufficient resources nor time to the fulfilment of their duties. Furthermore, several studies have clearly demonstrated that, faced with a chief executive officer who is omnipresent and in some cases authoritarian, non-executive directors felt unable to raise objections to, or even question, the proposed guidelines or conclusions due to a lack of technical expertise and/or confidence.

– members of boards of directors did not come from sufficiently diverse backgrounds. The Commission, like several national authorities, notes a lack of diversity and balance in terms of gender, social, cultural and educational background.

– boards of directors, in particular the chairman, did not carry out a serious performance appraisal either of their individual members or of the board of directors as a whole.

– boards of directors were unable or unwilling to ensure that the risk management framework and risk appetite of their financial institutions were appropriate.

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15 The term 'board of directors' in this Green Paper essentially refers to the supervisory role of directors in a company which, in a dual structure, generally falls within the scope of the supervisory board. This Green Paper does not prejudice the roles attributed to different company bodies under national legal systems.

– boards of directors proved unable to recognise the systemic nature of certain risks and thus to provide sufficient information upstream to their supervisory authorities Furthermore, even where effective dialogue existed, corporate governance issues were rarely on the agenda.

The Commission considers that these serious deficiencies and acts of misconduct raise important questions about the quality of appointment procedures. The basis for quality in a board of directors lies in its composition.

3.4. Risk management

Risk management is one of the key aspects of corporate governance, particularly in the case of financial institutions. Several large financial institutions no longer exist precisely because they neglected the basic rules of risk management and control. Financial institutions have too often failed to take a holistic approach to risk management. The main failures and shortcomings can be summarised as follows:

– a lack of understanding of the risks on the part of those involved in the risk management chain and insufficient training for those employees responsible for distributing risk products[16];

– a lack of authority on the part of the risk management function. Financial institutions have not always granted their risk management function sufficient powers and authority to be able to curb the activities of risk-takers and traders;

– lack of expertise or insufficiently wide-ranging experience in risk management. Too often, the expertise considered necessary for the risk management function was limited to those categories of risk considered priorities and did not cover the entire range of risks to be monitored;

– a lack of real-time information on risks. To allow those involved to react quickly to changes in risk exposures, clear and correct information on risk should be available rapidly at all relevant levels of the financial institution. Unfortunately, the procedures for getting information to the appropriate level have not always functioned. Furthermore, it is crucial to upgrade IT tools for risk management, including in highly sophisticated financial institutions, as they are still too disparate to allow risks to be consolidated rapidly, while data are insufficiently consistent to allow the evolution of group exposures to be followed up effectively in real-time. This concerns not only the most complex financial products but all types of risk.

The Commission considers that the deficiencies and shortcomings highlighted above are very worrying. They appear to indicate the absence of a healthy risk management culture at all levels of certain financial institutions. On this last point, the directors of financial institutions in particular are responsible, because in order to establish a healthy risk management culture at all levels, it is essential that directors are themselves exemplary in this respect.

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[16] See for example Renate Böhm and Hilla Lindhüber, *Verkaufen, Druck und Provisionen - Probleme von Beschäftigten im Finanzdienstleistungsbereich Versicherungen Ergebnisse einer Arbeitsklima-Index-Befragung*, Salzburg 2008.

3.5. The role of shareholders

The financial crisis has shown that confidence in the model of the shareholder-owner who contributes to the company's long-term viability has been severely shaken, to say the least. The growing importance of financial markets in the economy, due in particular to the multiplication of sources of financing/capital injections, has created new categories of shareholders. Such shareholders sometimes seem to show little interest in the long-term governance objectives of the businesses/financial institutions in which they invest and may be responsible for encouraging excessive risk-taking in view of their relatively short, or even very short (quarterly or half-yearly) investment horizons[17]. In this respect, the sought-after alignment of directors' interests with those of these new categories of shareholder has amplified risk-taking and, in many cases, contributed to excessive remuneration for directors, based on the short-term share value of the company/financial institution as the only performance criterion[18]. Several factors can help to explain the disinterest or passivity of shareholders with regard to their financial institutions:

- certain profitability models, based on possession of portfolios of different shares, lead to the abstraction, or even disappearance, of the concept of ownership normally associated with holding shares.

