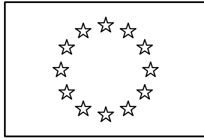

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IMPACT ASSESSMENT

Accompanying the document

Proposal for a

DIRECTIVE OF THE EUROPEAN PARLIAMENT AND THE COUNCIL

on the access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms and amending Directive 2002/87/EC of the European Parliament and of the Council on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate

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PART I

SANCTIONS IN THE FINANCIAL SECTOR

TABLE OF CONTENTS

1. Introduction ... 3
2. Procedural Issues and Consultation of Interested Parties ... 4
3. Policy context, Problem definition and Subsidiarity ... 5
3.1. Background and context ... 6
3.1.1. Nature and size of the market concerned ... 6
3.1.2. Overview of legislative framework ... 6
3.2. Problem definition ... 7
3.2.1. Affected stakeholders ... 18
3.2.2. Baseline scenario ... 18
3.3. The EU's right to act and justification ... 20
3.3.1. Subsidiarity and proportionality ... 21
4. Objectives ... 22
5. Policy Options, impact analysis and comparison ... 23
5.1. Options to approximate and reinforce the legal framework of sanctions ... 24
5.1.1. Options concerning appropriate administrative sanctions ... 24
5.1.2. Options concerning the personal scope of administrative sanctions ... 38
5.1.3. Options concerning the publication of sanctions ... 42
5.2. Options concerning the framework for detection of violations ... 46
5.3. Preferred policy options ... 53
5.3.1. Cumulative impacts of the preferred options ... 54
5.3.2. Impact on EU budget ... 55
6. Monitoring and Evaluation ... 55

ANNEX I ... 57

ANNEX II....63

ANNEX III....73

ANNEX IV....76

ANNEX V....82

ANNEX VI....90

1. INTRODUCTION

The "CRD IV" package is a comprehensive review of EU banking prudential rules and supervisory arrangements, currently provided for in Directives 2006/48/EC[1] (the Capital Requirements Directive) and 2006/49/EC[2]. It implements the international Basel accord on banking supervision. The key objective of the proposal is to address the shortcomings exposed during the financial crisis, to move towards a single rulebook regulating credit institutions in order to prevent recent problems from reoccurring in the future, and to ensure that risks linked to the issues of financial instability and pro-cyclicality are more effectively contained.

In order to achieve these objectives, the CRD IV proposal fundamentally overhauls the substantive prudential rules applicable to banks. But these rules will only achieve their objective if they are effectively and consistently enforced throughout the EU. This requires that competent authorities have at their disposal not only supervisory powers allowing them to effectively oversee credit institutions but also sufficiently strict and convergent sanctioning powers to respond adequately to the violations which may nevertheless occur, and prevent future violations.

However, the banking sector is one of the areas where national sanctioning regimes are divergent and not always appropriate to ensure deterrence.

In its Communication of 9 December 2010 "Reinforcing sanctioning regimes in the financial sector"[3] the Commission presented policy orientations on how to promote convergence and reinforcement of national sanctioning regimes in the financial services sector. The Communication suggested EU legislative action may be necessary to set EU minimum common standards on certain key issues of sanctioning regimes. Such standards are to be developed in the framework of common basic principles but adapted to the specifics of the different sectors and EU legislative acts in the financial services area.

This Impact Assessment provides an analysis of the possible measures that may be taken to approximate and reinforce sanctioning powers applicable to violations of the CRD. It builds on the analysis outlined in the Impact Assessment accompanying the above-mentioned Communication, and focuses in greater detail on the issues specific to the banking sector, and particularly the area covered by the CRD.[4]

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1 Council and Parliament Directive 2006/48/EC of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions, OJ L177/1 of 30 June 2006

2 Council and Parliament Directive 2006/49/EC of 14 June 2006 on the capital adequacy of investment firms and credit institutions, OJ L177/201 of 30 June 2006

3 COM(2010)716 final.

4 For an overview of the interaction of this initiative with other initiatives in the Financial Services Sector see Annex VI.

It is a complement to the Impact Assessment for the "CRD IV" proposal. It supplements that document with a detailed assessment of the impact of the provisions relating to sanctions contained in the proposal.

2. PROCEDURAL ISSUES AND CONSULTATION OF INTERESTED PARTIES

The Communication of 9 December 2010 "Reinforcing sanctioning regimes in the financial sector" (hereafter: "the Sanctions Communication") identified a number of shortcomings of existing sanctioning regimes in the banking, insurance and securities sectors (divergent and insufficiently deterrent sanctions), it explained the negative consequences they may have (lack of compliance with EU legislation, unlevel playing field, lack of trust between supervisors) and suggested possible EU actions to achieve greater convergence and efficiency of national sanctioning regimes.

The Sanctions Communication launched a public consultation on the problems identified and the policy actions envisaged. In line with the Commission's minimum standards, the consultation, which remained open for eight weeks, covered all the issues addressed in this Impact Assessment (types and level of sanctions, criteria for their application, addresses of sanctions, publication of sanctions, mechanisms supporting effective application of sanctions such as whistleblowing).

Concerning the banking sector, the Communication analysed the problems and the issues for possible EU actions based on a study carried out in 2008 by the European Committee of Banking Supervisors (hereunder: CEBS report)[5], and provided information concerning the administrative sanctions laid down in national banking legislation and the actual use of sanctions by banking supervisors. This allowed stakeholders to comment on the issues specifically relevant in the banking sector.

Indeed, the Commission received comments from a variety of respondents, including a significant number of stakeholders in the banking sector (supervisory authorities, central banks, banks and associations of bankers), which provided comments on the need for EU action in this field and the level of harmonisation warranted but also on the specific actions suggested and their potential benefits or disadvantages. A summary of the results of the consultation is enclosed (Annex 1). The non confidential replies are being published in the Commission website together with a feedback statement on the results of the consultation.

The actions envisaged in the Sanctions Communication were also discussed with Member States in the meeting of the Financial Services Committee held on 17 January 2011. Member States, which will have to implement those actions, agreed on the need to

[5] CEBS: "Mapping of supervisory objectives, including early intervention measures and sanctioning powers", March 2009/47, available on <http://www.c-ebs.org/home.aspx>. Information contained in this report has been subsequently updated on the basis of the contributions received from member States.

promote further convergence of national sanctioning regimes while underlying the need to be respectful of the different national legal frameworks and judicial systems.

In February 2011, additional information has been collected by the Commission on sanctions for violations of the CRD[6], which supplements and updates the information contained in the CEBS report. This Impact Assessment is based on this information and the replies to the public consultation.

An Impact Assessment Steering group was set up to steer the preparation of this Impact Assessment, comprising representatives from the Directorate General for Internal Market and Services, the Directorate General for Competition, the Directorate General for Economic and Financial Affairs, the Directorate General for Enterprise and Industry, the Directorate General for Employment, Social Affairs and Inclusion, the Directorate General for Health and Consumers, the Directorate General for Justice, the Directorate General for Home Affairs, the Legal Service and the Secretariat General. The Steering group met on 11 February, on 7 March and on 15 March.

A draft Report was sent to the Impact Assessment Board on 21 March and discussed at the Board meeting of 13 April. Further to opinions of the Board of 15 April and 6 May, the following main changes have been implemented : the policy context of the measures proposed and their relation with the other provisions of the CRD IV package have been clarified (sections 1 and 5); the scope of the public consultation and its compliance with the Commission's minimum standards have been clarified (section 2.1) and the stakeholders view better reflected in the report; in the problem definition (section 3.2) the analysis of enforcement issues, proportionality, and the role of EBA has been further developed; and it has been clarified how the existing divergences and weaknesses could lead to the problems identified, including by strengthening the evidence base by more recent data and by introducing more precise references to the replies to the public consultation; the description and the analysis of the policy options (section 5) has been developed by clarifying how types and level of sanctions and criteria to be taken into account will be established and linked to key violations, and by providing indications on the administrative costs of the options relating to effective application. In addition, the importance of the proposed intervention in light of the recent creation of EBA has been further justified (section 3), the analysis of all factors underlying the ineffectiveness of sanctioning regimes has been further deepened (section 3), in the analysis of the policy options, further clarification has been provided on the content of the envisaged minimum harmonisation and the assessment of efficiency has been further explained (section 5).

[6] Additional information has been received for twenty-three Member States. Based on this information, tables in Annex IV provide an overview of the sanctions currently applicable to key violations of the CRD.

3. Policy context, Problem definition and Subsidiarity

3.1. Background and context

This Impact Assessment addresses problems relating to divergences and weaknesses of administrative sanctions. It is without prejudice to the situation concerning criminal sanctions regimes in the field of CRD, which deserves further analysis. Following such analysis the Commission will decide on policy actions to be taken in this regard, based on a full assessment of the relevant impacts.

3.1.1. Nature and size of the market concerned

The EU banking sector is a key sector in the EU economy (for a detailed description of the EU banking sector see Annex II). In relative terms, the EU banking sector is larger than its US counterpart, which accounted in terms of assets respectively for 340% of GDP and 92% of GDP in 2009. Until the outbreak of the crisis, the EU banking sector grew steadily, in terms of total assets, to reach a maximum of over €45,000 bn in late 2008. After this peak, it slightly declined to around €43,000 bn.

The EU banking sector is the main financing source for the real economy. It is also a major contributor to the added value of our economies, and an important employer. As an illustration, the Euro Area financial sector generates an added value of over €400 bn (equivalent to 5% of GDP). In 2007, people working in the financial sector represented around 3% of the Euro Area workforce.

The European financial services market is becoming more and more integrated, particularly in the wholesale financial sector, and there is a growing number of large financial groups and infrastructures operating on a pan-European basis. Although the financial crisis led to increased market segmentation, the level of financial integration remains high.

The banking market is dominated by pan-European groups active in several Member States, whose risk management functions are centralised in the group's headquarters. Currently around 70% of EU banking assets is in the hands of some 40 banking groups with substantial cross-border activities. Especially in the EU-12, banking markets are dominated by foreign (mostly Western European) financial groups (see Chart 2 in Annex II). In these countries, on average 65% of banking assets are in foreign-owned banks. In countries like Estonia, the Czech Republic and Slovakia, over 92% of banking assets are in foreign-owned banks.

3.1.2. Overview of legislative framework

The key Directives in the banking sector are Directive 2006/48/EC of the European Parliament and the Council of 14 June 2006, relating to the taking up and pursuit of the business of credit institutions and Directive 2006/49/EC of the European Parliament and the Council of 14 June 2006, on the capital adequacy of investment firms and credit institutions. The “CRD IV” proposal, of which the provisions on sanctions discussed

herein are an integral part, will substantially reframe these rules. This impact assessment refers to the Capital Requirements Directive (hereunder: "the CRD") as comprising the Directives referred to above as reframed by the planned CRD IV proposal, which is analysed in a separate Impact Assessment.

Currently, the CRD provides some limited obligations in the area of sanctions (for a description of these obligations see Annex IV) and leaves considerable discretion for Member States as to the type and level of sanctions to be applied for violations of its requirements. .

Effective, proportionate and dissuasive sanctions are of relevance to ensure respect of three groups of key provisions of the CRD (for a detailed list of these key provisions see Annex IV):

(1) Violations relating to prior authorisation, including unauthorised banking activity and authorisation obtained by deceit (e.g. through false statements);

(2) Violation of prudential requirements, including violations of rules on capital adequacy and limits on risk exposures and obligations relating to the governance of credit institutions;

(3) Violation of reporting obligations, including the obligations to publicly disclose information and to report information to supervisors on capital as well as under CRD IV on liquidity and leverage.

Annex IV provides also an overview of the sanctioning powers provided for by Member States in the transposition of the CRD in relation to these violations.

3.2. Problem definition

National sanctioning regimes currently in place for violations of the CRD are divergent and not always appropriate to ensure effective enforcement of CRD rules.

First, regulatory problems arise from the **legal framework of sanctions**. Sanctions currently laid down in national legislation for violations of authorisation requirements, prudential obligations and reporting obligations (see Charts 1 to 6 in Annex IV) and criteria taken into account in their application (see Table 1 in Annex IV) vary across Member States and in several Member States sanctions appear to be too weak to ensure sufficient deterrence. The existing divergences between sanctioning regimes partly reflect the specificities of the different national legal systems and traditions and may also be explained by the fact that certain Member States have more experience in dealing with violations of banking legislation or give more political priority to the enforcement of prudential rules, due to the importance of their financial sector. However, divergences exist even between Member States with banking sectors of a similar size and even between geographically adjacent States that may have similar legislative cultures (see Annex III). Moreover, taking into account the increasing integration of the EU banking

sector, where credit institutions operate in several Member States, those reasons cannot justify that sanctions applied to the same type of violation in certain Member States are significantly lower that those applied in others.

The fact that some Member States provide also for criminal sanctions does not seem to be the main reason for the differences identified. Indeed, the scope of criminal sanctions is much narrower: they are usually applied to individuals rather than to credit institutions[7] and only for some of the most serious violations of the CRD. Moreover, for some key violations of the CRD, certain Member States have in place neither criminal sanctions nor strict administrative sanctions[8].

Second, the information received on the **actual application of sanctions** shows that in some Member States few sanctions or no sanctions at all, have been applied during the last years, which could be symptomatic of a weak enforcement of EU rules.

The limited number of sanctions applied in the last years may be explained by few actual violations but it may also be due to insufficient detection of violations by national authorities or by the difficulty to prove those violations. Significant divergences on the number of sanctions applied in Member States with similar banking sectors suggest that violations of CRD rules are not always detected and sanctioned. This phenomenon and the main problem drivers behind it have been described for financial services in general in the Impact Assessment for the Sanctions Communication. This section analyses the specific problem drivers in relation to sanctioning regimes in the banking sector.

Problem drivers

A legal framework conducive to effective deterrence should enable competent authorities to use a combination of various levers, depending on the specific circumstances of each case, taking into account all key factors determining effective deterrence:

- A credible threat of reputational risk for violators by way of publication of information on violations.
- A credible threat of pecuniary sanctions going well beyond disgorgement of benefits to remove any economic incentive for violations, including by offsetting the likelihood that a violation will remain undetected.
- A credible threat to ban violators – be it banks or their managers - from continuing the exercise of their professional activities.

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[7] A majority of Member States can not fine credit institutions under a criminal regime: for instance, 18 Member States cannot impose criminal fines for failure to report information and for violations concerning sound governance

[8] For instance, for violations concerning sound governance , 11 Member States have in place neither fines over 1 million nor imprisonment.

However, today the **legal framework** of sanctions for violations of the CRD varies widely across Member States and does not seem to be always appropriate to ensure that all these levers can be used and sanctions are proportionate, effective and sufficiently severe to deter credit institutions and their managers from infringing the CRD rules.

First, in case of some key violations of the CRD, certain important **sanctioning powers** are not available to all national authorities (for more detail on the situation in Member States see Annex IV), including in Member States with large banking sector[9].

Supervision of compliance with prudential legislation by credit institutions requires a wide range of sanctions in order to respond adequately to infringements ranging from unauthorised banking operations to failure to meet obligations relating to reporting of information, notification, organisation and capital requirements. A number of sanctioning powers are important to ensure that sanctions are sufficiently effective and deterrent. This is confirmed by the respondents to the consultation and particularly public authorities, e.g. a Central Bank from a Member State, several supervisory authorities who considered that certain key sanctioning powers should be guaranteed by EU law in all EU Member States to ensure effective enforcement. .

The **dismissal of the responsible persons** in the institution's management can be an effective sanction to prevent further violations. This sanction can be particularly appropriate in case of serious and repeated violations of reporting obligations. **Public reprimand or warning** can have a considerable impact in a sector such as banking, in which reputation is of crucial importance. For example, in case of violations of prudential requirements relating to the governance of a credit institution, such reprimands or warnings can encourage public pressure by deposit holders and investors in the credit institution to adjust its governance arrangements. Significant administrative **pecuniary sanctions** going well beyond the profits accruing from an infringement can be appropriate for example in case of violations relating to prior authorisation, and notably unauthorised provision of banking services, to deter unauthorised service providers from continuing their activity, which may be seriously detrimental to depositor's protection.

However, these powers are not available in several Member States:

- **Eight Member States** do not provide for this type of sanction even in cases where credit institutions fail to report important financial information to the supervisory authorities.

- No provision is made for a public reprimand or warning in **seven Member States**.

- **Ten Member States** do not provide for the application of administrative pecuniary sanctions in case of violations relating to prior authorisation.

[9] In three of those Member States, the total value of banks' liabilities is higher than 2,5 billions euros.

Second, the maximum levels of **administrative pecuniary sanctions** (fines) provided for in national legislation vary widely across Member States and seem too low in some Member States.

Administrative pecuniary sanctions can play a significant role to deter violations of the CRD, in particular by offsetting the benefits that can be derived from it.[10] Complementing the supervision of banks by competent authorities, sufficiently high fines can deter credit institutions from infringing disclosure obligations, which would better ensure that supervisory authorities receive all the information necessary for them to perform efficiently their activity.

For these purposes the maximum level of fines must be considerably higher than the benefit that can be expected from those violations, in particular because the potential offender may always hope that the infringement will remain undetected by the authorities. To ensure that a fine has a sufficiently dissuasive effect on a rational market operator, the possibility that an infringement will remain undetected must be offset by imposing fines which are higher than the benefit that the undertaking would gain from breaching the law. Certain violations of the CRD can lead to considerable benefits for a banking institution. For example, the benefits derived from unauthorised banking services engaged in at a large scale can reach several million Euros.[11] Similarly, by not reporting disadvantageous financial information to supervisory authorities, credit institutions may avoid the need to hold the necessary additional capital, leading to important cost savings. In case of a major European bank, a failure to report information can lead to an underestimation by the supervisor of its risk-weighted assets. Such an underestimation of only 1% can reduce the minimum capital the bank must hold by more than EUR 100 million .[12] In addition, in the banking sector, where a large number of potential offenders are cross-border financial institutions with very considerable turnover, sanctions of a few thousand euros are unlikely to be sufficiently deterrent.

