

Brussels, January 27<sup>th</sup> 2010



## 'European companies fail to link executive pay to ESG performance'

Belsif, the Belgian Sustainable & Socially Responsible Investment Forum ([www.belsif.be](http://www.belsif.be)), organised, in collaboration with Transparency International Belgium ([www.transparencybelgium.be](http://www.transparencybelgium.be)) & Eurosif, on January 27<sup>th</sup>, 2010, an event over "REMUNERATION: TRANSPARENCY & LINK WITH LONG TERM SUSTAINABILITY" with representatives from banks, research organisations and from the European Commission.

In the aftermath of the global financial crisis, remuneration policies and specifically the level of bonuses of senior executives of companies and traders continue to hit the headlines. Investors and regulators have expressed concern that remuneration structures may have contributed to excessive risk-taking and are asking for a stronger focus to be placed on long-term reward schemes and sustainable growth.

Stephen Hine (Head of Responsible Development - Eiris) presented first Eurosif's report on Remuneration, with research conducted by EIRIS.

Research highlights include:

- 29% of FTSE Eurofirst300 listed companies have some commitment to linking remuneration to performance on environmental, social and governance (ESG) issues – although concerns exists around the extent to which performance targets are set as 'soft targets' thereby guaranteeing a minimum level of bonus
- Only 16% of financial institutions have an ESG-linked remuneration system

Principles of a transparent & accountable remuneration framework:

- Disclosure of **remuneration policy**, structures (independency) & performance criteria
- **Shareholder vote** ('say on pay') on remuneration policy: shareholders should engage with companies by voting against unacceptable remuneration packages and calling for and taking part in shareholder dialogue in determining remuneration policy – preferably binding. For the moment, a binding say on pay only exists in three European countries: the Netherlands, Sweden & Norway.
- Disclosure of **individual director remuneration** packages for approval
- Significant part of variable remuneration linked to achieving **long-term performance**

Stephen Hine states, *"As calls from investors, regulators and NGOs to link extra financial ESG issues to executive remuneration increase, our research shows that relatively few European companies are currently doing so. Furthermore, approximately half of the companies that link remuneration to ESG issues do not clarify which ESG areas are linked to the remuneration. ESG targets should be quantified, time-bounded, verifiable and stretching."*

Regulators should promote active dialogue between companies and shareholders by legislating for a binding "say on pay" vote and setting appropriate guidelines to promote good remuneration practices and disclosure.

Elizabeth Tijssen, from the Directorate General Internal market, gave the European Commission's point of view on this hot topic:

The EU adopted two recommendations before the crisis on directors' remuneration:

- COMMISSION RECOMMENDATION of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board

- COMMISSION RECOMMENDATION of 14 December 2004 fostering an appropriate regime for the remuneration of directors of listed companies

It recommends that Member States should ensure listed companies disclose their policy on directors' remuneration and tell shareholders how much individual directors are earning and in what form, and ensure shareholders are given adequate control over these matters and over share-based remuneration schemes.

In 2007, the European Commission has published two reports on Member States' application of EU recommendations on company directors' pay and independence.

Both reports conclude that the application of corporate governance standards has improved, but some weaknesses remain. The report on directors' remuneration shows that transparency standards are widely followed, but in some Member States it is still not recommended that shareholders vote on this issue. The report on the role of independent non-executive directors finds that there is a real progress in improving governance standards in this field, but some of the recommended standards have not been followed in all Member States.

After the crisis, in July 2009, two additional recommendations were made, complementing the first ones and one recommendation is specific addressed to the financial services industry:

- Financial services sector pay: Commission sets out principles on remuneration of risk-taking staff in financial institutions

It recommends that Member States should ensure that financial institutions have remuneration policies for risk-taking staff that are consistent with and promote sound and effective risk-management. The Recommendation sets out guidelines on the structure of pay, on the process of design and implementation of remuneration policies and on the role of supervisory authorities in the review of remuneration policies of financial institutions.