- the costs which institutional investors would face if they wanted to actively engage in governance of the financial institution can dissuade them, particularly if their participation is minimal.

- conflicts of interest (see above).

- the lack of effective rights allowing shareholders to exercise control (such as, for example, the lack of voting rights on director remuneration in certain jurisdictions), the maintenance of certain obstacles to the exercise of cross-border voting rights, uncertainty over certain legal concepts (for example that of 'acting in concert') and financial institutions' disclosure to shareholders of information which is too complicated and unreadable, in particular with regard to risk, could all play a part, to varying degrees, in dissuading investors from playing an active role in the financial institutions in which they have invested.

The Commission is aware that this problem does not affect only financial institutions. More generally, it raises questions about the effectiveness of corporate governance rules based on the presumption of effective control by shareholders. As a result of this situation, the Commission will launch a broader review covering listed companies in general.

3.6. The role of supervisory authorities

Generally speaking, the recent financial crisis revealed the limits of the existing supervision system: in spite of the availability of certain tools enabling them to intervene in the internal governance of financial institutions[19], not all supervisory authorities, either at national or

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17 See article by Rakesh Khurana and Andy Zelleke, Washington Post, 8 February 2009.

18 See Gaspar, Massa, Matos (2005), Shareholder Investment Horizon and the Market for Corporate Control, Journal of Financial Economics, vol. 76.

19 For example, Basel II.

European level, were able to carry out effective supervision in an environment of financial innovation and rapid change in the business model of financial institutions[20].

Furthermore, the supervisory authorities also failed to establish best practices for corporate governance in financial institutions. In many cases, supervisory authorities did not ensure that financial institutions' risk management systems and internal organisation were adapted to changes in their business model and financial innovation. Supervisory authorities also sometimes failed to adequately enforce strict eligibility criteria for members of boards of directors of financial institutions ('fit and proper test')[21].

Generally speaking, problems linked to the governance of supervisory authorities themselves, particularly the means of combating the risk of regulatory capture or the lack of resources, have never been sufficiently discussed. Moreover, it is becoming increasingly clear that the territorial and substantive competencies of supervisory authorities no longer correspond to the geographical and sectoral spread of financial institutions' activities. This complicates risk management for financial institutions and makes it more difficult for them to comply with regulatory standards, as well as presenting a major challenge for cooperation between supervisory authorities.

3.7. The role of auditors

Auditors play a key role in financial institutions' corporate governance systems, as they provide assurance to the market that the financial statements prepared by those financial institutions present a true and fair view. However, conflicts of interest could arise as audit firms are remunerated by the same companies who mandate them to audit their financial accounts.

At present, there is no information to confirm that the requirement, pursuant to Directive 2006/48/EC, for auditors of financial institutions to alert the competent authorities wherever they become aware of certain facts which are liable to have a serious effect on the financial situation of an institution, has been effectively enforced in practice.

4. INITIAL RESPONSES

In the context of its Communication of 4 March 2009 and measures taken to boost the European economy, the Commission has undertaken to address issues related to remuneration. The Commission has launched the international debate on abusive remuneration practices and was leading the implementation at European level of FSB and G-20 principles on sound compensation practices. Leaving aside the issue of whether or not certain levels of remuneration are appropriate, the Commission started from two premises:

– since the end of the 1980s, the substantial increase in the variable component of listed company directors' salaries raises questions about the methods and content of performance evaluations for company directors. In this respect, the Commission made an initial response at the end of 2004 by adopting a recommendation aimed at strengthening obligations to publish director remuneration policies and individual salaries, and calling on

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20 On the failings of supervisory authorities in general, see the 'de Larosière' Report, footnote 1.

21 See, for example, OECD, Corporate Governance and the Financial Crisis, Recommendations, November 2009, p.27.

the Member States to establish a vote (mandatory or optional) on such director remuneration. For a variety of reasons linked, amongst other things, to the lack of shareholder activism, the explosion of the variable component and, in particular, the multiplication of profit-sharing plans granting shares or stock options, the Commission considered it necessary to adopt a new recommendation on 30 April 2009[22]. The aim of this recommendation is to strengthen governance of directors' remuneration, proposing several principles for director remuneration structures in order to better link remuneration to long-term performance.