However, in several Member States the maximum level of fines that competent authorities can apply is rather low:

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[10] Research on the level of fines and its relation to the level of enforcement, as well as on the optimal level of fines includes the following: John C. Coffee, Law and the Market: The Impact of Enforcement, Columbia Law and Economics Working Paper No. 304, 2007, p. 13 ssq (20 September 2010); Uldis Cerpsa Greg Mathersb and Anete Pajustec: Securities Laws Enforcement in Transition Economies, p. 12 ssq., (20 September 2010); with a specific focus on another area (antitrust) see Wouter Wils, Optimal Antitrust fines – theory and practice, World Competition 2006, p. 183, 199 ssq; Peik Granlund: Regulatory choices in global financial markets – restoring the role of aggregate utility in the shaping of market supervision, Bank of Finland Research Discussion Papers 1, 2008, p. 13 ssq; CRA International/City of London: Assessing the Effectiveness of Enforcement and Regulation, London, April 2009.

[11] See e.g. a recent case pursued by the FSA where the benefit derived by one individual was about 2.5 million pounds, see FSA press release FSA/PN/111/2010 of 29 June 2010.

[12] Estimation for a bank holding EUR 300 000 000 000 of risk-weighted assets, based on a minimum capital requirement of 7%. For an analysis of the costs of capital requirements as amended by the CRD IV, see the main impact assessment on the CRD IV proposal.

- In **five Member States** administrative fines laid down in national legislation are unlimited or variable and in nine Member States are at over EUR 1 million while in seven Member States they are below EUR 150 000.

- For example, maximum fines applicable for violation of reporting obligations are less than EUR 100 000 in **six Member States** (updated data available for 22 MS). These Member States would be unable to impose a fine of 17,5 million pounds (21,3 Million Euros) as recently imposed by the FSA on Goldman Sachs for violation of reporting obligations in relation to a failure to disclose facts relating to ongoing investigations in the US to the UK authorities.

- For example, maximum fines for violations of prudential requirements relating to the governance of a credit institution do not exceed EUR 250 000 in **five Member States**. These Member States would be unable to impose a fine of 4 million Euros as recently imposed by in France on Société Générale in the Kerviel case for violations of prudential requirements relating to risk management[13]

- For example, maximum fines for violations relating to prior authorisation, and notably unauthorised provision of banking services vary between less than EUR 150 000 (with a maximum fine as low as EUR 50 000 in at least one Member State) and more than EUR 1 000 000 in **four Member States** (updated data available for 22 Member States).

The result of these divergences, which concern almost all the violations of the CRD, is that all competent authorities are not able to apply sufficiently deterrent fines.

The results of the public consultation show that several national governments, regulators and some industry representatives consider that the existing low level of fines, at least in some Member States where low absolute levels are laid down in legislation, cannot ensure sufficient deterrence in the internal market.

Third, the **criteria taken into account** to determine the type and the level of administrative sanctions to be imposed in a particular case vary substantially and some

[13] Kerviel is a former trader for the French bank Société Générale who was convicted at first instance of breach of trust, forgery and unauthorized use of the bank's computer system for rogue bets that had the bank teetering near collapse when the trades were discovered in January 2008. He was sentenced in October 2010 to at least three years in prison, and was also ordered to pay restitution of €4.9 billion. Mr. Kerviel filed an appeal against the judgment which is still pending. Société Générale has acknowledged management failures and weaknesses in its risk control system. An internal audit published in May 2008 described Mr. Kerviel's immediate supervisors as "deficient" and acknowledged that the bank had failed to follow through on at least 74 internal trading alerts dating from mid-2006. The French Banking Commission later fined Société Générale 4 million euros.

criteria which are important to ensure proportionality and deterrence of sanctions, are not always taken into account by competent authorities.

A number of criteria are particularly relevant in the field of the CRD. Taking into account the **financial strength**[14] of the author of a violation can help to ensure that pecuniary sanctions imposed have an equivalent effect on all credit institutions: a fine of a small level, while being clearly dissuasive for certain smaller banking institutions, may have only a very limited dissuasive effect for some of the larger groups operating in the banking sector. Therefore, when competent authorities have to calculate the actual fine to be imposed in a specific case (most often within the maximum and/or minimum levels established in national legislation) they should consider the financial capacity of the offender. Taking into account the **benefits** derived from a violation or the **losses** caused to third parties by a violation may significantly contribute to proportionality and deterrence of the sanctions imposed in specific cases. Taking into account the **cooperation** of the author of a violation can encourage offenders to cooperate and therefore increase the investigatory capacity of the authorities.

However, these criteria are not taken into account by all Member States:

- **Only seventeen Member States** take into account the financial strength of a credit institution when determining the level of a fine imposed on it.
- **Only seventeen Member States** take account of the benefit/profit derived from the offence. Eighteen **Member States** take account of the loss caused by an infringement.
- **Only twenty Member States** take into account the cooperation of the author of a violation.

The majority of the respondents to the consultation, including several public authorities and stakeholders of the banking industry, confirmed that those criteria should be taken into account by all competent authorities for the reasons explained above.

Fourth, not all Member States can impose sanctions both on **credit institutions and on individuals responsible for certain violations**.

As the CRD imposes obligations on credit institutions, sanctions should always be applicable to those institutions. However, in areas where certain individuals within a credit institution are responsible for a violation by that institution, there should be the possibility of applying sanctions also on them. For example in case of **violation of prudential requirements**, the exclusion of individuals from sanctions does not allow

[14] The financial strength of an undertaking may be indicated for example by the level of its own funds, its turnover, or its total assets; when an individual is responsible for the violation, his financial strength may be indicated by his annual income. The relevant factors to be considered are clarified in national legislation.

competent authorities to choose a sanction that is optimal in terms deterrence: . a manager of a credit institution who is essentially responsible for such a violation is less likely to be discouraged from infringing the rules if he doesn't risk to be sanctioned for his illicit conduct because sanctions are applied to the credit institution only.

- However, while administrative financial sanctions can be imposed on both natural and legal persons in the vast majority of Member States, **two Member States** do not provide for the possibility to sanction natural persons.

There is a broad consensus in the public consultation (governments, regulators, and banking industry) that competent authorities should be able to apply sanctions to both credit institutions and individuals responsible for a violation in order to ensure effective compliance. In its response to the public consultation a bank highlighted that this would incentivise both natural and legal persons to take full account of their responsibilities and the implications of their actions.

Fifth, sanctions are not **published** on a systematic basis in all Member States, while publication of sanctions may have a strong deterrent effect on credit institutions, especially when they concern violations of prudential requirements which may alert the public and raise concerns about the financial soundness or the proper management of a credit institution. For example, publication of sanctions imposed for **violations of prudential requirements** relating to the governance of a credit institution can be appropriate to encourage public pressure by deposit holders and investors on the credit institution to adjust its governance arrangements.

- However, **only twelve Member States** publish sanctions on a systematic basis, subject to certain exceptions (such as situations where publication may jeopardise financial stability).

The responses received from the banking industry show that credit institutions consider the publication of sanctions as one of the most deterrent tools, mainly because of the reputational damage they will incur. In addition, consumers/investors association believe that wide publication of sanctions would help consumers and investors to take informed decision and "punish" indirectly wrongdoers by avoiding using their services.

In addition to these divergences and weaknesses of the legal framework, the **level of application of sanctions** is significantly divergent across the EU.

The effectiveness, proportionality and dissuasiveness of sanctioning regimes depend not only on the sanctions provided for by law but also on their application. In addition to the provision for appropriate sanctions in national legislation, it is key for the effectiveness of sanctioning regimes to ensure that sanctions are actually applied when a violation occurs. The lack of sufficient and uniform actual enforcement across all EU 27 Member States was listed as a major problem by several respondents in the public consultation (governments, industry).

There are important divergences in the number of sanctions applied by Member States in the last three years.

In the period 2008-2010 out of 19 Member States for which data is available, 6 Member States imposed no sanction in at least one of those three years. Moreover, in 2010, at least 5 Member States imposed no administrative fines during that year (3/6 Member States for 2009; 6/9 Member States for 2008; see data in Annex III).

Numbers of applied sanctions can be low either because there have not been any violations, or because violations are not detected, or cannot be proven. While the total absence of violations in some Member States cannot be ruled out as a possibility, it appears more likely that violations are not detected, especially when considering that in the same reference period a significantly different number of sanctions have been applied in Member States having banking sectors of similar size. In an integrated financial market, economic and cultural differences alone cannot explain such divergences. It is therefore very likely that the divergent number of sanctions applied is due, at least partly, to poor enforcement of EU rules

Poor enforcement may be due to a number of reasons, mainly related to the organisation and functioning of national administration. For instance, lack of human and financial resources devoted to the activities of national supervisory authorities or lack of appropriate training of persons carrying out investigations may make it difficult to detect violations. Moreover, insufficient application of sanctions might be the result of the difficulty to prove certain violations of financial services rules, the strict rules on burden of proof, and possibly the lack of specific expertise in the field of financial services of the national authorities responsible for the application of sanctions.

Since the CRD leaves the application of sanctions in the responsibility of Member States, in line with the principle of subsidiarity, this initiative focuses on the problems linked to the investigative tools which are necessary to facilitate detection of violations and therefore improve the application of sanctions. In particular, the information available shows that a majority of Member States do not have in place any mechanism encouraging persons who are aware of potential violations of the CRD to report those violations within a financial institution or to the competent authorities (whistle blowing). While some industry representatives raised doubts on the appropriateness of an EU mechanism, almost all respondents to the consultation agreed that whistle blowing is an important tool to facilitate detection of violations. Indeed, whistleblowing programmes have been successful across sectors within the EU and in other jurisdictions. For example, on the basis of an internal whistleblowing programme, OLAF, the European Anti-Fraud Office, has received important pieces of information – for example in five cases in 2008.[15] In the US, the SEC reports that in 2009 in 303 cases investigations were triggered by tips.[16]

Consequences of the problem drivers – specific problems

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[15] http://ec.europa.eu/anti_fraud/reports/olaf/2008/EN.pdf

[16] http://www.sec.gov/about/secpar/secpar2010.pdf#performance

First, weak and divergent sanctioning regimes risk being **insufficiently deterrent** to prevent violations of the CRD, which can result in a **lack of compliance with the EU bank capital rules**.

A study carried out on a set of countries including nine Member States confirms that "*enforcement actions do have a statistically significant disciplinary effect upon banks. Therefore, it is corroborated that by imposing direct or reputation costs upon banks, supervisory sanctions contribute considerably to constraining banks' risk-taking appetite*."[17]

Lack of important sanctioning powers and appropriate criteria for the application of sanctions may send the message that consequences of illegal behaviours are not serious, which will not discourage such behaviours. This view was expressed by the majority of respondents in the public consultation on the Communication on sanctions (governments, some industry representatives, consumers/investors associations).

- When competent authorities cannot issue orders to put an end the unauthorised provision of banking services, there is a risk that the providers of those services would not be discouraged to continue this activity, from which they may be very profitable for them.

- When sanctions are not published on a regular basis and competent authorities are not empowered to issue public warning, credit institutions will not fear risks to their reputation and possible loss of customers if they infringe prudential requirements. Therefore they will not be encouraged to take all the measures necessary to prevent violations of those requirements.

- When the maximum amount of the pecuniary sanctions is very low and the level of those sanctions is not linked to the benefits derived from a violation of the CRD, there is a high risk that they will not have a sufficiently dissuasive effect, as the perceived reward from such behaviour will far outweigh the real risk. In addition, even in Member States where the level of pecuniary sanctions provided for by national legislation is sufficiently high, if competent authorities calculate the amount of the sanction to be imposed in a specific case without taking into account criteria such as the financial strength of the author of the violation, there is a risk that sanctions actually applied will not be deterrent for larger groups operating in the banking sector.

- When the managers of a credit institution responsible for ensuring compliance with reporting obligations cannot be dismissed even in case of serious and repeated violations of those obligations, they could not be discouraged enough from repeating such violations.

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[17] "On-site audits, sanctions, and bank risk-taking: An empirical overture towards a novel regulatory and supervisory philosophy"; Delis, Manthos D and Staikouras, Panagiotis 17. August 2009

Second, divergences and weaknesses in national sanctioning regimes may also **prevent the development of a level playing field** within the Internal Market, where cross-border groups have a considerable market share in EU banking markets (see section 3.1.1 above). Unequal treatment of violations in different Member States may result in different costs for credit institutions, which along with other regulatory divergences risks creating competitive disadvantages for institutions from certain Member States. The importance of such cost differences is illustrated by the fact that, as indicated above, failures by major banks to report information to the supervisor, which lead to an underestimation of only 1% by the supervisor of the bank's risk-weighted assets, can reduce the minimum capital the bank must hold by more than EUR 100 million. Unequal treatment of violations may encourage credit institutions operating branches or subsidiaries in several Member States to exploit differences between sanctioning regimes in different Member States.

- For example, a credit institution operating under the CRD regime in Member State A may exploit the fact that if it breaches reporting requirements it will be subject to fines exceeding several millions of Euros, whereas a subsidiary of the same company based in Member State B under the same regime may be subject to fines of no more than EUR 15 000.

The responses sent by several supervisors and stakeholders from the financial industry (including a bank and an association of banks) show that they share concerns about possible competitive distortions and see a risk of regulatory arbitrage linked to divergent and weak sanctioning regimes. This is also confirmed by research investigating the factors influencing international bank flows[18].

Third, divergences of sanctioning regimes risk having a **negative impact on effective supervision of cross border banks**. This is particularly important given the considerable number of credit institutions operating in the EU which are structured as cross-border groups.

Cooperation and trust between supervisors is key to ensure effective supervision of cross-border banks. Partly as a response to the serious failings in the cooperation, coordination, consistency and trust among national supervisors exposed by the crisis, ***colleges of supervisors*** have been set up under the CRD (Art 131a) to ensure coordination of supervision for cross-border groups and to facilitate among others the exchange of information and the consistent application of prudential requirements across the banking group. However, if national supervisors are not equipped with equivalent and consistent

[18] *Regulatory Arbitrage and International Bank Flows*, Joel F. Houston University of Florida - Department of Finance, Insurance and Real Estate; Chen Lin Chinese University of Hong Kong (CUHK) - Department of Finance; Yue Ma Lingnan University, Hong Kong - December 18, 2009), this research found evidence "*suggesting that a type of regulatory arbitrage has taken place where banks have transferred funds to markets with fewer banking regulations"*, taking into account both banking rules and their enforcement.

powers, including sanctioning powers, there is a risk that the decisions agreed within a college will not be applied in a consistent way by the supervisors concerned.

- For example, the authorities of Member State A may be reluctant to rely on the completeness of information collected by authorities in a college from Member State B, if it is clear that in Member State B violations of reporting requirements cannot be sanctioned effectively.

- For example, if in a college of supervisors, the authorities of Member States A, B and C agreed to replace the managers of a bank at central and subsidiary level because of failures at both levels, the authority of Member State A would apply the measure without difficulty, the authority of Member State B would need the cooperation of other national authorities and the authority of Member State C would be unable to do anything, because it lacks the necessary power.

In addition, supervisors can ***delegate*** some of their supervisory tasks to supervisory authorities in the college from other Member States (Art. 28 of Regulation No (EU) 1093/2010 establishing a European Banking Authority). However, a national supervisory authority could be unwilling to delegate powers to an authority in another Member States in which the sanctioning regime is considerably weaker.

Moreover, in relation to cross-border groups structured by way of branches, the CRD confers powers for the ***supervision of*** those ***branches*** to the home Member State. Such arrangements, which are key to the functioning of the internal market for banking services, may be put into doubt if sanctioning regimes in home Member States are weak, and host Member States can therefore not rely on effective enforcement of the CRD by the home Member State. For example, in response to the consultation, one supervisory authority explicitly reported that it has experienced situations where it has identified violations as a host Member State but the competent home Member State has not acted effectively.[19]

General problems

Insufficiently deterrent sanctions leading to lack of compliance with the EU bank capital rules, unlevel playing field and ineffective supervision risks seriously **undermining proper functioning of banking markets,** which can be detrimental to the protection of deposit-holders and investors, whether they are consumers or undertakings and can also negatively affect the whole economy. Indeed, if prudential rules are not complied with and effective supervision of cross-border banking groups is not ensured, credit institutions could take excessive risks in their activity. As shown by the financial crisis, this may cause serious economic damages to investors and deposit holders and to safety and stability of financial markets, which in turn can have serious negative repercussions on the whole economy. Similarly, proper functioning of banking markets could be

[19] However, the authority has not clarified the reasons of that lack of effective action.

undermined if credit institutions may take competitive advantages from the weaknesses and the divergences of sanctioning regimes.

This situation also risks **undermining confidence in the banking sector**, where consumers see that illegal behaviour is not met with appropriate sanctions which are capable of discouraging further infringements. If consumers have the impression that even major financial institutions are not sufficiently stable to fulfil their obligations for any financial instruments they issue, they will not invest in such instruments. Consumers will be reluctant to shop around Europe if they feel that the level of protection of deposit holders is significantly different in different Member States.

3.2.1. Affected stakeholders

The following stakeholders may be affected by EU action aiming at approximating and reinforcing sanctioning regimes for violations of the CRD:

– credit institutions, including their stakeholders;

– employees of credit institutions;

– depositors-holders and investors, including retail consumers and non financial companies;

– public authorities, including central banks, supervisors and other national authorities in charge of the application of sanctions.