- Directors' pay: Commission sets out further guidance on structure and determination of directors' remuneration

An appropriate remuneration policy should ensure pay for performance and stimulate directors to ensure the medium and long term sustainability of the company. The existing Directors' remuneration Recommendation is based on the idea of pay for performance through disclosure of the remuneration policy. The new Recommendation will give further guidance on achieving this by setting out best practices for the design of an appropriate remuneration policy. To this end, it focuses on certain aspects of the structure of directors' remuneration and the process of determining directors' remuneration, including shareholder supervision. The Commission has also adopted a Recommendation on remuneration policy in the financial services sector.

The next steps include reports on the application of the 2009 recommendations on directors' remuneration and remuneration in the financial services sector and a report on corporate governance in financial institutions (which could address a wider area than remuneration, such as governance of the risk management process and the role of shareholders), which are expected to be adopted around April 2010.

Chantal Hébette, Chair of Transparency International Belgium (TI-B) and Cécile Louchard, adviser to TI-B presented Transparency International Belgium's position about remuneration in the banking sector. This position is in line with Eurosif's report but has a slightly different focus. : to be concerned about not only the remuneration of executives and traders but also the variable pay of bank agents, to reflect on global performance award as a substitute to variable pay, to show also the weaknesses of the control by shareholders (say on pay) when they are not independent from the Board, to highlight the importance of rules and sanctions, and to focus on sound risk management.

Key recommendations about the variable pay of the bank agent as presented in TI-B's report are: to define a maximum towards the fixed pay (1 to 1 cap = 100%), the introduction of sustainability in objectives, the possibility to block variable pay and even get reimbursement when the long term performances are poor, the establishment of controls & sanctions in line with amounts at stake. Moreover, the variable pay parameters should be clear & predictable, reflecting the company's values,

should take into account innovation and client satisfaction and should be based on individual as well as collective performances.

Another key issue is the communication with clients. Many clients don't know that the bank agents have incentives to sell products and should be aware of the remuneration scheme.

A panel discussion, animated by Robin Edme (Vice-president of Eurosif & President of the F.I.R.) followed these three presentations and was composed by Antti Savilaakso (Analyst at Dexia Asset Management), Stephen Hine and Cécile Louchard.

*Is the limitation of remuneration an option?*

Stephen Hine: *"It's difficult to determine the maximum allowed amount. What's too much? What's too little? The salary should be in line with the performances, but if we take the example of some financial institutions, we could argue about their salaries. Moreover, it can be a barrier to attract new talents, especially in UK/US corporations."*

Antti Savilaakso: *"During the 80's, the congress legislated a maximum deductible severance payment to be three times of the base salary. The result was that overwhelming majority of companies that did not provide severance payments started to do so at three times of the base salary. So we should prudent in exact legislation in order to avoid perverse incentives. Moreover, it has an important cultural aspect, varying from country to country and the correct level would be very tricky to set. We praise the transparency and disclosure, not the remuneration amount."*

Cécile Louchard: *"Motivation elements are diverse: salary of course but also the work environment, the possibility to learn, to have promotion, etc. But I think that since the crisis, the government and the public have a different opinion on this topic, so it's the right time to put in places some rules. After the crisis, ethics is a must, not an option!"*

*Are you in favour of a voluntary regulation or a mandatory regulation? What do you expect from the EU? What are your recommendations?*

Cécile Louchard: *"Rules should be applicable easily and should offer the possibility to be implemented directly because there are many different ways to implement EU's rules. There will always be a way to do the minimum. TI-B recommends to limit the variable pay to 100% of the fixed income as in the Netherlands. But regulations do not change the culture..."*

Stephen Hine: *"We are in favour of mandatory rules, but not too detailed because they should be applicable in different countries, with different cultures. The EU should enhance the regulation about ESG disclosure and make the say on pay binding. I would also recommend to shareholders to use their power and vote."*

Antti Savilaakso: *"Mandatory rules are easier to monitor as an analyst. But I'm afraid that the EU will take the lowest common denominator, and adopt a minimum rule. I think that national rules on disclosure and on the structure of remuneration committee (fully independent) would be more efficient."*