– remuneration policies in the financial sector, based on short-term profits without taking into account the corresponding risks, contributed to the financial crisis. For this reason, the Commission adopted another recommendation on remuneration in the financial services sector on 30 April 2009[23]. The aim was to align remuneration policies in the financial services with healthy risk management and financial institutions' long-term viability.

Taking stock one year after the adoption of the two abovementioned recommendations, and in spite of a favourable climate for tough action on the part of the Member States, the Commission finds a mixed overall picture of the situation in the Member States[24].

Although there were strong legislative moves in several Member States to achieve greater transparency in remuneration for listed company directors and to empower shareholders in this respect, it was also noted that only 10 Member States have applied the majority of Commission recommendations. A large number of Member States have still not adopted the relevant measures. Furthermore, where the recommendation led to measures at national level, the Commission noted great diversity in the content and requirements of these rules, particularly on sensitive issues such as remuneration structure and severance packages. The Commission is also concerned about remuneration policies in the financial services. Only 16 Member States have applied the Commission Recommendation in full or in part while five are still in the process of doing so. Six Member States have at present taken no action on this front and do not intend to do so in the near future. Furthermore, the intensity (particularly requirements relating to remuneration structure) and scope of application of the measures taken vary depending on the Member State. Thus only seven Member States have extended implementation of the principles of the recommendation to the entire financial sector, as the Commission called on them to do.

5. OPTIONS FOR THE FUTURE

The Commission considers that, while taking into account the need to preserve the competitiveness of the European financial industry, the deficiencies listed in Chapter 3 call for concrete solutions to improve corporate governance practices in financial institutions. This chapter considers a variety of ways to respond to these deficiencies and tries to strike the right balance between the need for improved corporate governance of financial institutions and the necessity of allowing these institutions to contribute to economic recovery by providing credit to businesses and households. The Commission invites all interested parties to express their

22 Recommendation 2009/385/EC.
23 Recommendation 2009/384/EC.
24 For a detailed examination of the measures taken by the Member States, see the two Commission reports on the application by the Member States of Recommendation 2009/384/EC and Recommendation 3009/385/EC.

views on the considerations set out below. Each of the options explored could lead to the development of measures on corporate governance in financial institutions. The added value of such measures should nevertheless be assessed in the context of impact analyses carried out in accordance with the Commission's guidelines on the subject[25].

More particularly, the Commission is currently exploring different ways of improving the functioning, composition and skills of boards of directors, strengthening risk management-related functions, expanding the role of external auditors and strengthening the role of supervisory authorities in the governance of financial institutions. The place and role of shareholders is also considered.

The main challenge in seeking to improve existing corporate governance practices will be to ensure real change in the behaviour of the relevant actors. This cannot be achieved through new regulatory and non-regulatory requirements alone. It must also be backed up by effective financial supervision.

The various solutions presented below provide a platform for general improvement of corporate governance in financial institutions. Their concrete application should be proportionate and could vary according to the legal form, size, nature and complexity of the financial institution concerned and the various existing legal and economic models.

5.1. Boards of directors

Based on the shortcomings highlighted by the recent crisis, it appears necessary for boards of directors to ensure the right balance between independence and skills is struck. Recruitment policies which precisely identify the skill needs of the board of directors and which aim to guarantee the objectivity and independence of members' judgment could help increase the board of directors' ability to effectively monitor management.

In order to safeguard the objectivity and independence of judgment of members of the board of directors, it seems necessary to strengthen measures intended to prevent conflicts of interest both within the board of directors but also within the financial institution in general, in particular by putting in place clear policies for managing conflicts of interest.

In view of the crucial role that the chairman plays in organising the work of the board, it would be useful to clearly define his/her skills, role and responsibilities.

