EUROPEAN CENTRAL BANK

EUROSYSTEM

OPINION OF THE EUROPEAN CENTRAL BANK

of 14 May 2010

on compensation systems at institutions and insurance companies

(CON/2010/41)

Introduction and legal basis

On 9 March 2010 the European Central Bank (ECB) received a request from the German Federal Ministry of Finance for an opinion on a draft law on the prudential supervision requirements for the compensation systems at institutions and insurance companies (hereinafter the 'draft law').

The ECB's competence to deliver an opinion is based on Articles 127(4) and 282(5) of the Treaty on the Functioning of the European Union and the sixth indent of Article 2(1) of Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions[1], as the draft law relates to rules applicable to financial institutions insofar as they materially influence the stability of financial institutions and markets. In accordance with the first sentence of Article 17.5 of the Rules of Procedure of the European Central Bank, the Governing Council has adopted this opinion.

1. Purpose of the draft law

1.1 The draft law aims at implementing the Financial Stability Board (FSB) Principles for Sound Compensation Practices of 2 April 2009 and their Implementation Standards released in September 2009, together with the measures currently being finalised at Union level[2]. According to the explanatory memorandum to the draft law, one of the causes of the financial market crisis was compensation policies geared to short-term parameters and unilaterally rewarding success without having sufficient sanctions for failure, which can lead to sight being lost of long-term and sustainable corporate success and thus increase the employees' risk propensity. As the financial market crisis has shown, such compensation policies can endanger not only individual companies but also financial stability in general. The aim of the FSB principles and standards and the legislation implementing them is to establish compensation systems in the financial sector that are

1 OJ L 189, 3.7.1998, p. 42.

2 For the banking sector, 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) 362 final). The Committee of European Banking Supervisors also developed guidelines for sound compensation policies ('High-level principles for Remuneration Policies' of 20 April 2009), which have also been taken into account in this draft law.

commensurate with effective risk management, particularly by orienting compensation structures more strongly to the long-term success of the financial institution.

1.2 To ensure swift implementation of the international standards, the Federal Government pursued a three-stage approach. As a first step, in December 2009 some large German credit institutions and insurance companies committed themselves on a voluntary basis to orient their compensation systems to long-term business success. Second, the Federal Financial Supervisory Authority implemented the international rules by two circulars[3] in anticipation of the draft law. As a third step, the draft law and two forthcoming implementing regulations will establish the legal basis for compensation systems at credit and financial services institutions as well as of insurance companies.

1.3 The draft law aims at establishing appropriate and transparent compensation systems that are oriented to the long-term development of the financial institution or company in question; these compensation systems will form part of the statutory minimum requirements for appropriate and effective risk management by institutions and insurance companies. The two forthcoming implementing regulations will lay down the detailed requirements for compensation systems, in particular regarding structure; monitoring and further development, including the decision-making processes; the composition of the compensation, the compensation parameters and the performance period; and disclosure.

1.4 In case of failure or impending failure of the financial institution to meet specific supervisory requirements, the Supervisory Authority has the power to prohibit the payment of variable compensation components or to limit them to a specific share in the annual result. Variable compensation components are concluded within the framework of contractual freedom, which is protected by the German Constitution. The draft law also covers agreements concluded before its entry into force insofar as entitlement to specific future compensation was contained in such agreements. In that regard, Section 45(1), first sentence, No 4, of the Law on banking prohibits payment of specific compensation components, but does not retrospectively affect compensation that has already been paid.

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3 Circular 22/2009 (BA) of 21 December 2009 – Requirements for remuneration systems for institutions, and Circular 23/2009 (VA) of 21 December 2009 – Requirements for remuneration systems in the insurance industry. The circulars entered into force on publication.
According to these rules, all institutions are required to comply with a set of general requirements while the application of additional stricter requirements relating, in particular, to the structure and form of the remuneration, the establishment of a remuneration committee and disclosure, is conditioned upon the size of the institution, its remuneration structure as well as the type, extent, complexity and scope of risk or internationality of the business pursued. In this respect, the institution has to assess itself whether it falls under the respective requirements. The analysis must be plausible, comprehensive and understandable for third parties.
Under these specific requirements, the broad lines of the deferred payment of variable remuneration for risk takers are as follows. At least 40% of variable remuneration is to be stretched over a withholding period of at least three years. Moreover, at least 50% of deferred variable remuneration must depend on the sustainable growth of the institution.
In accordance with the general requirements in the circular, the administrative or supervisory board of an institution needs to be informed at least annually about the remuneration systems so it can form an independent judgment on their appropriateness. The institution must try everything legally possible to adapt existing labour law agreements which do not comply with an adequate remuneration system.

2. General observations

2.1 This draft law can be viewed as a logical step following (i) the compensation restrictions adopted for institutions benefiting from rescue measures by the Federal Government in the Law on financial market stabilisation and the Financial Market Stabilisation Fund Regulation[4], and (ii) the measures reforming financial supervision instruments in the Law on strengthening the supervision of the financial market and insurance sector[5], on which the ECB was consulted[6]. The draft law will put in place measures with a view to limiting incentives for risk-taking behaviour and ensure efficient and effective supervision on a long-term basis.

2.2 The ECB welcomes the draft legislation by the Federal Government which, together with the implementing regulations to be issued subsequently, will implement the international standards on compensation intended to enhance the stability and robustness of the financial system. In this respect the ECB emphasises the importance of fully aligning requirements relating to compensation practices and policies with the international standards on compensation, and with the envisaged revision of 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)[7], introducing provisions aimed at ending practices that lead to excessive risk-taking.

2.3 The ECB understands that the draft law sets out the general terms of compensation, whereas the detailed rules are to be set out in the foreseen implementing regulations. These implementing regulations have not yet been subject to consultation of the ECB. The ECB encourages the consulting authority to consult it also on these implementing regulations in due time before their adoption.

2.4 The ECB draws the consulting authority's attention to the need, in addition to adopting measures such as the draft law, to strengthen coordination of policy measures in response to the crisis[8].

This opinion will be published on the ECB's website.

Done at Frankfurt am Main, 14 May 2010.

[signed]

The President of the ECB

Jean-Claude TRICHET

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4 *Finanzmarktstabilisierungsgesetz*, *Bundesgesetzblatt* I, 17.10.2008, p. 1982.

5 *Gesetz zur Stärkung der Finanzmarkt- und der Versicherungsaufsicht*, *Bundesgesetzblatt* I, 31.7.2009 p. 2305.

6 See Opinions CON/2008/57 and CON/2009/50. Furthermore, the ECB was consulted on further German crisis-related legislation: CON/2009/24 and CON/2009/54. All ECB opinions are available on the ECB's website at www.ecb.europa.eu.

7 OJ L 177, 30.6.2006, p. 1.

8 See in particular paragraph 2.1 of Opinion CON/2008/57 and paragraph 2.2 of Opinion CON/2009/24.