3.2.2. Baseline scenario

The baseline scenario would be one in which no action is taken. The EU would continue to rely on the existing national sanctioning regimes, which are divergent both in terms of the **available sanctioning powers** and their **application**, and are sometimes not sufficiently dissuasive.

The provisions on sanctions already contained in the CRD would be maintained. Member States would be therefore obliged to ensure that sanctions regimes are in place, but they would be free to decide how to achieve this result.

As regards convergence of **sanctioning powers** available to competent authorities, they will have to ensure that competent authorities have at their disposal some sanctioning powers provided for in the CRD, for instance the power to withdraw the authorisation in the cases listed in Article 17 of Directive 2006/48/EC or the power to take measures to put an end to the unlawful situation deriving from the violation of the obligations on acquisition of qualifying holdings.

However, those provisions are limited in scope and could hardly ensure that effective, proportionate and sufficiently deterrent sanctions are in place in all Member States.

As regards convergence on the **application of these sanctioning powers**, the baseline scenario takes into account the recent creation of the European Banking Authority (EBA) on 1 January 2011[20], which should enhance the previous coordination work of the CEBS, predecessor to the EBA. The EBA would continue such work and could play an important role in increasing the coherence and monitoring of the application of sanctions. In particular, the EBA has powers to

- carry out peer reviews of national sanctioning regimes, and receive information about sanctions applied by national authorities; those powers can be used in order to monitor national legislation and to promote exchange of information and best practices between Member States in relation to the application of sanctions, which is expected to improve the overall application track record of competent authorities;

- settle disagreements between national authorities, where in cross-border cases the application of sanctions requires cooperation and exchange of information between supervisory authorities from more than one Member State; this is expected to improve the application of sanctions in cases of cross-border banking groups;

- issue guidelines and recommendations on the application of sanctions by national authorities; this is expected to make administrative practices more convergent.

However, the EBA powers are limited to coordinate application of sanctions by national *supervisors*, while sanctioning powers are made available to those authorities by national *legislators* .EBA will be unable to tackle deficiencies of sanctioning powers framed by national legislators,. Moreover, without a stronger convergence in national supervisors' sanctioning powers, coherence in the application of sanctions promoted by EBA would face certain limits, as national supervisors will have diverging powers and will not be able to overcome those divergences set by the legislative framework.

Within this scenario, national authorities in different Member States would continue to have different sanctioning powers and the same infringements to European rules would be dealt with in a different way across the EU. Member States with strong sanctioning regimes could be reluctant to fully trust those with weaker sanctioning regimes, making it difficult to ensure effective cross-border supervision. The Commission would continuously monitor the functioning of sanctioning regimes and would assess the need for policy action at later stage.

In the baseline scenario, credit institutions will also be subject to civil liability for violations in accordance with national law. However, the deterrent effect is very limited as this would probably not cover several violations of the CRD: violation of prudential requirements (e.g. capital adequacy) or reporting obligations, which are severe violations

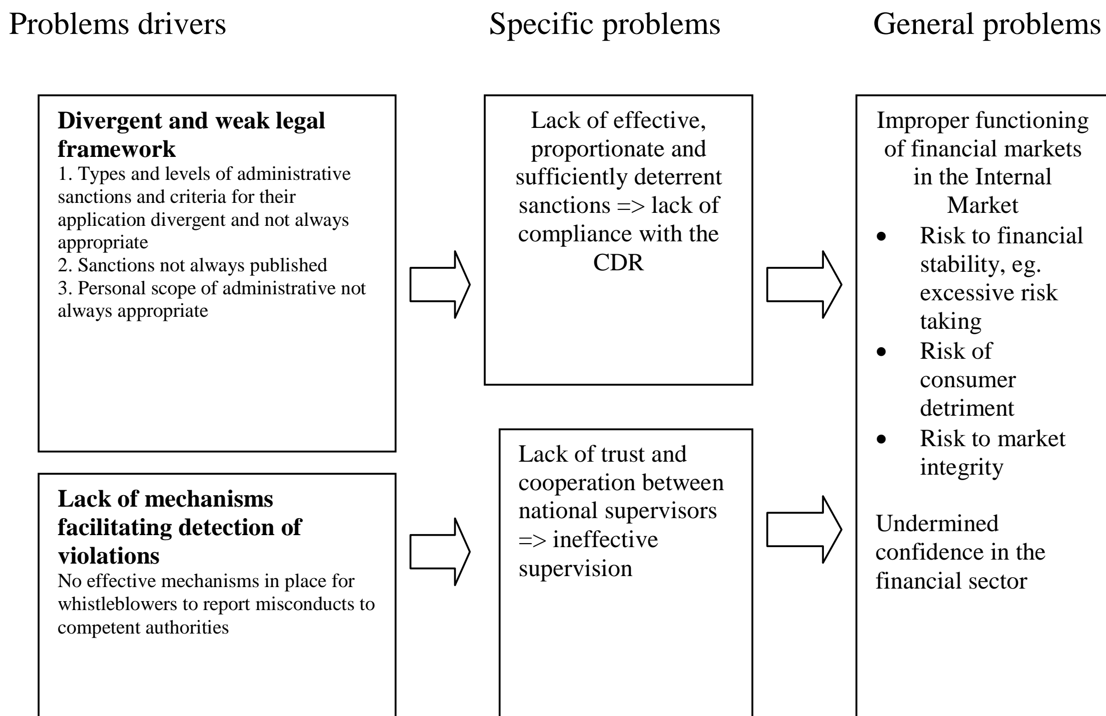
[20] Regulation No (EU) 1093/2010.

of that directive, does not always lead to actual damages for which third parties can claim a compensation and/or the damages caused by the violation cannot often be quantified. In any case, the purpose of civil actions is to compensate damages caused, which would probably not be deterrent in cases where the profit derived from the violation is higher than the damages to be compensated.

Credit institutions will also be subject to reputational damage linked to a violation that becomes publicly known. However, the public will not be aware of all sanctions imposed, as they will not be systematically published.

At the international level, the EU would continue to push for rigorous enforcement of financial regulations in order to ensure more effective, proportionate and dissuasive sanctions, but the lack of common standards at EU level would make it difficult to propose concrete measures to be adopted at international level. Lack of European common standards would weaken the EU's credibility at international level and could threaten its global competitiveness as a financial centre.

Problem tree *



3.3. The EU's right to act and justification

The legal bases for EU level action in this specific field are: Article 53 TFEU (former Article 47 CE) which provide the EU legislature with the possibility of adopting directives for the coordination of the provisions concerning the taking-up and pursuit of activities as self-employed persons and the provision of services in the Internal Market,

and Article 114 TFEU according to which the European legislator can adopt "measures for the approximation of the provisions laid down by law, regulation or administrative action in Member States which have as their object the establishment and the functioning of the Internal Market." The European legislature has discretion as to the method of approximation which is the most appropriate in order to improve the conditions for the establishment and proper functioning of the Internal Market. This may include the approximation of national laws concerning the type and level of administrative sanctions to be imposed.

The objective of the CRD is to contribute to the achievement of an integrated, open, competitive, and economically efficient European financial market, where credit institutions benefit from equal conditions of competition and financial services can circulate freely at the lowest possible cost throughout the EU, with adequate and effective levels of prudential control, financial stability and a high level of consumer protection.

The corollary of an integrated financial services market is that the same unlawful conduct incurs similar sanctions wherever the infringement is committed in the European Union. Such sanctions should be sufficiently dissuasive in order to discourage future wrongdoings. In this way, the EU would put out a strong message that certain types of conduct are unacceptable and punishable on an equivalent basis, which would increase confidence in the financial sector. This requires some convergence in sanctioning regimes across the EU.

The impact of the measures under consideration on the relevant fundamental rights and principles as embodied in the Charter of Fundamental Rights of the European Union is analysed in section 5.

3.3.1. Subsidiarity and proportionality

Convergence of national sanctioning regimes seems necessary to promote deterrence, thereby ensuring a level playing field, a uniform application of the CRD, and full cooperation and mutual trust between banking supervisors across the EU. These objectives cannot be sufficiently achieved by the Member States alone. This is particularly important in the banking sector where large credit institutions operate across the EU and full cooperation and trust within the colleges of banking supervisors is essential for the credit institutions to be effectively supervised on a consolidated basis.

Member States will remain responsible to ensure application of sanctions. However, better use of the existing sanctioning powers by competent authorities at national level would be insufficient to achieve the above mentioned objectives if those powers are divergent and too weak. Approximating national legislation is therefore necessary to ensure that all national authorities have at their disposal appropriate sanctioning powers, which is a necessary condition for improvement and convergence in the application of sanctions. This requires that sanctioning powers available in every single Member State adhere to common minimum standards, to be established at EU level.

Moreover, proper enforcement of banking legislation across the EU requires that all Member States provide for adequate tools to detect violations and to ensure they are punished. Most of the issues relating to the enforcement of EU legislation can be better addressed at national level (eg. adequate human and financial resources devoted to investigations). However, EU action seem necessary to ensure that all Member States have at least in place some mechanisms facilitating the detection of violations, such as those encouraging persons who are aware of potential violations to denounce them.

The objectives of the proposal can therefore be better achieved through EU action rather than by different national initiatives.

The measures proposed will not go beyond what is necessary to achieve those objectives. They will approximate the legislation of Member States on sanctions applicable to the key violations of the CRD, based on common principles to be applied consistently across the European Union. This appears particularly important when considering that EU financial markets are increasingly integrated, especially at the wholesale level[21].

The proposal will ensure respect for different national legal systems and traditions. Changes in national legislation will be necessary only where the existing rules do not comply with some basic standards of an efficient sanctioning regime. In principle, Member States will not be obliged to put in place new administrative procedures. As to the regional and local dimension of the action envisaged, no specific implications of the proposal for certain regions has been identified, as sanctions in the banking sector are generally laid down in national legislation and applied by national banking supervisors.

4. OBJECTIVES

The general policy objectives of this exercise are the following:

- Proper functioning of banking markets and restored confidence in the banking sector

To achieve these general objectives, the following specific objectives must also be achieved:

- Effective, proportionate and deterrent sanctions which better ensure compliance with CRD rules,
- Development of a level playing field which minimises the opportunities for regulatory arbitrage,
- Effective supervision of banking service providers.

[21] See European Financial Integration Report 2009.

The specific objectives listed above require the attainment of the following operational objectives:

- Reinforcement and approximation of the legal framework concerning sanctions,
- Reinforcement and approximation of mechanisms facilitating detection of violations.

5. POLICY OPTIONS, IMPACT ANALYSIS AND COMPARISON

Different policy options have been envisaged to approximate and reinforce national sanctioning regimes on the issues identified in the problem definition. They concern sanctions applicable to the key violations of the CRD, as identified in section 3.1.2. For each option, it has been assessed whether it is of specific relevance for some of the key violations identified (see detailed analysis in Annex V). The options concern two main areas: the legal framework of sanctions and the mechanisms facilitating detection of violations.

The envisaged policy actions are **complementary to the other policy actions introduced by the CRD IV proposal**. The measures for the implementation of the Basel agreement on banking supervision in the EU will maintain the basic prudential rules contained in the CRD (requirement of prior authorisation for banking activities, prudential requirements including in particular capital rules, reporting requirements) and will strengthen these rules. The policy actions in relation to corporate governance maintain the fundamental prudential rules contained in the CRD on governance and strengthen these rules. Approximating and reinforcing national sanctioning regimes for violations of these rules will support the effective application of these prudential rules as updated by the CRD IV proposal.

The policy options have been evaluated and compared against criteria deriving from the problems identified and the specific objectives of this proposal. The analysis takes into account the issues relating to proportionality, subsidiary and the impact on the stakeholders concerned including the impact on fundamental rights. The options are compared with regard to their effectiveness and efficiency in achieving the objectives of approximating and reinforcing sanctioning regimes with regard to both the legal framework of sanctions and the detection of violations.

The following schema is used to compare the contribution of the different options to the achievement of the objectives: +++ (strongly positive), ++ (positive), + (slightly positive) 0 (neutral), slightly negative (-).

In view of the limits of the data available and the nature of the subject-matter, the analysis is essentially of a qualitative nature. The options envisaged aim at ensuring better compliance with CRD rules by reinforcing national legal frameworks. As the number of undetected violations is by definition unknown, it is very difficult to quantify the reduction of the number of violations that reinforced sanctioning regimes could bring

about and therefore their potential impact. An attempt to quantify the costs for credit institutions of the option on whistleblowing systems has been made, but the actual costs would largely depend on how Member States will implement those systems. The impacts of the options envisaged include the need to amend national legislation, which would have the same cost of any other national legislative procedure. This impact is therefore taken into account in terms of efficiency based on the number of Member States which will be required to amend their legislation and the scope of the revision needed.

5.1. Options to approximate and reinforce the legal framework of sanctions

Options are grouped in the following sub-groups: 1) appropriate administrative sanctions, 2) personal scope of administrative sanctions, 3) publication of sanctions.

5.1.1. Options concerning appropriate administrative sanctions

Options	**Description**
1: no EU action	The existing sanctioning regimes will continue to exist. Member States will have to ensure compliance with the provisions on sanctions already contained in the CRD (e.g. empower the competent authorities to withdraw the authorisation in the cases listed in Article 17 of the Directive 2006/48/EC or to take the measures laid down in Article 21)
2. Uniform rules on types and level of administrative sanctions	Uniform rules would determine both the types of administrative sanctions available to competent authorities and the minimum and maximum levels of fines. Member States would not be allowed to stipulate different types of sanctions and would not be able to exceed the maximum levels laid down in the uniform rules.
3. Minimum common rules on types of administrative sanctions	Minimum common rules on the types of administrative sanctions laid down in national legislation would be determined. This would include a list of key sanctioning powers that should be available to all competent authorities in case of violations of key obligations of the CRD. The list would include the sanctions which, based on the CEBS report, on the Sanctions Communication, and on the replies to the public consultation, have been identified as key sanctions for ensuring compliance with the CRD (administrative fines, cease-and-desist orders, dismissal of management, public warning, withdrawal of authorisation). Member States should ensure that national legislation provides at least for the types of sanctions included in the minimum list. They would remain free to provide for additional sanctioning powers.
4. Minimum common rules on levels (minimum and maximum) of administrative fines	Minimum common rules on the level of administrative fines would be established, including the formulation of minimum and maximum levels of administrative fines. Those levels should be sufficiently high to ensure dissuasiveness (e.g. the maximum level should significantly exceed the potential benefit derived from the infringement, and the minimum level should reflect the seriousness of the violation). A range of minimum and maximum levels would be established for each key violation or category of key violations of the CRD, depending on their nature and seriousness. This option would not impose the obligation to provide for unlimited pecuniary fines, which may not be compatible with the fundamental principles of all national legal systems. Member States would be prevented from setting minimum and maximum levels lower that those established at the EU level. They would remain free to set levels higher than those

	determined by the EU, or to provide for an unlimited maximum level. In principle, competent authorities would not be allowed to impose fines which are lower than the common minimum level.
5. Minimum common rules on maximum level of administrative fines	Minimum common rules would be set on the maximum level of administrative fines. It would be established that the maximum level laid down in national legislation cannot be lower than a common EU level. This option would not impose the obligation to provide for unlimited pecuniary fines, which may not be compatible with the fundamental principles of all national legal systems. The level should exceed the benefits derived from the violations and, in any case, should be sufficiently high to ensure dissuasiveness: it would combine reference to a fixed amount and to the turnover of the author of the infringement. Member States would be prevented from setting maximum levels lower that those established at the EU level. Member States would remain free to set higher maximum levels or provide for an unlimited maximum level. They would also remain free to decide whether or not a minimum level has to be set and to establish that level.
6. Uniform rules on factors to be taken into account in the application of sanctions	All factors to be taken into account by competent authorities when determining the actual sanction to be imposed in a specific case, would be defined in order to ensure that sanctions imposed are effective, proportionate and dissuasive. In this case, the same factors would be applied by competent authorities throughout the European Union. Competent authorities would not be allowed to consider other factors.
7. Minimum common rules on factors to be taken into account in the application of sanctions	EU-level provisions would establish a minimum list of common key factors to be taken into account by all competent national authorities when determining the level of the sanction to be imposed in a specific case. Those factors would include the mitigating and aggravating factors which based on the CEBS report on the Sanctions Communication and on the replies to the public consultation have been identified as key factors for ensuring proportionality and dissuasiveness of sanctions. This would include the benefits derived from the violation when they can be determined, the financial strength of the author of the infringement, cooperation of the authors of the violation, and recurrence of violations. Member States would be obliged to provide in national legislation that the key factors established at EU level have to be taken into account by competent authorities. Member States would be allowed to provide for additional factors they consider relevant, to be taken into account in addition to the common ones.

Analysis of options [22]

(1) No EU action

Mere compliance with the current provisions of the CRD, which do not cover all violations nor all relevant sanctioning powers, will be insufficient to ensure sufficient convergence in the type of sanctioning powers that should be available to all national authorities.

In the absence of any action at EU level, Member States' sanctioning regimes will continue to diverge as regards the level of administrative fines that can be imposed.

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[22] The specific impacts of these option have been also analysed in relation to sanctions applicable to the different types of violations of the CRD concerned. A more detailed analysis of this option is provided in Annex V.

Divergences will also remain on the criteria taken into account by competent authorities when deciding the type of administrative sanctions and/or calculating the amount of the administrative pecuniary sanction to be applied to the author of a specific violation. Almost all Member States will continue to take into account some criteria (e.g. the gravity of the violation) but various other factors will be taken into account only in some Member States or for some violations of the CRD (e.g. the impact of the violation or the financial strength of the author of the violation).

The new EBA will monitor the functioning of national sanctioning regimes and conduct peer review analyses of those regimes (for more detail see section 3.2.2 above). The EBA will have the power to actively promote further convergence in the application of sanctions by competent authorities via guidelines and recommendations. Without any approximation of the legal framework, however, it is very likely that type and level of sanctions would remain divergent and not always optimal in terms of dissuasiveness.