It would also be useful to review the diversity of the composition of boards of directors. In addition to the need for specific individual qualities (independence, skill, experience, etc), greater diversity (women, directors with different cultural and educational backgrounds, etc) can contribute to the quality of the board's work.

In view of the increasing complexity of the structure and activities of financial institutions, ways to improve the efficiency of the board of directors' work should be investigated. In particular, limiting the number of boards on which a director may sit should be considered to enable them to devote sufficient time to performance of their duties.

It would also seem necessary to formalise the procedure for evaluating the board of directors' performance, in particular by defining the role of external evaluators and supplying

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25 SEC(2009) 92.

supervisory authorities and/or shareholders with the results of the evaluation so that they can judge the capabilities and effectiveness of the board of directors.

It seems that the duties and responsibilities of the board of directors, particularly with regard to the board's role in risk supervision, also need to be strengthened. It would be useful to consider creating a specialised risk supervision committee within the board of directors. Publishing the board of directors' approval of the risk strategy and profile in a public document (risk control declaration) could also contribute to good management and supervision of risks within financial institutions.

Generally speaking, it seems necessary for members of the board of directors to be familiar with the structure of their financial institution and ensure that organisational complexity does not prevent effective control of the institution's activity in its entirety.

It also seems necessary to clarify the respective roles and responsibilities of the various players in decision-making within the financial institution, particularly members of the board of directors and the senior management. In particular, the board of directors should ensure that clear responsibility structures are put in place covering the entire organisation, including subsidiaries, branches and other related entities.

Increased cooperation between the board of directors and the supervisory authorities would also seem desirable. In particular, a requirement that the board of directors alert the supervisory authorities to any substantial/systemic risks that they are aware of could be considered.

The Commission is also considering whether, in addition to shareholders' interests, which are essential in the traditional view of corporate governance, financial institutions also need to take better account of other stakeholders' interests. In particular, the creation of a specific duty for the board of directors to take account of the interests of depositors and other creditors in their decision-making ('duty of care') could help encourage the board of directors to adopt less risky strategies and improve the quality of the financial institution's long-term risk management. The creation of such a duty would nonetheless require careful examination of the existing legal regimes in the different Member States. Depending on the results of this examination, the Commission will then have to determine whether action at European level is needed to help strengthen financial stability across the European Union as a whole.

General question 1: Interested parties are invited to express whether they are in favour of the proposed solutions concerning the composition, role and functioning of the board of directors, and to indicate any other measures they believe would be necessary.

1. Specific questions:

1.1. Should the number of boards on which a director may sit be limited (for example, no more than three at once)?

1.2. Should combining the functions of chairman of the board of directors and chief executive officer be prohibited in financial institutions?

1.3. 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?

1.4. 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?

1.5. 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?

1.6. 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?

1.7. Should it be compulsory for one or more members of the audit committee to be part of the risk committee and vice versa?

1.8. Should the chairman of the risk committee report to the general meeting?

1.9. What should be the role of the board of directors in a financial institution's risk profile and strategy?

1.10. Should a risk control declaration be put in place and published?

1.11. Should an approval procedure be established for the board of directors to approve new financial products?

1.12. Should an obligation be established for the board of directors to inform the supervisory authorities of any material risks they are aware of?

1.13. 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')?

5.2. Risk-related functions

One of the main observations in the wake of the recent financial crisis was the failure of risk management functions, due in particular to the lack of authority of these functions and a poor system for risk-related communication and information.

It therefore seems necessary to strengthen the independence and authority of the risk management function, particularly by enhancing the status of the chief risk officer (CRO). In particular, it seems desirable that the chief risk officer should have at least equal status to the chief financial officer within the internal organisation of a financial institution, and that they should be able to directly report any risk-related problem to the board of directors. Establishing close relations between the chief risk officer and the board of directors (and its risk committee) could also help to strengthen the role of the chief risk officer.

It also seems desirable to improve the risk management function's communication system, in particular by introducing a procedure for referring any conflicts and problems encountered to the hierarchy for resolution. The board of directors should establish the frequency and content of the risk reports to be submitted to it regularly. Updating the IT infrastructure should also be a priority in order to substantially develop financial institutions' risk management capabilities and allow risk information to be circulated in good time.