A large majority of the respondents to the consultation on the Sanctions Communication, including almost all public authorities, the majority of the industry representatives and all the consumers/investors associations, share the view that minimum harmonisation of sanctions is warranted to achieve sufficient deterrence and convergence for the development of a level playing field within EU. Even the minority who is unfavourable to EU legislative action in this field, acknowledges the existing problems (lack of deterrence and convergence), considering that soft law measures may be adequate to solve them.

(2) Uniform rules on types and level of administrative sanctions

This option would imply that administrative sanctions are fully harmonised and that the violation of any of the key provisions of the CRD would be subject to the same type and level of sanctions across all Member States.

As pointed out in the **public consultation** by several respondents, this would assist the development of a level playing field in the European financial market: credit institutions would not derive any advantage from differing national regimes, as they would risk incurring the same sanctions and therefore bear the same costs[23] wherever they commit a violation. This would also increase consumer confidence and mutual trust between supervisors, leading to more efficient cross-border supervision. This option would increase the deterrent effect of sanctions by ensuring that appropriate types of sanctioning powers are available and sufficiently high fines are applicable for each key violation of the CRD. This could consequently reduce risks of violations of EU law, which would have a significant positive impact on consumer protection, competition, safety and integrity of credit institutions.

However, the fact that Member States would not be able to provide for further types of sanctions or higher levels of fines than those provided for in the uniform EU framework would weaken the overall deterrence of some national regimes. In particular, in some

[23] This term is broadly defined as to include all potential negative consequences.

Member States which currently have a very high or an unlimited maximum level for pecuniary sanctions, this might lead to a reduction in the maximum level and reduce deterrence if the actual level established would be lower than what is currently in place. This risk has been highlighted by several stakeholders in the public consultation, who consider that EU action in this field should allow Member States to maintain stricter sanctioning regimes.

The majority of the respondents to the consultation on the Sanction Communication, in particular public authorities, are in favour of a list of core sanctioning powers available to all competent authorities, provided that such a list is not exhaustive and allow competent authorities to apply stricter sanctions. For this reason, the big majority of the respondents do not support the principle of full harmonisation and full-fledged EU sanctioning regime.

For this policy option, the following **fundamental rights** of the EU Charter are of relevance: the right to an effective remedy and fair trial (Art. 47), presumption of innocence and right of defence (Art 48), freedom to conduct a business (Art 16), consumer protection (Art 38), and – even though Art. 49 on the legality and proportionality of criminal offences and penalties may not be directly applicable to all of the administrative sanctions envisaged – the general principles of legality and proportionality underpinning the Charter. In relation to these fundamental rights, this option would ensure that a violation of requirements for authorisation, of prudential requirements and of reporting requirements would be subject to the same type of administrative sanctions across the EU. These uniform rules would particularly ensure that the types and levels of administrative sanctions that can be imposed are proportionate to each specific violation across all Member States, and that Member States lay down those sanctions by law.

This option will not create an **administrative burden** on financial institutions, or non-financial companies, which are already today subject to sanctioning regimes in all Member States. More uniform sanctioning regimes throughout the EU may in fact lead to reduced compliance costs for market participants through the simplification of the legal framework for cross-border financial institutions.

As to the **impact on Member States**, this option would require significant changes in national legislation of all Member States, in order to make types and level of sanctions uniform. Types and levels of sanctions would have to be modified in almost all Member States, as types of sanctions different from the common ones would no longer be allowed and some Member State would have to provide for the application of new types of sanctions. This could require the overall sanctioning regime to be revised. Therefore, the impact on Member States could be significant and the uniform regime may not fit national legal system and culture in different Member States.

This option is expected to ensure better enforcement of the CRD obligations. The specific impacts of those options on **stakeholders** are in fact the same as the impacts of those

rules themselves, which are identified and assessed in the impact assessments of the main parts of the Commission proposal for the CRD, not covered by this impact assessment.

In particular, a large part of deposit-holders and investors are **consumers** for whom savings placed with credit institutions constitute a key part of their financial means and a major element of provision for retirement. The confidence of consumers in the stability of the banking system has been severely hit during the financial crisis, and the reinforcement and convergence of sanctioning regimes for violations of banking capital rules will have a positive impact on the protection of consumers holding deposits and investments, and the availability of such sanctions for misconduct will contribute to restore consumer confidence in credit institutions. This policy option can therefore have positive effects on consumer protection as enshrined in Art. 38 of the EU Charter.

This option is not expected to have specific negative impacts on **SMEs**. More efficient sanctioning regimes ensuring better compliance with EU law would benefit all players in financial markets, as well as all users of financial services, including in both cases SMEs. As the reinforcement and convergence of sanctioning regimes for violations of banking capital rules will contribute to ensure credit institutions are stable, they reduce the risk of financial instabilities caused by violations of EU law, which – as the financial crisis in 2007/2008 has shown – can have a strong negative impact on the economy at large and on **employment**. The option will therefore also have a positive impact on employees and society at large

Environmental impacts of this option have not been identified.

The reinforced focus on effective, proportionate and dissuasive sanctioning regimes is compatible with the common objectives of major **third country jurisdictions** within the G20 Group to strengthen the regulation and supervision of the financial sector. It is in line with developments in other jurisdictions.[24] This option is also expected to have a positive impact on the EU's **global competitiveness**. A strong and credible enforcement of banking capital rules contributes to the stability of the EU financial sector, with positive effects on it. Moreover, it contributes to strengthening the EU's reputation as a global centre for the provision of competitive reliable and stable financial services, benefiting from a high level of investor and consumer confidence.

(3) Minimum common rules on the type of administrative sanctions to be available to competent authorities

This option would contribute to the objective of improving the deterrent effect of administrative sanctions by ensuring that all competent authorities have at their disposal certain key sanctioning powers which can be particularly effective for the different

[24] For example, the US has recently adopted rules to reinforce the detection of violations, including better protection of whistleblowers, in the framework of the Dodd-Frank-Bill of July 2010. Moreover, several sanctions applied by US regulators in the aftermath of the financial crisis express a level of concern to ensure sufficient deterrence that is without doubt equivalent to the suggestions made in this Communication.

violations of the CRD while allowing Member States to keep or introduce any other additional powers which they consider to be effective.

In their **replies to the consultation**, several stakeholders, including some financial supervisors and banks, have specified the key powers that should in their view be in the minimum list of sanctioning powers available to all competent authorities. Those powers should include the withdrawal of authorisation, which may be appropriate for the most serious violations of the banking legislation, the dismissal of management, which may be appropriate in case of serious and repeated violations of prudential rules or disclosure obligations, the possibility of issuing cease and desist orders, which can effectively ensure that the responsible credit institution put an end to the violation, public warning or reprimand, which can effectively prevent credit institutions from repeating violations.

Common rules on the types of sanctions would help in ensuring that violations of the CRD are dealt with in a similar way in all Member States. This would reinforce the development of a level playing field, as credit institutions would risk incurring similar, even if not identical sanctions. Even in Member States where already today all necessary types of sanctions are available and therefore no changes would be brought about by this option, banks and supervisors could be confident that competitors from other Member States are subject to similarly stringent powers – application of which is subject to coordination by EBA as outlined in section 3.2.2 - and therefore these powers will not place banks at a competitive disadvantage. Knowing that the response to violations of banking legislation is broadly equivalent throughout the EU would also increase consumer confidence and may lead to more cross-border provision of banking services, reducing the fragmentation of the single market along national lines.

Further, a minimum list of sanctioning powers would increase mutual trust between national supervisors and improve supervision of cross-border credit institutions. Where the use of the passport limits the host Member State's power to impose sanctions for violations of the CRD, that Member State could count on the fact that violations will be sanctioned in an equivalent manner in the home Member State. For example, where the risk management systems of a cross-border branch are not appropriate, the host Member State can count on the fact that the home Member State can sanction such a violation effectively.

This option would require only a minority of **Member States** to modify their legal framework (7 Member States would have to amend their laws in relation to public warnings, 2 Member States in relation to the dismissal of the management).[25]

The benefits of this option are unanimously recognised by the respondents to the **public consultation** on the Sanctions Communication, with only one respondent considering that this should be left to Member States. In particular, there is a common view that all European competent authorities should have at their disposal a minimum set of core administrative sanctions to be established at EU level, which would reduce divergence

[25] Assessment based on CEBS report, and additional information by national authorities.

and improve efficiency of sanctioning regimes while maintaining some flexibility in the sense that Member States may provide for any additional sanctions.

The impacts of this option on **fundamental rights, stakeholders including consumers and SMEs, social and environmental matters, third countries and the EU's global competitiveness** are similar to the impacts of option 2 above albeit less accentuated as the level of convergence achieved under this option is lower than under option 2.

(4) Minimum common rules on minimum and maximum levels of pecuniary administrative sanctions

This option would significantly contribute to the objective of improving the deterrent effect of the administrative fines, as it would ensure that fines applied are sufficiently high, and improve convergence of national regimes, as the minimum and maximum levels of administrative sanctions would be based on common rules

In the Member States where the maximum level laid down in the legislation is lower than the level laid down at EU level, this option would allow competent authorities to apply pecuniary sanctions higher than those they can currently apply on the basis of the national legislation.

In addition, common rules on the minimum level of pecuniary sanctions would prevent competent authorities from applying pecuniary sanctions which are too low to ensure sufficient deterrence. They would be obliged to impose a sanction at least equal to the minimum level established on the basis of the EU common rules.

Those rules could therefore increase the amount of the sanctions actually imposed, especially in Member States where no minimum amount is laid down in the legislation, which would ensure better deterrence. However, a minimum level would reduce the possibility of adapting the amount of the actual pecuniary sanction to the circumstances of the specific case concerned, which could make it more difficult to ensure proportionality.

Ensuring that the level of fines envisaged in national legislation cannot be lower than the level determined by the EU would allow for the imposition of fines that are optimal in terms of dissuasiveness and consequently reduce risks of violations of EU legislation. This would have a significant positive impact on competition between financial institutions (e.g. by removing the competitive advantages derived from violations of banking legislation), and on safety of financial markets (e.g. increased compliance with prudential rules). Even in Member States where already today the level of fines is sufficiently high and therefore no changes would be brought by this option, banks and supervisors could be confident that competitors from other Member States are subject to similarly high fining powers – application of which is subject to coordination by EBA as outlined in section 3.2.2 - and therefore the high level of fines will not place banks at a competitive disadvantage. At the same time it would not prevent Member States from going beyond the EU minimum criteria, and fine other violations, provide for higher levels of fines or for further types of sanctions.

The majority of the **respondents to the consultation** are favourable to a minimum harmonisation of the level of fines but their views diverge significantly on the scope of the harmonisation. While most of them consider that common rules should be set to ensure a sufficiently high maximum level for fines to be applied across the EU, only a few stakeholders are favourable to setting rules on the minimum level and several of them are opposed, the latter underlining the differences between national legal systems in this respect and arguing that such a minimum level may lead to the application of disproportionate sanctions.

However, this option would have a significant impact on **Member States** at it would require changes in all national legislation which provide for minimum and maximum levels lower than those established on the basis of the EU common rules. In addition, Member States where the legislation does not establish any minimum level would be obliged to introduce that level.

The impacts of this option on **fundamental rights, stakeholders including consumers and SMEs, social and environmental matters, third countries and the EU's global competitiveness** are similar to the impacts of option 2 above albeit less accentuated as the level of convergence achieved under this option is lower than under option 2. However, in relation to fundamental rights, fixed and inflexible minimum levels, when applicable to all violations across the EU and when not set with due regard to proportionality, could prevent authorities from imposing lower sanctions in cases where particular mitigating circumstances would warrant this.

(5) Minimum common rules on maximum level of pecuniary administrative sanctions

This option will require setting only the maximum level of fines to be imposed across the EU, the Member States being left free to provide higher levels and will refrain from requiring any minimum level to be established.

In particular, when setting the maximum level of fines in their law, Member States would have to take into account the following common rules.

First, national legislation would be required to provide that the maximum level should **exceed the benefits** derived from a violation. This would significantly increase deterrence since, where the benefits derived from the violation can be established, wrongdoers will be deprived of the benefits they made and will have to pay an additional amount. The administrative practice of some Member States shows that competent authorities are able to establish the benefits derived by one person or company from some violations, for instance in case of the unauthorised provision of banking services[26].
However, this rule would be insufficient to ensure sufficient deterrence in the situations

[26] See e.g. a recent case pursued by the FSA (UK) where the benefit derived from unauthorised activity by one individual was about 2.5 million pounds, see FSA press release FSA/PN/111/2010 of 29 June 2010.

where it is very difficult or even impossible to estimate the benefits derived from a violation of the CRD (for instance in case of failure to report information to supervisors).

Second, given these limitations national legislation would in addition be required to provide that, in any case (including those where the benefits cannot be established), the maximum level is not lower than (1) a **fixed absolute amount or (2) a percentage of the total annual turnover** of the wrongdoer.
They will remain free to provide for maximum levels higher that the absolute amount or the percentage set by the EU or for an unlimited maximum level.

(1) As regards **natural persons**, Member States where maximum levels are lower than a specific **absolute amount**, to be fixed on the basis of the highest levels currently provided for in national legislations, would be required to increase them. This would increase the deterrent effect of the sanctions, in particular in the Member States with very low levels, while being compatible with the way maximum sanctions are fixed today in most Member States and therefore not requiring modifications of those Member States' legislation. The actual amount could be set at EUR 5 000 000 which is the level of fines provided for or exceeded by the 20% of Member States with the highest levels of fines currently provided for in national legislation (see data in Annex III). It would be a sufficiently high amount to impose deterrent sanctions for the most serious violations even for the most well paid managers of credit institutions (for instance, as of 2010, the highest-paid CEOs of a credit institution in the EU received about EUR 10 000 000 annual compensation). In particular, it would be sufficiently high to exceed the benefits which wrongdoers could derive from a violation in past cases.[27]
However, as regards **credit institutions** such a fixed amount would not take into account the size of the wrongdoer: in case of very serious violations by the largest cross-border credit institutions it may not be sufficient to offset the expected benefits from a violation and to ensure appropriate attention by senior management. These concerns were reflected in the public consultation by a significant number of respondents who argued that the maximum amount of the fine to be imposed should relate to the objective characteristics of the wrongdoer such as its annual turnover or assets.

(2) A common floor for maximum fines for credit institutions would therefore be established by reference to a **percentage of their total annual turnover**, as suggested by

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27 See previous footnote; pls note that a broader assessment of the benefits derived from violations of the CRD is difficult,as in many cases due to the nature of the violations these cannot be established.

28 Council Regulation (EC) No 1/2003 of 16 December 2002 on the implementation of the rules on competition laid down in Articles 81 and 82 of the Treaty (Article 23(2); OJ L 1/1; 01/04/2003, Art. 23(2).

29 Council and Parliament Directive 20097/73/EC of 13 July 2009 concerning common rules for the internal market in natural gas and repealing Directive 2003/55/EC, OJ L211/94 of 14.8.2009.

30 Regulation of the Council and the Parliament amending Regulation (EC) No 1060/2009 on credit rating agencies, Doc 70/10, http://register.consilium.europa.eu/pdf/en/10/pe00/pe00070.en10.pdf.

31 Estimate based on information on a survey of information about EU bank's risk weighted assets and income from annual reports.

several respondents in the public consultation. Requiring the Member States to provide that maximum levels should be based on a percentage of the annual turnover would ensure sufficient deterrence, including for bigger cross-border players, as the objective characteristics of the wrongdoer (in particular its size) will be taken into account.
The actual percentage of turnover would be determined on the basis of the existing experience in other fields where administrative fines are imposed and at a level which is sufficiently high to offset the benefits that can be expected from violations of CRD requirements. The following **existing practice** exists in other areas of EU policy:

– EU **competition rules** [28]provide already that the Commission cannot impose a fine in excess of 10 % of the company's total annual turnover for violations. This provision was replicated and applied without major difficulties in several Member States.

– Similarly, a percentage of 10% of the turnover has been considered appropriate in the context of the Directive 2009/73/EC concerning **common rules for the internal market in natural gas**[29]. This Directive obliges Member States to ensure that those authorities must be empowered to apply penalties of up to 10% of the annual turnover of the undertaking concerned.

– Under the newly adopted regulation on **credit rating agencies** (CRAs)[30] the European Securities Markets Authority (ESMA) may by decision impose on a CRA a fine for a breach of the regulation, which can not be in excess of 20% of the total annual turnover of the CRA.

The objective of the **CRD** review is to provide only for minimum rules on levels of fines while leaving the possibility for the Member States to provide higher maximum levels for fines. The level of fines therefore does not have to be equally high than in the CRA Regulation which establishes absolute maximum levels of fines. On the other hand a maximum fine of less than 10% could be too low in order to effectively deter breaches of CRD capital and reporting requirements which can lead to important benefits in terms of the level of regulatory capital requirements. Depending on the specific circumstances of the bank, 10% of total annual turnover equates to about 10% of the minimum capital banks are required to hold under CRD IV/Basel III when the new regime will be fully phased in.[31] Violations of the CRD may imply that banks hold less capital than required under the CRD. A minimum level significantly lower than this would risk to be insufficiently deterrent in certain cases of serious violations affecting a bank's entire business and leading to important benefits in terms of regulatory capital requirements.

This option would not prevent competent authorities from applying fines significantly lower than the maximum, and therefore would not ensure that fines actually imposed are sufficiently high to be deterrent. However, this could be ensured by providing for appropriate criteria (such as the seriousness of the violation, the financial strength of the credit institutions involved and the benefits/losses derived from the violation) to be taken into account by competent authorities when they calculate the actual fine to be imposed in each individual case. The introduction of a list of relevant criteria is analysed under options 6 and 7.

Similarly to option 4, this option would have a significant positive impact on competition between financial institutions and on safety of financial markets. However, this option would also leave sufficient flexibility to ensure proportionality of the fines since competent authorities will not be restrained by a minimum level to impose lower pecuniary sanctions in less serious cases involving smaller players or less severe violations within the same category.

This option is supported by the majority of respondents to the **public consultation** since it can increase deterrence and empower competent authorities to impose sufficiently high fines in the most serious cases while leaving sufficient discretion for competent authorities to decide on the actual level (no minimum required level). Similarly to option 4, this option would contribute to the objective of improving the deterrent effect of administrative fines, as it would ensure that competent authorities have the power to apply fines which are sufficiently high to be deterrent even on the larger credit institutions.

The impact of this option on **Member States** would be less significant than in option 4, as it would require changes only in national legislation where the maximum level does not comply with the common minimum standard. No changes would be required where that level is higher or unlimited and Member States would not be obliged to introduce a minimum level. Based on the information available to the Commission, legislative amendments would be necessary in 8 Member States.[32]

The impacts of this option on **fundamental rights, stakeholders including consumers and SMEs, social matters, third countries and the EU's global competitiveness** are similar to the impacts of option 2 above albeit less accentuated as the level of convergence achieved under this option is lower than under option 2. In relation to fundamental rights, this option respects the principle of proportionality in particular by refraining from laying down fixed and inflexible minimum levels of administrative pecuniary sanctions, thereby allowing Member States and competent authorities to imposing lower sanctions in cases where particular mitigating circumstances would warrant this.

(6) Uniform rules on the factors to be taken into account in the application of sanctions

This option would eliminate any divergence on factors to be taken into account in deciding the type of sanctions and/or calculating the amount of the fine to be applied to the author of a specific violation of the CRD, within the range of sanctions and the levels of pecuniary sanctions laid down in the legislation. The factors to be taken into account would include the seriousness of the violation, its consequences (e.g. benefits obtained, losses caused to third parties, etc), and the personal conditions of the author of the violations (e.g. the financial strength of the credit institution) or its cooperation with the competent authorities.

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[32] Assessment based on CEBS report, p. 53, and additional information by national authorities.

Providing for similar types and level of sanctions in national legislation would be insufficient to ensure that the perpetrators of similar violations would incur similar sanctions in different Member States if the factors taken into account to determine the actual sanctions imposed were completely different. In particular, this option would help to ensure that the level of fines actually applied is sufficiently high even when no minimum level is fixed. This option will therefore reinforce the deterrent effect of option (5) above.

Uniformity in the way sanctions are applied would facilitate cooperation between competent authorities and therefore ensure better cross-border supervision.

This option would also help in ensuring proportionality and dissuasiveness of sanctions. The sanctions imposed would always be linked to criteria ensuring that competent authorities take duly into account the seriousness of the violation, its consequences (e.g. benefits obtained, losses caused to third parties, etc), the personal conditions of the author of the violations (e.g. the financial strength of the credit institution) or its cooperation with the competent authorities. The respondents to the consultation on the Sanctions Communication agree that the above-mentioned criteria should be taken into account by all competent authorities in the EU to ensure proportionality and deterrence of sanctions.

In the banking sector, those criteria are particularly relevant: for instance, taking into account the financial strength of the credit institution is important to ensure that sanctions for the violations of the CRD have an equivalent effect on small and large credit institutions, linking the sanction applied to the benefits, potentially very high, derived from the violation of prudential rules would increase their deterrent effect.

However, under this option, the common list would in principle include only factors that can be applied in the same way in all national legal systems, which would preclude the possibility to take also into account those factors which can be part of the principles of some legal systems but not relevant in others.

This option would require **changes** in all **national legislation**, as it implies a revision of all provisions concerning the way sanctions are applied.

The impacts of this option on **fundamental rights, stakeholders including consumers and SMEs, social and environmental matters, third countries and the EU's global competitiveness** are similar to the impacts of option 2. However, in relation to fundamental rights, uniform criteria may make more difficult to ensure the respect the principle of proportionality, as competent authorities would no longer be allowed to take into account certain factors currently provided for in some Member States which may be relevant in their legal systems to adapt sanctions to the particularities of each specific case.

(7) Minimum common rules on the factors to be taken into account in the application of sanctions

Likewise option 6, this option would allow competent authorities to better adapt the type and the level of sanctions imposed to the seriousness and the impacts of the violation and to the personal conditions of the author of the violation, which would help ensuring effectiveness, proportionality and dissuasiveness of the sanctions actually applied. It would also reinforce the deterrent effect of option (5) above: even if no minimum level of fines if established, the fact that competent authorities would take into account factors such as the gains obtained from the violation and the financial strength of the credit institution would help ensuring that the fine actually imposed is not too low.

The common list of key factors would include the factors mentioned in option 6. This option would therefore have the same positive impacts on competition, consumer protection and stability of financial markets.

This option would lead to increased convergence in the way sanctions are applied by competent authorities across Europe while maintaining some flexibility. This would ease cooperation between banking supervisors who would rely on a common understanding of how sanctions imposed for a particular violation should be adapted to the specifics of that violation. At the same time, Member States would have the possibility to consider additional factors that are particularly relevant in a specific national context.

The results of the **consultation** on the Sanctions Communication show that a large majority of stakeholders are opposed to an exhaustive list of factors to be taken into account by all competent authorities, since this would prevent Member States from considering other relevant factors in their national legal systems.

This option would not require major **changes in national legislation**. Some Member States already provide for the most relevant factors, and the others could add those factors without repealing the existing provisions. For example, in the banking sector, thirteen Member States already take into account the financial strength of the author of an infringement, while the remaining Member States would have to add that factor to existing provisions.[33] Based on the information available to the Commission, 10 Member States would have to amend their laws to take into account the benefit derived from a violation and the financial strength of the offender, 7 Member States in order to take into account the cooperation of the offender, and 6 Member States in order to take into account the losses for third parties caused by a violation).[34]

The impacts of this option on **fundamental rights, stakeholders including consumers and SMEs, social and environmental matters, third countries and the EU's global competitiveness** are similar to the impacts of option 2 above albeit less accentuated as the level of convergence achieved under this option is lower than under option 2. In relation to the fundamental rights the criteria relating for example to the gravity of a violation or to the benefit derived from a violation contribute to ensure that the principle of proportionality is respected when determining applicable fines.

[33] CEBS report, p. 53, and responses by national authorities.

[34] Assessment based on CEBS report, p. 53, and additional information by national authorities.

Comparison of options

The objectives outlined in section 4 cannot be achieved under option 1, which preserves the "status quo" and thus the problems identified in section 3.2. Although the EBA could promote further convergence of national provisions concerning sanctions, this action would hardly be effective without an EU framework in place.

Options 2 and 6 would eliminate any divergence in types, level of sanctions and criteria for their application, and therefore will be the most effective in terms of ensuring level playing field and facilitating cross-border supervision. Options 3, 4, 5 and 7 would be less effective as they would set only minimum common rules on types, levels of sanctions and criteria for their application. However, they would leave some flexibility which would permit to adapt sanctions to the specificities of the different national legal systems, and therefore help competent authorities to apply optimal sanctions in terms of deterrence. Option 4 would be more effective than Option 5 in reducing divergences in the levels of pecuniary sanctions, as it would set common rules on both maximum and minimum levels while Option 5 will better ensure proportionality, as it would not oblige competent authorities to impose pecuniary sanctions of a minimum amount which could be disproportionately high in certain particular cases.

Options 2, 3 and 4 are considered to be similarly effective in terms of ensuring deterrence: uniform types and level of sanctions are not necessarily more dissuasive than different sanctions complying with minimum standards which are sufficiently strict. However, option 3 would allow for the provision of additional types, which can increase dissuasiveness in some Member States. option 5 will be less effective in ensuring that sufficiently high pecuniary sanctions are actually applied but could better ensure those sanctions are proportionate. Similarly, both Options 6 and 7 can be considered equally effective to the extent the relevant factors identified in Option 6 are included in the minimum list of factors established under Option 7. However, the latter could better ensure appropriateness of sanctions actually applied, as it would not prevent competent authorities from taking into account other factors relevant in their national legal systems.

Regarding efficiency, Options 2 and 6 are the less efficient as they would require important changes in national legislation. The substantial impact Options 2 and 6 would have in terms of the number of Member States required to modify their rules and their overall sanctioning regimes is not compensated for by an equally substantial increase in effectiveness compared to options 3 and 7 – in fact a full harmonisation of types of sanctions and factors to be taken into account may be less effective in some respects as it will not allow Member States to provide for types and factors that may be necessary to respond to specific national circumstances. Option 5 is more efficient than option 4 as it would require legislative changes only in some Member States. In addition, Option 4, while being more effective to achieve the objectives of dissuasiveness, a level playing field and improving trust between supervisors, would have a substantial negative impact on the objective of proportionality because it would limit the possibility of authorities to take into account the specificities of each case when determining the level of a fine. Therefore, an obligation to provide for minimum levels of fines would require important

legislative changes, especially in Member States where current national legislation does not lay down any minimum level, without bringing and equivalent contribution to the achievement of the objectives envisaged.

None of the Options considered will harmonise the procedure for the imposition of administrative sanctions for violations of the CRD and will therefore preserve Member States' current arrangements ensuring compliance with the rights for judicial protection of the Charter, such as the right to an effective remedy and to a fair trial (Art. 47), the presumption of innocence and the right of defence (Art.48).

Based on the analysis of the impacts above, Options 3, 5 and 7 have been selected.

	Effectiveness in achieving the specific objectives below through the relevant operational objective			Efficiency in achieving all objectives
	Improve effectiveness, dissuasiveness and proportionality of sanctions	Develop level playing field	Improve trust between supervisors	
1. Do nothing	0	0	0	0
2. uniform rules on types and level of administrative sanctions	++	+++	+++	-
3. Minimum common rules on types of administrative sanctions	+++	++	++	+++
4. Minimum common rules on levels (minimum and maximum) of administrative fines	+++	++	++	+
5. Minimum common rules on maximum level of administrative fines	++	++	++	+++
6. Uniform rules on factors to be taken into account for the application of sanctions	+	+++	+++	-
7. Minimum common rules on factors to be taken into account for the application of sanctions	+++	++	++	+++

5.1.2. Options concerning the personal scope of administrative sanctions

Options[35]	**Description**
1: no EU action	The existing sanctioning regimes will continue to exist. Member States will have to ensure compliance with the provisions on sanctions already contained

[35] These options would apply to all key violations of the CRD.

	in the CRD.
2. general obligation to provide for the application of administrative sanctions to both individuals and credit institutions	Member States would be obliged to provide competent authorities with possibility of applying sanctions to both individuals and credit institutions responsible for a violation. Competent authorities would establish whether the responsibility for a specific violation is on an individual or a credit institution or both, on the basis of the existing national rules on liability.
3. Minimum common rules on the application of administrative sanctions to individuals and/or credit institutions	Minimum common rules would be set out on the liability of individuals (i.e. managers, employees of a credit institution) and/or credit institutions. For instance, those rules may establish the conditions under which the credit institutions and its managers are jointly responsible for a violation.

Analysis of options

(1) No EU action

The CRD requires Member States only to provide for the application of administrative sanctions "against credit institutions or those who effectively control the business of credit institutions" (Art. 54 Directive 2006/48/EC). However, compliance with this general clause cannot ensure that sanctions may be applied to the individuals who have key positions within the credit institutions (e.g. members of the Board).

In the absence of any action at EU level, Member States would probably not extend the personal scope of administrative sanctions as currently provided in their legislation and they would continue to apply their national liability regimes. The fact that, in some Member States, the individuals responsible for a violation will evade sanctions for their illegal behaviour would probably not ensure optimal dissuasiveness. The problems relating to insufficient deterrence of sanctions (lack of enforcement of banking rules, leading to improper functioning of financial markets) would remain unsolved.

(2) Administrative sanctions applicable to both credit institutions and individuals

Under this option, competent authorities would have the power to establish the responsibility for a violation on an individual or a credit institution or both of them. However, they would be left free to decide how to attribute this responsibility in a given case. This would apply to all violations of the CRD for which sanctions are provided. This would significantly increase dissuasiveness of sanctions: knowing that they cannot escape the negative consequences of their illegal behaviours, for instance the violation of reporting obligations, the managers of credit institutions would be discouraged from reiterating such behaviours. Increased dissuasiveness of sanctions would ensure better compliance with EU rules, with positive impacts on consumer protection, fair competition, safety and stability of financial markets.

Harmonising the personal scope of sanctions across Member States would also have a positive impact on the level playing field in the European financial market, as the players would risk to be held liable for violations of EU rules wherever they operate in the

European Union. This would also increase consumer confidence and mutual trust between supervisors.

The majority of the **respondents to the consultation** on the Sanctions Communication agree that competent authorities should have the power to impose administrative sanctions to both individuals and legal persons, some of them arguing that sanctions imposed to credit institutions are more deterrent others that individuals should also be held liable for some violations. Respondents are of the view that competent authorities should enjoy sufficient flexibility to decide in each individual case to whom attributing responsibility for an infringement.

This option would require legislative measures to be taken at national level only in **Member States** where the scope of sanctions do not cover both individuals and credit institutions responsible for the violation (based on the information available to the Commission this concerns 3 Member States).

For this option, the following **fundamental rights** are of relevance: right to an effective remedy and fair trial (Art. 47), presumption of innocence and right of defence (Art 48), freedom to conduct a business (Art 16), consumer protection (Art 38), and – even though Art. 49 on the legality and proportionality of criminal offences and penalties may not be directly applicable to all of the administrative sanctions envisaged – the general principles of legality and proportionality underpinning the Charter. In relation to these fundamental rights, introducing the possibility of applying administrative sanctions to both individuals and credit institutions will improve a coherent sanctioning regime across the EU and will increase deterrence of sanctions.

This option will not harmonise the national liability regimes and will not affect the procedure for the imposition of administrative sanctions. Therefore it will preserve Member States' current arrangements ensuring compliance with procedural rights such as the right to an effective remedy and to a fair trial (Art. 47), the presumption of innocence and the right of defence (Art.48).

The impacts of this option, and in particular the increased deterrence of sanctions brought by it, on **stakeholders including consumers and SMEs, social and environmental matters, third countries and the EU's global competitiveness** are similar to the impacts analysed in section 5.1.1 above (option 2).

(3) Common rules on the application of administrative sanctions to individuals and/or credit institutions

Under this option, competent authorities would not only be empowered to attribute responsibility for an infringement to both individuals and credit institutions, but also will apply common criteria when establishing who is responsible for a key violation of the CRD. Therefore, when a violation of the CRD occurs, the individuals and the credit institutions involved would be treated similarly in terms of liability in all Member States.

This option would reduce divergences in the application of sanctions, which would have a positive impact on the level playing field in the European financial market. To the extent the common rules introduced would better target the response to a violation, this option may also increase dissuasiveness of sanctions.

Several **stakeholders** have raised the issue of how responsibility should be shared between financial institutions and individuals, and particularly between credit institutions and their managers or employees. However, they have divergent and sometimes unclear views on the conditions under which credit institutions should or should not be responsible for the misconducts of their employees and managers should be held responsible for violations of banking rules. Some of them have expressed concerns on the possible impact that common rules in this area may have on the civil liability regime. In any event, the majority of the stakeholders, including the public authorities, are of the view that the rules on responsibility should be left to the Member States at this stage.

Indeed, this option would have a significant **impact on Member States**: they would be obliged to adapt their liability regimes to the common rules set at EU level, which may requires significant changes in the legislation. Those changes would probably concern not only the banking legislation but also general rules and principles of the national legal systems and may have an impact on the civil liability of the persons concerned.

The impacts of this option on **fundamental rights, stakeholders including consumers and SMEs, social and environmental matters, third countries and the EU's global competitiveness** are similar to the impacts of option 2.

<u>Comparison of options</u>

Option 1 would preserve the "status quo" and therefore would not contribute to the achievement of the objectives set out in section 4. Option 3 would be more effective than option 2 in ensuring level playing field and better cross-border supervision, as it would introduce common rules on liability of individuals and credit institutions while option 2 would only ensure that sanctions can be applied to both of them. As to the dissuasiveness of sanctions, the difference on the effectiveness of those options is considered to be minor: general rules on liability would help ensuring deterrence and proportionality of sanction only to the extent the existing liability regimes are inappropriate.

Option 3 is much less efficient than option 2, as it would require more changes in national legislation and may oblige Member States to adapt their general liability regimes: under Option 3 they would have to revise the national rules that competent authorities apply to decide who may be held responsible for a violation while under Option 2, amendments of national legislation would be necessary only in the Member States (3 according to the available information) where sanctions are not applicable to both credit institutions and individuals. The substantial impact option 3 would have on Member States' legal systems is not compensated for by an equally substantial increase in effectiveness compared to option 2 – the key objective to ensure that all responsible persons can be sanctioned can be achieved by option 2 as well, while the only difference is that detailed rules and conditions for liability would not be harmonised.

Based on the analysis of the impacts above, Option 2 has been selected.