Generally speaking, implementation of a policy to increase awareness of risk problems ('risk culture') for the benefit of all staff, including members of the board of directors, should be a requirement. In particular, it seems advisable to carry out an evaluation of the underlying risks before setting up any new financial products, market sectors or areas of activity.

Finally, it seems appropriate for senior management to approve an evaluation report on the adequacy and functioning of the internal control system, in order to ensure that internal control systems within a financial institution are effective, including with regard to risk.

General question 2: Interested parties are invited to express whether they are in favour of the proposed solutions regarding the risk management function, and to indicate any other measures they believe would be necessary.

Specific questions:

2.1. 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?

2.2. 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?

2.3. Should the chief risk officer be able to report directly to the board of directors, including the risk committee?

2.4. 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?

2.5. Should executives be required to approve a report on the adequacy of internal control systems?

5.3. External auditors

In order to respond to the problems highlighted in Chapter 3, it seems necessary to examine ways of extending the reporting scheme by which external auditors alert the board of directors and supervisory authorities of any substantial risks they discover in the performance of their duties ('duty of alert').

Generally speaking, it seems desirable to strengthen cooperation between external auditors and the supervisory authorities in order to benefit from auditors' knowledge not only of individual financial institutions but also of the financial sector as a whole, while taking into account constraints relating to professional secrecy.

Finally, it is worth reviewing the role that external auditors should play more generally with regard to risk-related information in financial institutions. In particular, it could be envisaged for the external auditor to validate a greater range of information which is relevant to shareholders than it does at present in order to improve investor confidence in this type of information, thereby encouraging the proper functioning of the markets.

General question 3: Interested parties are invited to express whether they are in favour of the proposed solutions concerning the role of external auditors, and to indicate any other measures they believe would be necessary.

Specific questions:

3.1.	Should cooperation between external auditors and supervisory authorities be deepened? If so, how?
3.2.	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?
3.3.	Should external auditors' control be extended to risk-related financial information?

5.4. Supervisory authorities

In order to respond to the shortcomings in financial institutions' corporate governance highlighted by the recent crisis, it seems necessary to redefine and strengthen the role of supervisory authorities in the internal governance of financial institutions. There is a need, however, to ensure a clear delimitation of roles and responsibilities between the supervisors and the governing bodies of financial institutions.

In particular, it might be possible to envisage creating a duty for supervisory authorities to check the correct functioning and effectiveness of the board of directors, and to regularly inspect the risk management function to ensure its effectiveness. It would be useful for the supervisory authorities to inform the board of directors of any shortcomings they discover so that the financial institution can correct them in good time.

It also seems necessary for the supervisory authorities to extend the eligibility criteria ('fit and proper test') for future directors to cover technical and professional skills, including those relating to risk, as well as candidates' individual qualities, in order to ensure better independence of judgment of future members of the board of directors.

Finally, cooperation between supervisory authorities on corporate governance of cross-border financial institutions should be strengthened, particularly within colleges of supervisors but also in the context of future European supervisory authorities.

General question 4: Interested parties are invited to express whether they are in favour of the proposed solutions concerning the role of supervisory authorities, and to indicate any other measures they believe would be necessary.

Specific questions:

4.1	Should the role of supervisory authorities in the internal governance of financial institutions be redefined and strengthened?
4.2.	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?
4.3.	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?

5.5. Shareholders

The problems related to the particular role of shareholders in financial institutions have been partly discussed above. Shareholders' lack of interest in corporate governance raises questions in general about the effectiveness of corporate governance rules based on the presumption of effective control by shareholders for all listed companies. Similarly, engaging shareholders presents a real challenge for financial institutions.

In order to motivate shareholders to engage in a dialogue with the financial institution and monitor senior management's decision-making, as well as to consider the long-term viability of the financial institution, the Commission intends to carry out a review centred around the following topics:

– strengthening shareholder cooperation through the creation of discussion platforms;

– disclosure by institutional investors of their voting practices at shareholders' meetings;

– institutional investors adherence to 'stewardship codes' of best practice;

– identification and disclosure of potential conflicts of interest by institutional investors;

– disclosure by institutional investors of the remuneration policy for intermediaries[26];

– providing shareholders with better information on risk.