	Effectiveness in achieving the specific objectives below through the relevant operational objective			Efficiency in achieving all objectives
	Improve effectiveness, dissuasiveness and proportionality of sanctions	Develop level playing field	Improve trust between supervisors	
1. Do nothing	0	0	0	0
2. general obligation to provide for the application of administrative sanctions to both individuals and credit institutions	+	++	++	+++
3. Minimum common rules on the application of administrative sanctions to individuals and/or credit institutions	++	+++	+++	+

5.1.3. Options concerning the publication of sanctions

Options[36]	**Description**
1. Do nothing	The existing sanctioning regimes will continue to exist. Member States will have to ensure compliance with the provisions on sanctions contained in the CRD, which do not deal with the publication of sanctions
2. publication of sanctions as general rule	Publication of sanctions would be imposed as a general rule. Exceptions will be allowed but only in certain narrowly defined cases (e.g. when publication would seriously jeopardise the financial markets)
3. publication of sanctions decided by competent authorities	Member States would have to ensure that competent authorities have the power to publish all sanctions imposed. Those authorities could decide whether or not sanctions imposed in a particular case are to be published , but they would have to properly justify the decision not to publish

Analysis of options

(1) No EU action

In the absence of EU action, divergences will remain on the publication of sanctions. In seven Member States, competent authorities would continue to publish sanctions relating to violations of banking legislation as a matter of course without restrictions[37] while in the other Member States similar sanctions would not be always published. In those

[36] These options would apply to all key violations of the CRD.
[37] CEBS report, p.58

Member States, competent authorities will maintain the discretionary power to decide whether or not sanctions have to be published, either on a named basis or anonymously.

Inconsistencies will remain. In some Member States the systematic publication of sanctions for violations of the CRD will ensure those sanctions will have a strong dissuasive effect not only on the credit institution or individuals concerned, which when considering a violation of the CRD will likely take into account that when sanctioned they risk a significant negative impact on their reputation, but also on other potential perpetrators to whom the publication of sanctions is likely to recall the chance of their violation being detected and sanctioned. In other Member States however, these positive effects of publication will not be present.

(2) Publication of sanctions as a general rule

This option would significantly increase dissuasiveness of sanctions, as competent authorities would be obliged to publish all sanctions imposed unless an exception is applicable.

Credit institutions would fear a negative impact on their reputation when they violate the CRD, and would be well informed about the enforcement activity of the competent authorities, which would raise their awareness of the risk that violations are detected. This will make such violations less attractive for them.

The **public consultation** has shown that a large majority of stakeholders, including public authorities, banks and associations of banks, consider the publication of sanctions as one of the most deterrent tools, particularly because of the reputational damage that the author of the violation will incur.

Publication of imposed sanctions would contribute to improve market integrity and investor protection. Deposit-holders and investors would be alerted about the fact that a credit institution did not respect the applicable rules on financial soundness and proper management, and would therefore be able to take this into account when judging the reliability of credit institutions for their investment and deposits.

Public authorities as well as some banks and associations of banks, support systematic publication of sanctions with very limited exceptions, as they consider it as being of high importance to enhance transparency and maintain confidence in financial markets. Consumers associations are particularly vocal on this issue since in their view systematic publication of sanctions can help consumers to make informed decision and avoid using the services of companies which infringe the rules.

This option would require limited changes in national legislation of the **Member States** where competent authorities are not obliged to systematically publish sanctions (based on the information available to the Commission, today 15 Member States do not systematically publish sanctions[38]).

[38] Assessment based on CEBS report, and additional information by national authorities.

For this policy option the following **fundamental rights** are of relevance: right to an effective remedy and fair trial (Art. 47), presumption of innocence (Art 48), freedom to conduct a business (Art 16), data protection (Art 8), consumer protection (Art 38). In relation to these fundamental rights, an obligation to publish all sanctions imposed unless an exception is applicable may have a negative impact on the right to protection of personal data (Art. 8) in regard to any individuals concerned. Moreover, it could have a negative impact on the credit institutions' freedom to conduct a business (Art. 16), as any publication of the value judgment by the authorities imposing the sanction risks to impinge on the public image of the credit institution and to alienate existing or potential customers and investors. Those impacts are particularly relevant where the identity of the addressee of the sanction is disclosed. However, publication of sanctions is an important element in ensuring that sanctions have a dissuasive effect on the addressees and is necessary to ensure that sanctions have a dissuasive effect on the general public. Publication of sanctions is also proportionate, provided that it includes information on the nature and seriousness of the sanctioned violation which is factually correct. This will ensure that the public value judgment inherent in the publication of a sanction will be proportionate to the violation. The interference with private life (Art.7) and protection of personal data (Art. 8) resulting from the publication and processing of sanctions will be addressed by national laws regulating time limits on publicity of sanctions and data processing of sanctions pursuant to Directive 95/46/EC.

To the extent that a decision by a competent authority to impose a sanction is published when court appeals against that decision are still pending, the right to a fair trial (Art. 47) and the presumption of innocence (Art 48) are also relevant. However, the envisaged policy option will enable national authorities to clearly indicate in the publication that the published decision is still subject to appeal. Publication of a sanction which clearly states that it is subject to appeal is not equivalent to a presumption of guiltiness and does not unfairly restrict the rights of the addressee in the court proceedings against that sanction, the very object of which is to ascertain whether the sanctioning decision is correct.

The publication of sanctions can have a positive impact on **consumer** protection (Art. 38) as it will enable consumers to judge whether specific credit institutions respect applicable laws.

The impacts of this option, and in particular the increase in effective deterrence brought by it, on **stakeholders including SMEs, social and environmental matters, third countries and the EU's global competitiveness** are similar to the impacts analysed in section 5.1.1above (option 2).

(3) Publication of sanctions to be decided by competent authorities

Similarly to option (2), this option would increase deterrence of sanctions.

However, the competent authorities would have to assess if the publication is appropriate in a specific case and may decide not to publish sanctions, which would reduce the deterrent effect of the publication.

In the public **consultation**, some minority stakeholders who are not in favour of a systematic publication of sanctions mention a number of different reasons that may justify the decision not to publish: disproportionate damages to the parties involved, public interest, minor offences, data protection, and liability issues.

If publication is excluded on the basis of factors such as the potential reputational damages to the author of the violation, deterrence would be significantly weakened.

Similarly, the positive effects of the publication on market integrity and consumer protection, would be reduced under this option as the public would not always be informed about the violation of prudential rules and will therefore not be able to take this into account when judging the reliability of credit institutions for their investment and deposits.

This option would have a very limited **impact on Member States** as it would require changes only in national legislation of the Member States where competent authorities have not the power to publish all sanctions imposed for violations of the CRD or are not obliged to properly justify their decision not to publish.

In relation to the **fundamental rights**, the impact is similar in nature to the impact of the previous option. However, to the extent that the fact that publication is not mandatory will lead to a smaller amount of sanctions being published, the impact is less severe. Correspondingly, the positive impact on consumer protection (Art. 38) may be less accentuated.

The impacts of this option on **stakeholders including consumers and SMEs, social and environmental matters, third countries and the EU's global competitiveness** are similar to the impacts of option 2.

<u>Comparison of options</u>

Option 1 would preserve the "status quo" and therefore would not contribute to the achievement of the objectives set out in section 4. Option 2 would be much more effective than option 3 in increasing deterrence of sanctions leading to better protection of consumers and market integrity, and in improving supervision. Publication of sanctions is expected to have a limited impact on the development of a level playing field but option 2 would be more effective also in this regards as credit institutions will be treated similarly in all Member States. Option 3 is slightly more efficient than option 2, as it would require fewer changes in national legislation and Member States which already provide for the possibility to publish sanctions under certain conditions to be assessed by competent authorities would not be obliged modify their legislation.

Based on the analysis of the impacts above, Option 2 has been selected.

	Effectiveness in achieving the specific objectives below through the relevant operational objective			Efficiency in achieving all objectives
	Improve effectiveness, dissuasiveness and	Develop level	Improve trust between	

	proportionality of sanctions	playing field	supervisors	
1. Do nothing	0	0	0	0
2. publication of sanctions as general rule	+++	++	++	+++
3. publication of sanctions decided by competent authorities	+	+	++	++

5.2. Options concerning the framework for detection of violations

The mechanisms facilitating the detection of sanctions have been identified in the Sanctions Communication as an area where EU action may be envisaged. The analysis of other possible measures that may help improving application of sanctions and the reasons why EU action does not seem to be appropriate in other areas is contained in the Impact Assessment accompanying the Sanction Communication.

Options[39]	**Description**
1: no EU action	Member states would continue to use the existing investigatory tools
2. internal whistleblowing procedure in credit institutions	Member States will be obliged to provide an obligation on credit institutions to put in place dedicated procedure for the internal reporting of potential violations as part of their corporate governance and audit arrangements
3. Member States to set up systems for the promotion and protection of whistleblowers	Member States will be required to take appropriate measures to promote whistle blowing and to protect persons who denounce potential violations of the banking legislation they become aware of. No detailed rules will be established on how whistle blowing systems have to be designed, which will allow Member States to adopt the measures which best fit their legal systems.
4. Detailed EU requirements for whistle blowing programmes	This option would establish detailed requirements at EU level on the whistle blowing systems and procedures that Member States are required to put in place.

Analysis of options

(1) No EU action

Under this option, certain Member States would continue to provide for rules obliging credit institutions to put in place early warning systems for malfunctions in the internal control mechanisms and prohibiting retaliation against whistleblowers. However, other Member States would probably not put in place consistent and predictable programs to encourage whistle blowing.

[39] These options would apply to all key violations of the CRD.

Competent authorities would continue to cooperate with each other making use of the existing mechanisms. They would render assistance to competent authorities of other Member States, particularly by exchanging information and cooperating in investigation activities.

Under this option, the EBA could further facilitate cooperation between competent authorities, which would help in ensuring more consistent application of sanctions and more efficient supervisory activities. To this purpose, the EBA can use its power to carry out peer reviews and collect information on sanctions to promote exchange of information and best practices between Member States.

(2) Internal whistle blowing procedures to be put in place by credit institutions

In several Member States, financial institutions are either required (eg FR[40], DE[41]) or encouraged (UK[42]) by the financial regulators to have in place appropriate internal procedures which will encourage employees with concerns to blow the whistle internally about potential violations of financial services rules. Beyond the financial services sector, corporate governance codes in some Member States (eg UK[43], NL[44]) encourage undertakings to have such procedures in place.
Several senior employees of credit institutions which required public support during the financial crisis in 2008/2009 had alerted their employers about prudential risks and violations of prudential rules well before, but their alerts had been disregarded.[45]

This option would oblige all Member States to provide for an obligation on credit institution to ensure that appropriate whistleblowing procedures are in place, which would encourage the employees to report misconducts to the persons responsible within the institution. Those procedures would guarantee confidentiality and adequate protection of the personal data of both the whistleblower and the person denounced.

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[40] See Article 11-2(2) of CRBF [Banking and Financial Regulation Committee] Regulation No 97-02; Article 321-23 of the General Rules of the AMF [Financial Markets Authority].

[41] http://www.bafin.de/SharedDocs/Veroeffentlichungen/DE/Service/Rundschreiben/2009/rs__0915__ba__marisk.html

[42] http://fsahandbook.info/FSA/html/handbook/SYSC/18/2;

[43] UK Corporate Governance Code, and the relevant auditors' guidelines (http://www.pcaw.co.uk/organisations_pdf/icaew.pdf).

[44] NL Corporate Governance Code: "The management board shall ensure that employees have the possibility of reporting alleged irregularities of a general, operational and financial nature in the company to the chairman of the management board or to an official designated by him, without jeopardising their legal position. Alleged irregularities concerning the functioning of management board members shall be reported to the chairman of the supervisory board. The arrangements for whistleblowers shall in any event be posted on the company's website."

[45] Whistleblowers had alerted internal management or supervisory authorities before about failures that were exposed by the financial crisis, including in important financial institutions such as Fortis, HBOS, or Northern Rock, Lehman, AIG and in relation to the Madoff fund. See also United States Securities and Exchange Commission - Office of Inspector General, Investigation of Failure of the SEC To Uncover Bernard Madoff's Ponzi Scheme, Case No. OIG-509, August 2009,http://www.sec.gov/news/studies/2009/oig-509-exec-summary.pdf.

Clear and effective reporting and follow-up procedures for the receipt of whistle blowing alerts and for the protection of whistle blowers are key for the successful use of whistle blowing.[46] This will be mutually reinforcing with the option (3) below. It will encourage persons (e.g. the employees of a bank) who have knowledge of a suspect violation thanks to their position within the credit institution, to report their suspicions to internal control functions. The "insider knowledge" may be a very useful source of information for a credit institution's senior management to become aware of violations of prudential rules, which often requires complex analysis of a large amount of information. The management or control functions should then ensure appropriate follow up and inform the competent authorities where necessary.

Increasing the information available to supervisors means that this option significantly contributes to meeting the objective of increasing the detection of violations by supervisors and thereby enable competent authorities to ensure sanctions provided for by law are effectively applied in all Member States. This will increase the dissuasiveness of sanctioning regimes for violations of the CRD, and will help create a level playing field between credit institutions in different EU Member States and a better cooperation between banking supervisors.

In the **public consultation**, almost all respondents agreed on the usefulness of whistle blowing systems. While the majority of public authorities, industry, unions and financial services users supported minimum convergence in the area of whistleblowing, another group of public authorities and industry felt that there is a need for further studies and examination before acting at EU level, for example on national practices, or on the impact of whistle blowing on civil liability or criminal sanctions, and another group was fully opposed to EU action in this area. Among the few opponents to whistle blowing, some feared a negative impact on privacy and a reversal of the burden of proof.

In terms of **administrative costs**, this option could involve some costs for credit institutions to set up and manage the whistleblowers systems. An exact quantification of those costs cannot be made as they would largely depend on the requirements that national legislation may laid down on how to implement those internal systems. However, an indication of the potential costs involved could be found in the evaluation made by the UK FSA in 2002, which concludes that costs to firms of introducing whistleblowing procedures are minimal, as they mainly use in-house resources[47]. For instance, setting up costs (awareness and training, management time, consultancy fees) were estimated at maximum £ 18.000 for large firms and much lower for small firms and continuing costs (management time, recording of complaints made) which are estimated at about £ 5.000 per year.

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[46] Transparency International, "Alternative to silence – whistleblower protection in 10 European Countries", 2010.

[47] Policy statement, Whistleblowing,the FSA & the financial services industry – Feedback on CP101 and made text, April 2002, http://www.fsa.gov.uk/pages/Library/Policy/CP/2001/101.shtml

In addition, the cost of setting up internal whistleblowing systems will be mitigated by the fact that these systems will be part of the corporate governance systems which those institutions are obliged to put in place under the CRD in any event (see in particular impact assessment on CRD amendments relating to corporate governance).

The following **fundamental rights** of the Charter of Fundamental Rights are of particular relevance: respect for private and family life (Art. 7) and protection of personal data (Art. 8).

The proposed measure will ensure that credit institutions and investment firms provide adequate procedures and protection to whistle blowers which report misconduct to the persons responsible within the institution, including the protection of private and personal data. In addition, the personal and private data of suspects under investigation as a result of whistle blowing should be protected by the credit institution. If after an internal investigation the credit institution fails to detect a violation, the data provided by the whistle blower should be deleted by it.

As indicated above, whistle blowing activities may affect the protection of personal data. In order to mitigate this effect and ensure that it is not disproportionate to the objectives pursued by this option, the implementation of whistle blowing schemes must comply with data protection rules laid down in Directive 95/46/EC[48] and all the criteria indicated by the data protection authorities.[49]

Due to the low expected compliance costs, this option is not expected to have specific negative impacts on **SMEs**.

In relation to **social impacts, e**mployees of credit institutions who act as whistle blowers and report suspected violations to the authorities will benefit from better protection. The existing horizontal rules on the protection of whistleblowers, and particularly those contained in labour legislation will remain in place and will be reinforced by the provision of more targeted rules.

(3) Require Member States to set up systems for the protection of whistleblowers

Some Member States have already in place specific systems to protect whistle blowers against reprisals, but such systems are usually horizontal rules (relating to, for example, labour law), and therefore are not specific to the financial services area.[50] Other Member

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[48] Directive 95/46/EC of the European Parliament and of the Council of 24 October 1995 on the protection of individuals with regard to the processing of personal data and on the free movement of such data.

[49] Article 29 working party Opinion 1/2006 on the application of EU data protection rules to internal whistle blowing schemes in the fields of accounting, internal controls, auditing matters, fight against bribery, banking and financial crime, available at: http://ec.europa.eu/justice/policies/privacy/docs/wpdocs/2006/wp117_en.pdf

[50] For example see the Public Interest Disclosure Act 1998 (PIDA) in the UK which protects employment rights for individuals who "blow the whistle", e.g. from and employer not offering a

states have no specific provisions at all. This option would ensure that whistleblowers receive appropriate attention, protection and are not discriminated against. This option will be without prejudice of the existing horizontal rules on the protection of whistleblowers, and particularly those contained in labour legislation, which will remain in place and will be reinforced by the provision of measures specific to the banking sector.

In the financial sector, several senior employees of credit institutions which required public support during the financial crisis in 2008/2009 had alerted the authorities about prudential risks and violations of prudential rules well before, but their alerts had not received strong attention, and in some cases they suffered retaliation by their employers[51]. Clear and effective reporting and follow-up procedures for the receipt of whistle blowing alerts and for the protection of whistle blowers are key for the successful use of whistle blowing as an investigative tool.[52] This option will ensure competent authorities put in place specific systems to receive whistle blowing alerts, to dedicate to them the necessary investigative attention and to protect whistle blowers.

In the **public consultation**, almost all respondents agreed on the usefulness of whistle blowing systems. Respondents considered that sufficient protection of whistleblowers is indispensible for that mechanism to work efficiently in practice in all Member States.

This option could involve some **costs for Member States** to put in place and to manage whistleblowing systems, which would mainly depend on how they will implement those systems. As they would be allowed to set up those systems within the existing administrative structure and to manage them by using the financial and human resources already affected to the competent authorities activities, the costs relating to this option are expected to be limited limited.[53]

This option will be mutually reinforcing with the option (2) above as credit institutions' internal whistle blowing systems may not always ensure that violations are terminated and the necessary information is forwarded to the competent authorities. It will encourage persons (e.g. the employees of a bank) who have knowledge of a suspect violation thanks to their position within the credit institution, to report their suspicions to competent authorities and will encourage competent authorities to take such alerts seriously.

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promotion or other opportunities they would have otherwise offered. For example, in FR, under Labour law retaliation against whistleblowers is prohibited (See Article L. 1161-1 of the Labour Code).

[51] See above footnote 46.

[52] Transparency International, "Alternative to silence – whistleblower protection in 10 European Countries". On the effectiveness of whistleblowing programmes see also US SEC – Assessment of the SEC bounty programme, March 2010, http://www.sec-oig.gov/Reports/AuditsInspections/2010/474.pdf

[53] The UK FSA authority estimated that the total amount of work undertaken to implement a complete guidance and information sheet on whistleblowing is equivalent to one full-time member of staff working for one year. See reference in footnote 50.

Likewise option 2, increasing the information available to supervisors means that this proposal significantly contributes to meeting the objective of increasing the detection of violations by supervisors. This will increase the dissuasiveness of sanctioning regimes for violations of the CRD, and will contribute to the development of a level playing field between credit institutions in different EU Member States and a better cooperation between banking supervisors.

By protecting those who support law enforcement by competent authorities, this option will have a positive impact on such individuals. On the other hand it may have a negative impact on the confidentiality of information held by credit institutions, as information submitted by employees to public authorities will likely include personal data and business secrets. Therefore, whistle blowing systems must comply with data protection principles and criteria indicated by the data protection authorities.[54]

In relation to **fundamental rights**, the proposed measure will ensure protection of whistle blowers, including the protection of private and personal data. In addition, the personal and private data of suspects under investigation for violations of the CRD as a result of whistle blowing should be protected by the competent authorities. If the investigation fails to detect a violation, the data provided by the whistle blower should be deleted by the competent authorities. To this end, competent authorities should assess if there are reasonable grounds to suspect a violation. In addition, whistle blowing activity should preserve the "presumption of innocence and right of defence" (Art. 48). While the whistle blowing activity will contribute to the detection of violations, competent authorities should assess if there are reasonable grounds to suspect a violation, based on the presumption of innocence and right of defence when they pursue their investigations. As indicated above, whistle blowing activities affect the protection of personal data. In order to mitigate this effect and ensure that it is not disproportionate to the objectives pursued by this option, the implementation of whistle blowing schemes must comply with data protection rules laid down in Directive 95/46/EC and all criteria indicated by the data protection authorities.[55]

As regards **social impacts**, this option will have similar positive effects on the protection of employees as option 2.

(4) Detailed EU requirements for whistle blowing systems

This option would establish detailed requirements at EU level on the whistle blowing systems and procedures that Member States are required to establish. These requirements would include specific provisions on reporting mechanisms (for example telephone numbers or email boxes) and published guidance to be provided by competent authorities (for example a web page outlining the protection available to whistle blowers), and rules

[54] See above footnote 49

[55] Article 29 working party Opinion 1/2006 on the application of EU data protection rules to internal whistle blowing schemes in the fields of accounting, internal controls, auditing matters, fight against bribery, banking and financial crime, available at: http://ec.europa.eu/justice/policies/privacy/docs/wpdocs/2006/wp117_en.pdf

on the competent authorities' procedures for handling the information including confidentiality requirements.

This option would ensure that persons envisaging to blow the whistle could be sure to receive the same support and protection in all EU Member States. Procedures would be harmonised across the EU, and in cases relevant to authorities from several Member States involved for example in the supervision of a cross-border banking group, whistle blowers could be sure that the procedures to be followed would be the same for all Member States concerned. However, in the absence of a convergence in procedural rules for the imposition of sanctions between Member States this would require major modifications of these rules in most **Member States**. Moreover, such detailed rules may require adjustments depending on whether sanctioning powers are held exclusively by supervisory authorities or are shared between supervisory authorities and courts. In the latter case this may require a modification of judicial procedures.

In relation to **fundamental rights**, any whistle blowing programme should preserve particularly the "presumption of innocence and right of defence" (Art.48). While whistle blowing programmes will contribute to the detection of violations and the gathering of evidence, this should not affect the standard of proof to be applied by the competent authorities when imposing a sanction. Competent authorities will have to prove to the requisite standards under national law whether a violation has been committed or not, based on the presumption of innocence and right of defence when they pursue their investigations. As stated in Options 2 and 3, this option may affect the protection of personal data. In order to mitigate this effect and ensure that it is not disproportionate to the objectives pursued, the EU rules on whistle blowing schemes would include detailed safeguards for the compliance with data protection rules laid down in Directive 95/46/EC and all the criteria indicated by the data protection authorities. Incentives for whistle blowers should be proportionate and only be granted in case where the investigation has lead to the effective detection of a violation and to a sanction and should not interfere with the fundamental right of presumption of innocence.

As regards **social impacts**, this option will have similar positive effects on the protection of employees as option 2.

Comparison of options

Options 2, 3 and 4 are all effective in pursuing the objective achieved, a higher detection of violations of the CRD leading to a higher level of enforcement and ultimately to a more effective, dissuasive and proportionate sanctioning regime in all Member States. Option 4 is considered slightly more effective in this regard as it will ensure procedural convergence between the systems put in place in Member States.

All three options have impacts on fundamental rights, in particular the respect for private and family life (Art. 7), protection of personal data (Art. 8) and presumption of innocence and right of defence (Art 48). However, those impacts can be mitigated by requiring the processing of personal data in compliance with Directive 95/46/EC and adequate procedures for the protection of confidential information, and clarification that competent

authorities should assess if there are reasonable grounds to suspect a violation. In view of this mitigation, and given the importance of the objectives to ensure sanctioning regimes for violations of the CD are effective, dissuasive and proportionate, this impact is necessary and proportionate.

Options 2 and 3 are equally efficient in terms of impact on Member States and credit insitutions: they would both require changes in national legislation and procedures to be put in place by Member States and credit institutions, and would involve compliance costs to set up and manage the whistle blowing systems. This would concern Member States where no whistle blowing mechanisms are currently in place (i.e. a large majority of member States).

Option 4 is considered to be inefficient as it would require more radical changes in national legislation, probably also in Member States which already provide for whistleblowing mechanisms, in order to comply with the EU requirements. Moreover, EU detailed rules may require adjustments depending on whether sanctioning powers are exercised exclusively by supervisory authorities or are shared between supervisory authorities and courts. In the latter case this may require a modification of judicial procedures. Compliance costs could also be higher than those required by Options 2 and 3 as Member States will have less flexibility on how to implement the whistleblowing mechanisms. Those impacts are not justified by the slightly higher effectiveness of this option in improving dissuasiveness of sanctions.

Based on the analysis of the impacts above, Options 2 and 3 have been selected.

	Effectiveness in achieving the specific objectives below through the relevant operational objective			Efficiency in achieving all objectives
	Improve effectiveness, dissuasiveness and proportionality of sanctions	Develop level playing field	Improve trust between supervisors	
1. Do nothing	0	0	0	0
2. Internal whistleblowing procedure in credit institutions	+	+	+	+
3. Member States to set up systems for the protection of whistleblowers	+	+	+	+
4. Detailed EU requirements for whistle blowing programmes	++	+	+	-

5.3. Preferred policy options

In the light of the comparative analysis carried out in section 5.1, the following options have been selected in the two main areas of the legal framework and the actual application of sanctions.

Legal framework of sanctions

The most appropriate to approximate and reinforce the legal framework is a combination of the options analysed in the four sub-groups identified, which are considered to be mutually reinforcing:

Appropriate administrative sanctions:

- Minimum common rules on the type of administrative sanctions to be available to competent authorities
- Minimum common rules on maximum level of pecuniary administrative sanctions
- List of key factors to be taken into account when determining the administrative sanctions

Personal scope of administrative sanctions

- Obligation to provide for the application of administrative sanctions to both individuals and credit institutions

Publication of sanctions

- Publication of sanctions as a general rule.

Detection of violations

The most appropriate to approximate and reinforce the mechanisms facilitating detection of violations is a combination of the following mutually reinforcing options

- Internal whistleblowing procedure in credit institutions
- Require Member States to set up systems for the protection of whistleblowers

Choice of the instrument

Legislative action is necessary to implement the preferred policy options, which require changes in national legislation. Those policy options will be implemented by way of introducing provisions on sanctions in the CRD.

5.3.1. Cumulative impacts of the preferred options

The impacts of the preferred options will be further reinforced by the cumulative nature of the action taken, as convergence on all of those issues together will ensure national authorities have at their disposal a broad range of sanctioning powers that enable them to apply, in each specific case, the sanctions that are the most appropriate in terms of

effectiveness, proportionality, and dissuasiveness. On the other hand, taking policy action on only some of the issues considered (e.g. the publication of sanctions), but not on others (e.g. the type and level of sanctions) will not lead to such synergies and will substantially reduce the positive impact on the specific objectives of the initiative to achieve stronger deterrence. The publication of sanctions will have a clear deterrent effect on some potential violators such as institutions with a strong brand but the negative publicity linked to it may have only minimal impacts on other institutions competing exclusively on factors such as price, for whom on the contrary high fines may have a much stronger deterrent effect.

The cumulative action will therefore increase the positive effect on credit institutions, deposit-holders and investors, and on public authorities in charge of the application of sanctions, as well as on stakeholders, SMEs, and in relation to social impacts, third countries and EU competitiveness.

5.3.2. Impact on EU budget

The policy options selected do not have any implication for the budget of the European Union. Revision of sanctioning regimes would be primarily managed by national authorities.

6. MONITORING AND EVALUATION

The Commission is the guardian of the Treaty and therefore will verify timely and correct implementation of the provisions on sanctions introduced in the CRD. When necessary, the Commission will pursue infringement proceedings under the EU Treaty in case any Member State fails to respect its duties concerning the implementation and application of EU Law.

The evaluation of the consequences of the application of the legislative measure could take place three years after the entry into force of the legislative measure, in the context of a report to the Council and the Parliament.

The main indicators of the effectiveness of the measures introduced are:

- Number of violations detected and number of sanctions applied;

- Practice of the national competent authorities in the application of sanctions (e.g. sources of information used in the investigation, level of fines applied, criteria taken into account in calculation that level);

The main sources of information that could be used in the evaluation are as follows:

- Peer reviews carried out by the European Banking Authority, which has taken up its work on 1 January 2011 and has been conferred the explicit task to carry out peer reviews of competent authorities, including in the area of sanctioning.

- A report (which could be undertaken by the European Banking Authority) on the experience gained by supervisors in enforcing the legislation.
- If not already covered by the EBA peer reviews, information from national competent authorities on the modifications made following the entry into force of the directive and the number of cases they have investigated and sanctioned.

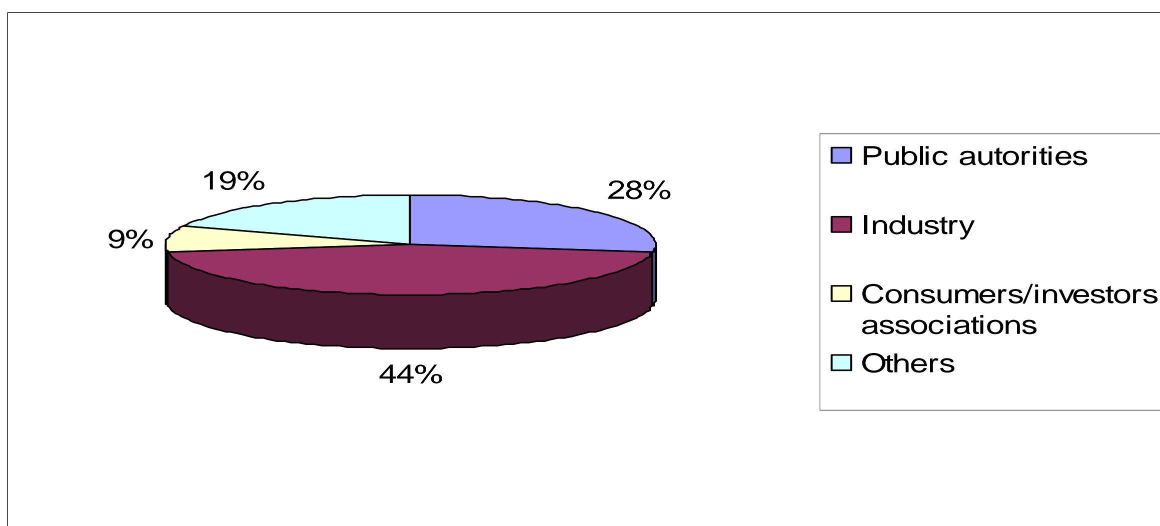
ANNEX **I**

Summary of responses to the public consultation on Commission Communication - Reinforcing sanctioning regimes in the financial sector

Introduction

On 8 December 2010, the European Commission published a consultation document on sanctioning regimes in the financial sector and invited the stakeholders to respond by 18 of February 2011. The Commission received 61 replies. This document summarises the contributions received.

The public consultation raised interest among a broad range of stakeholders. Responses were categorised in the following broad definitions shown in Figure 1.



Public authorities (governments, regulators and supervisors)

Financial industry (industry associations and individual financial institutions)

Consumers/investors associations

Others (individuals, academics, research bodies, law firms etc)

Among all the responses received, 28% were sent by the interest representatives registered within the EU Register of Interest Representatives.

Responses to the public consultation

General comments on envisaged legislative approach

A significant majority of respondents shared the Commission's analysis of the shortcomings in the existing national sanctioning regimes in the financial sector in terms of lack of sufficient deterrence and divergences in the application of sanctions across the EU. Different views were expressed on the solution to solve the existing shortcomings.

The majority of the respondents agreed that there should be a minimum harmonisation of national sanctioning regimes while the minority suggested considering alternative solutions. Some minority respondents (two public institutions, some industry representatives) considered that the Commission should provide for non-binding recommendations rather than for binding legislation. Other minority respondents (one public institution, an individual company) were of the view that the Commission should rather act against some individual Member States, which fail to enforce properly the financial services legislation, rather than harmonising the rules.

Comments on key issues for approximation

The majority of the respondents are to a varying degree supportive of a minimum harmonisation of national sanctioning comprising the following issues: appropriate types of sanctions (1), publication of sanctions (2), level of administrative fines (3); addressees of sanctions (4), appropriate criteria to be taken into account when applying sanctions (5), appropriateness to introduce at EU level some mechanisms facilitating enforcement such as whistle-blowing and leniency (6). Numerous comments were also submitted on the introduction of criminal sanctions for the most serious violations of the EU financial services legislation (7).

(1) Appropriate types of administrative sanctions

There is a consensual view among different stakeholders that, to have a level playing field in the EU, a common set of core administrative tools should be available to all national competent authorities to address key violations of the EU financial services legislation. Respondents underlined, however, that this set of tools should be non-exhaustive in the sense that the Member States should be left free to provide their authorities with additional powers. Respondents also stated that the EU initiative should be limited at this stage to a common set of administrative tools. Indeed, the competent national authorities should continue to benefit from a wide flexibility to use the most appropriate tool for each individual violation.

In the view of the majority of respondents, the common set should comprise both sanctions and measures taken by competent authorities to address a breach of EU financial services legislation. There is a broad agreement that the Commission should reflect on including at least the following tools: warnings; cease and desist orders; restriction/prohibition of certain activities; removal of individuals from management positions; revocation of authorisation/licence if the activity in question is subject to authorisation/licensing; imposition of monetary sanctions.

(2) Publication of sanctions

The publication of the sanctions triggered numerous comments. Respondents broadly agree that sanctions should be published but there were different views expressed on how to publish the sanctions. Some respondents, in particular the public authorities and consumer associations, considered that there should be a general rule requiring the publication of sanctions. This is because the publication of sanctions creates more

transparency in the decisional practice, reinforces deterrence of sanctions and helps customers of the companies concerned and investors to take informed decisions. Other respondents, in particular the industry representatives, believe that the publication should be decided on a case-by case basis in view of the high reputational damage this could create for an individual company.

As regards the exceptions to the publication, the public authorities considered that the exceptions to the publication should be limited to the situation when disclosure of the sanctions to the public at large would seriously jeopardise the financial markets. Some respondents from the industry considered that there should be a case-by-case assessment whether the publication of the sanction is liable to create disproportionate reputation damage for the company concerned, in which case the sanction should not be published. Others proposed to have a *de minimis* rule, that is not to publish the sanctions imposed on small companies or for small offences.

The respondents provided different answers on when a decision should be published. Some respondents, in particular consumer associations, favoured a maximum of transparency with a wide publication requirement. Other respondents considered that only final decisions of competent authorities punishing an identifiable breach of law should be published (excluding intermediate decisions such as the decision to launch investigation or simple warnings). A group of respondents considered that decisions can only be published when all legal remedies (appeals) available against a decision were exhausted.

(3) Level of administrative pecuniary sanctions

Respondents were in general favourable to harmonising certain aspects related to the level of administrative fines in order to have more deterrent and effective sanctioning regimes in the EU. Only a small minority expressed the view that legislative harmonisation is not warranted in this area.

The public consultation triggered a lot of discussions on which levels should be subject to harmonisation. To increase deterrence, few respondents advocated for a harmonisation of the minimum levels of the fines. However, most of the respondents rejected this idea mainly because of the difficulty to establish an appropriate minimum figure in the EU 27. There is however a broad agreement among the stakeholders that the EU law could provide for a sufficiently high maximum levels to be applied across the EU to allow competent authorities to apply deterrent sanctions even for the most serious violations. As regards the issue of how to calculate the levels of fines, some stakeholders expressed their preference for a calculation based on objective criteria such as a percentage of the turnover or based on profits derived from the violation.