General question 5: Interested parties are invited to express their view on whether they consider that shareholder control of financial institutions is still realistic. If so, how in their opinion would it be possible to improve shareholder engagement in practice?

Specific questions:

5.1. Should disclosure of institutional investors' voting practices and policies be compulsory? How often?

5.2. 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.

5.3. 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'[27]?

[26] Particularly the managers of asset management companies.

[27] 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.

5.4.	Which other measures could encourage shareholders to engage in financial institutions' corporate governance?

5.6. Effective implementation of corporate governance principles

In addition to the role of supervisory authorities in implementing good corporate governance practices within financial institutions as discussed above, it is worth considering senior management's legal accountability for the correct implementation of these principles. Effective and efficient sanctions may be needed in order to change the behaviour of the relevant actors. However, the Commission is of the view that any increase in managers' civil or criminal accountability should be examined carefully. An in-depth study on this subject should be carried out beforehand, recognising Member States' competence on matters of criminal law.

General question 6: Interested parties are invited to express their opinion on which methods would be effective in strengthening implementation of corporate governance principles?

Specific questions:

6.1.	Is it necessary to increase the accountability of members of the board of directors?
6.2.	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?

5.7. Remuneration

The Commission has already adopted several recommendations on this subject[28]. Legislative proposals for credit institutions and investment firms are also currently being discussed in the context of the modification of the CRD[29] as well as for Alternative Investment Fund Managers. The Commission considers that, to prevent distortions of competition between financial institutions in different sectors, other similar legislative measures will have to follow for the other financial services sectors, in particular UCITS and insurance companies.

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. Although a specific recommendation on remuneration exists for financial services, the recommendations on directors' remuneration also apply to directors of listed financial institutions and contain additional rules, particularly with regard to transparency of remuneration for directors. For this reason, the Commission gives consideration in this Green Paper to the need for and content of relevant legislative measures.

[28] See Recommendation 2009/384/EC and Recommendation 2009/385/EC.

[29] See the proposal for a Directive of the European Parliament and of the Council amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies – COM/2009/0362 final.

General question 7: Interested parties are invited to express their views on how to enhance the consistency and effectiveness of EU action on remuneration for directors of listed companies.

Specific questions:

7.1. 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?

7.2. 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?

7.3. 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?

7.4. Do you think that the role of shareholders, and also that of employees and their representatives, should be strengthened in establishing remuneration policy?

7.5. 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?

General question 7a: Interested parties are also invited to express their views on whether additional measures are needed with regard to the structure and governance of remuneration policies in the financial services. If so, what could be the content of these measures?

Specific questions:

7.6. Do you think that the variable component of remuneration in financial institutions which have received public funding should be reduced or suspended?

5.8. Conflicts of interest

The weight and role of the financial sector in the economy and considerations relating to financial stability require that conflicts of interest should be at least partly regulated by very clear rules rooted in law and by attributing a clearly defined role to the supervisory authorities in monitoring their correct application.

General question 8: Interested parties are invited to express whether they agree with the Commission's observation that, in spite of current requirements for transparency with regard to conflicts of interest, surveillance of conflicts of interest by the markets alone is not always possible or effective.

Specific questions:

8.1. 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?

8.2.	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?

6. NEXT STEPS

Member States, the European Parliament, the European Economic and Social Committee and other interested parties are invited to submit their views on the suggestions set out in this Green Paper with a view to establishing a broad consensus on any measures that could be envisaged. Contributions should be sent to the following address to reach the Commission by 1st September 2010 at the latest: markt-cg-fin-inst@ec.europa.eu. In the follow-up to this Green Paper and on the basis of the responses received, the Commission will take a decision on the next steps. Any future legislative or non-legislative proposal will be accompanied by an extensive impact assessment.

Contributions will be published on the internet. It is important to read the specific privacy statement attached to this Green Paper for information on how your personal data and contribution will be dealt with.