(4) Addressees of the administrative sanctions

The results of the public consultation showed that there is a large consensus on the principle that the national competent authorities should be able to impose sanctions on both individuals and financial institutions. Only two public authorities from a Member

State and one industry representative considered that it is inappropriate to introduce at EU level the possibility for regulators to impose sanctions on individuals. The two opposing public authorities considered that regulators are not well equipped to scrutinise the subjective elements of an offence (intent, negligence) committed by individuals, which can be better assessed by courts in criminal cases. The industry representative considered that the issue on whom to impose sanctions should be left to the Member States to decide.

Respondents provided numerous comments on whom to impose a sanction in an individual case. Some respondents are of the view that sanctions should be imposed on individuals only in exceptional cases when they are individually obliged to fulfil some legal requirements (i.e. appropriate qualification required by law). Other respondents favoured a more extensive approach whereby an authority decides on case-by-case basis whether a sanction to be imposed on an individual is appropriate.

(5) Appropriate criteria for sanctions

There is a consensual view among different stakeholders that all the national competent authorities from the EU have to use a common set of appropriate criteria when applying sanctions. As for the types of sanctions, respondents underlined that this set of appropriate criteria should be non-exhaustive in the sense that the Member States may provide any additional criterion to be taken into account by their authorities. Respondents also stated that, at this stage, the EU initiative should not limit the freedom of the competent national authorities to weigh different criteria when determining a sanction in an individual case.

In the view of the majority of respondents, the common set of criteria should comprise at least the following: seriousness and duration of the violation; financial strength and size of the offender; benefits deriving from the violation when those can be established; impact on the market/losses incurred by third parties; repeated breach; cooperation by the offender during the investigation; survival of the company as a result of the sanction.

(6) Mechanisms facilitating administrative enforcement and cooperation among enforcers

The results of the public consultation show that there is a broad agreement among stakeholders that some mechanisms, such as the whistle-blowing and to a lesser degree leniency, could considerably facilitate the enforcement of the EU financial services legislation. The views are, however, divided on the necessity to foresee any harmonisation in this area at the EU level. Some stakeholders support the idea of some degree of harmonisation while others consider that any EU action at this stage is still premature in the light of the limited knowledge about the national practices.

Respondents expressed a bigger interest for whistle-blowing than for leniency. The respondents, who were in favour of harmonisation in the area of whistle-blowing, considered that the EU initiative should be limited to general principles. Some respondents, in particular some industry representatives and companies, considered that

the EU initiative could require the Member States to introduce only internal (intra-company) whistle-blowing. Other respondents, in particular the public authorities, were of the view that the EU initiative should cover also the external whistle-blowing (i.e. whistle-blowing directly to the competent authorities).

Some respondents also pointed out that any successful whistle-blowing procedure should provide for an adequate protection for whistle-blowers against the retaliation of the offender by preserving their anonymity and/or providing for immunity from any judicial action against *bona fide* whistle-blowers. As to the issue of financial incentives for whistle-blowers, some respondents, including a consumer association, expressed a negative opinion in view of the risk of abuse.

Fewer comments were received on leniency. A respondent (academic) indicated that leniency should be available only for infringements involving several individuals/companies, such as for instance the insider dealing rings. Some other respondents stated that leniency should only be available for undetected breaches since cooperation in the ongoing investigation is already taken into account to reduce sanctions. A law firm insisted on the right incentives to be provided for leniency applicants.

There is a large consensus that a good cooperation between enforcers is key to ensure a convergent decisional practice across the EU. Many respondents underlined the important role of the new European Supervisory Authorities (ESAs) in that respect.

(7) Criminal sanctions

The respondents are divided on requiring the Member States to introduce criminal sanctions for some violations of the EU financial services legislation. Although respondents generally agree that criminal sanctions could considerably increase deterrence, different views were expressed on whether the EU should act in this area.

Some respondents, including public authorities, a consumer association and to a lesser degree some industry representatives, are favourable for introducing the obligation for the Member States to foresee criminal sanctions under strict conditions. Thus in their view, criminal sanctions could be introduced for the most serious violations for which administrative sanctions are not sufficiently deterrent and under strict compliance with fundamental rights and with proportionality and subsidiarity principles.

Other respondents, in particular some public authorities and to larger degree the industry, are not favourable for requiring the Member States to criminalise certain violations of the EU financial services legislation. Some respondents, who shared the view that criminal sanctions could be more deterrent than administrative sanctions in some cases, considered that it should be left to the Member States to decide when and for which infringements to introduce criminal sanctions. Other respondents questioned the assumption that the criminal sanctions are more efficient than administrative sanctions. In their view, it is in general more difficult to handle criminal cases because of the higher procedural and evidence requirements in criminal proceedings and because of the reliance on criminal

courts, which are not always well prepared to assess complex financial issues. Other respondents with a negative view on criminal sanctions pointed at the risk of having divergences in the application of the EU law since it is not easy to foresee a cooperation mechanism among criminal courts within the EU.

ANNEX II

Nature and size of the market concerned

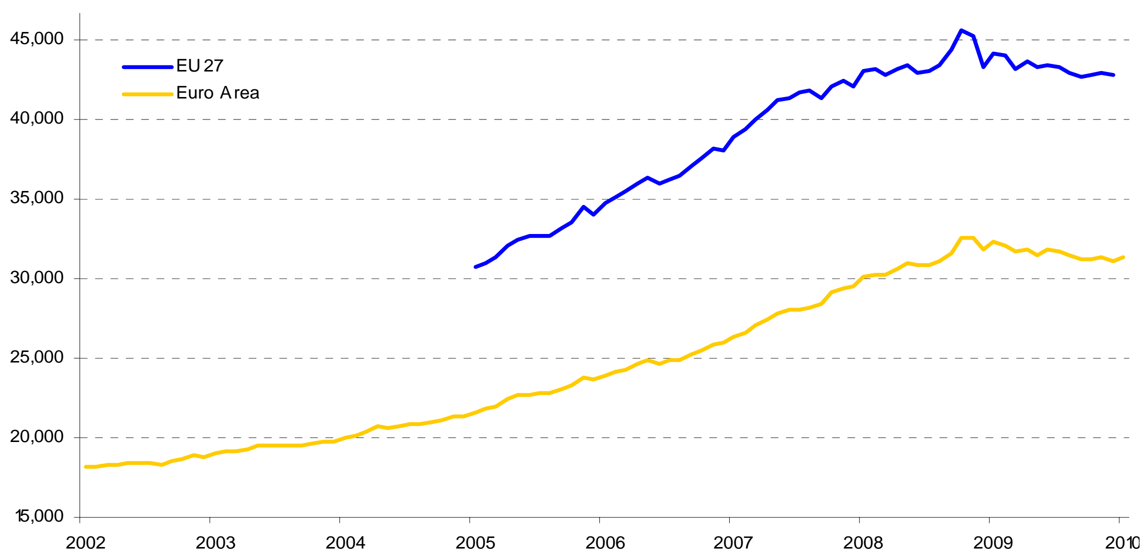
This annex aims at providing a general description of the banking sector in the EU, namely, its size, main characteristics and role in the financing of the real economy.

The size of the EU banking sector

The EU banking sector is a key sector in the EU economy. In relative terms, the EU banking sector is larger than its US counter part, which accounted respectively for 340% of GDP and 92% of GDP in 2009. Until the outbreak of the crisis, the EU banking sector grew steadily, in term of total assets, to reach a maximum of over €45,000 bn in late 2008. After this peak, it slightly declined and stagnated at around €43,000 bn.

Chart 01: Total assets of Euro Area MFIs

MFIs excluding the Eurosystem. € bn



Source: ECB: Aggregated balance sheet of EA MFIs and own calculations

Chart 01 illustrates the increasing size of the banking sector by plotting the evolution of the total assets of Euro Area Monetary and Financial Institutions (MFIs). Although MFIs include both money markets funds and credit institutions, the share of the former is relatively negligible (just over €1,000 bn, around 4% of MFIs).

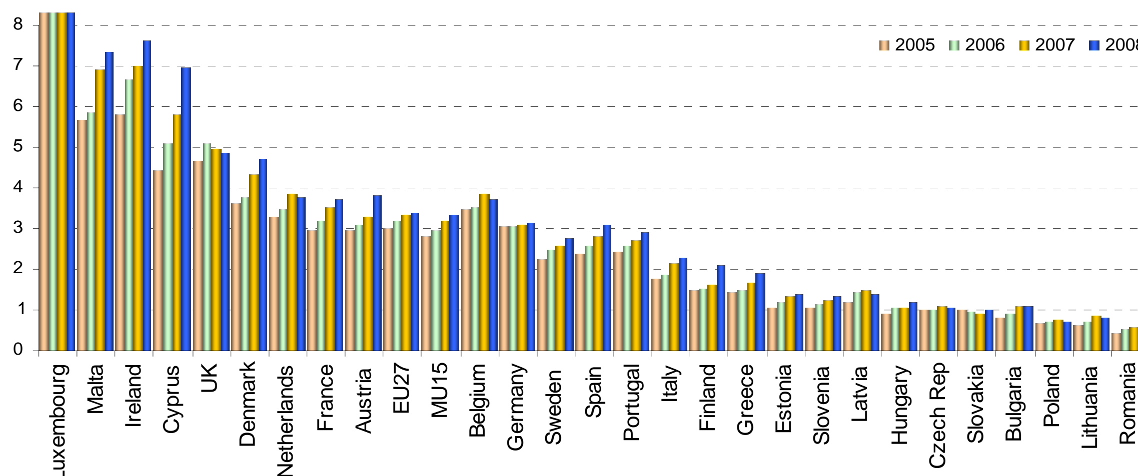
In 2008, the banking sector in EU27 was 3.4 times its GDP[56]. However, these aggregate figures hide very different realities across countries. The banking sector is, in general, much more developed in the old Member States than in the recently acceded ones. LU,

[56] It should however be kept in mind that GDP is an annual flow while the size of the banking sector in terms of total assets is a stock.

MT, IE, CY, UK and DK have a very important banking sector with a size over 4 times their GDP. On the other hand, RO, LT, PL, BG, SK, CZ are characterized by a banking sector smaller than their GDP (See Chart 02).

Over the recent years (2005-2008), the banking sector grew steadily in most countries, although the growth has been particularly important in MT, IE, CY and DK.

Chart 02: Total assets of credit institutions with respect to GDP



Note: Values for **Luxembourg** ranked from 26.2 in 2005 to 25.4 in 2008.

Source: European Central Bank and own calculations.

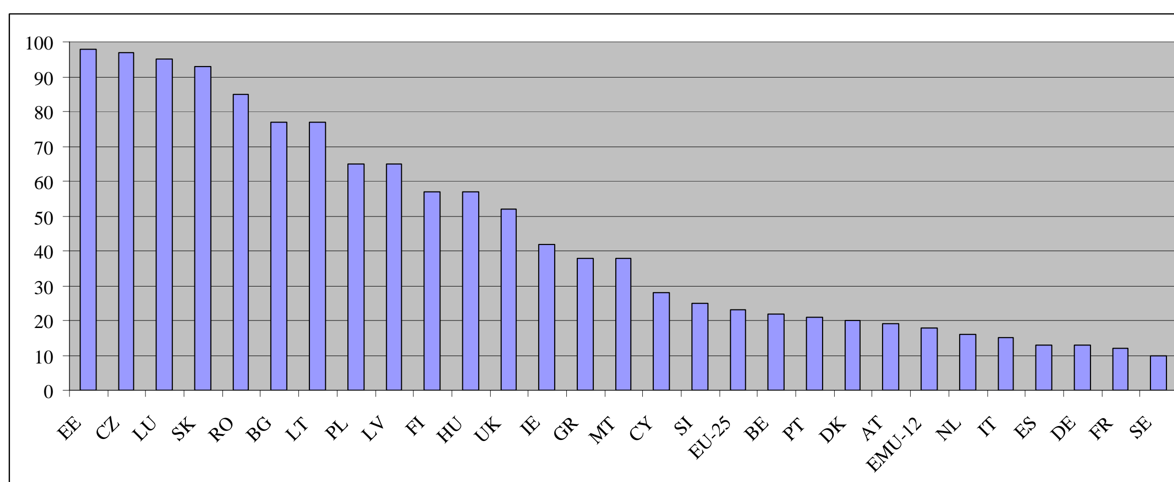
The EU banking sector is the main financing source for the real economy. It is also a major contributor to the added value of our economies and an important employer. As an illustration, the EA financial sector generates an added value of over €400 bn (equivalent to 5% of the GDP). In 2007, people working in the financial sector represents around 3% of the EA workforce.

European integration of banking markets

The European financial market is becoming more and more integrated, particularly in the wholesale financial sector, and there are a growing number of large financial groups and infrastructures operating on a pan-European basis. Although the financial crisis led to increased market segmentation, the level of financial integration remains high.

The banking market is dominated by pan-European groups active in several Member States, whose risk management functions are centralised in the group's headquarters. Currently around 70% of EU banking assets is in the hands of some 40 banking groups with substantial cross-border activities. Especially in the EU-12, banking markets are dominated by foreign (mostly Western European) financial groups (see Chart 2). In these countries, on average 65% of banking assets are in foreign-owned banks. In countries like Estonia, the Czech Republic and Slovakia over 92% of banking assets are in foreign-owned banks.

Chart 3 - Market share of foreign-owned banks (% of total assets)



Source: European Commission, European Financial Integration Report 2008 (2009)

The crucial role of bank intermediation for the real economy: intermediation vs. direct financing

In general, financial system impacts allocative efficiency in the real economy through its intermediary role, producing information about possible investments, mobilizing savings, monitoring investments, managing and diversifying risk as well as easing the exchange of goods and services. Empirical evidence would indicate that restricting bank activities has generally negative repercussions for economic growth although there may be a trade-off in terms of stability. Similarly, facilitating bank entry generally yields benefits in terms of competition and access to finance and so enhances economic growth. Although effects of competition on financial stability have been subject of controversy, most recent evidence suggests that increased competition via contestable markets is positive for stability.

In the EU, the banking sector is the main financing source for the real economy. In the Euro Area, almost 50% of the financing of the real economy is performed via banking loans[57].

In 2009, the outstanding amount of loans granted by Euro Area MFIs was €17,700 bn, while outstanding amount of securities issued in official markets were €15,300 bn for bonds and €4,400 bn for shares and equity. When the interbank loans and the securities issued by banks are not considered the figures were €11,750 bn for loans, €10,000 bn for bonds and €3,800 bn for shares and equity.

It should be underlined that the role of the banks as providers of financing to the economy goes beyond their "direct" intermediation activity. Beyond the lending activities, MFIs are very active in both the equity and bond markets. Indeed, in 2009, EA MFIs held over €5,000 bn bonds and €1,200 bn shares, corresponding to approximately one third of the respective markets. Therefore, taking into consideration the lending activity through loans and the financing through securities, the banking sector is responsible for about two thirds of the financing available in the Euro Area (see Chart 4).

Chart 4: *Sources of financing in the Euro Area*

Total, € bn *Excluding MFIs, € bn*

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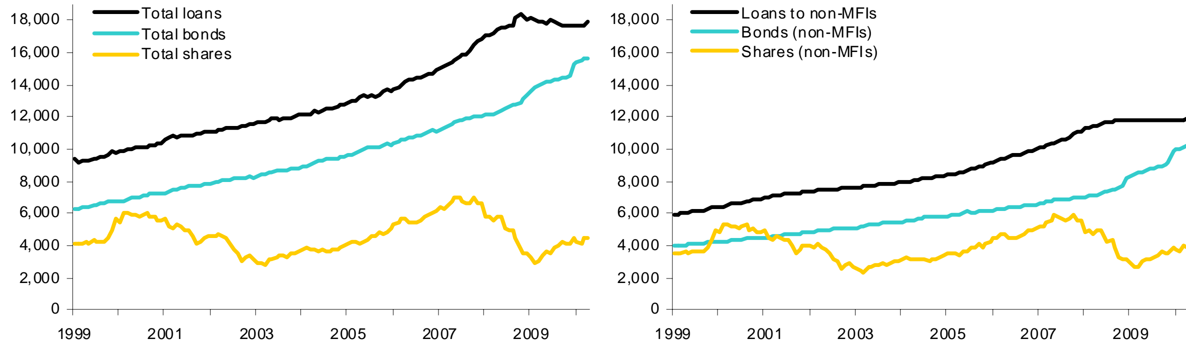
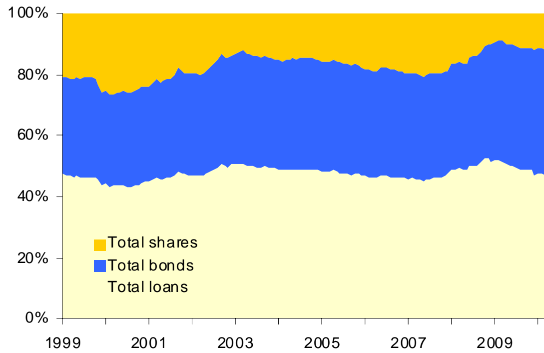
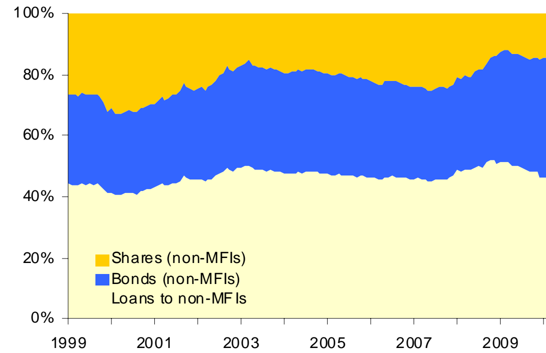
[57] Equity, bonds and loans not issued in official market or through the banking system are neglected



Total, %



Excluding MFIs, %



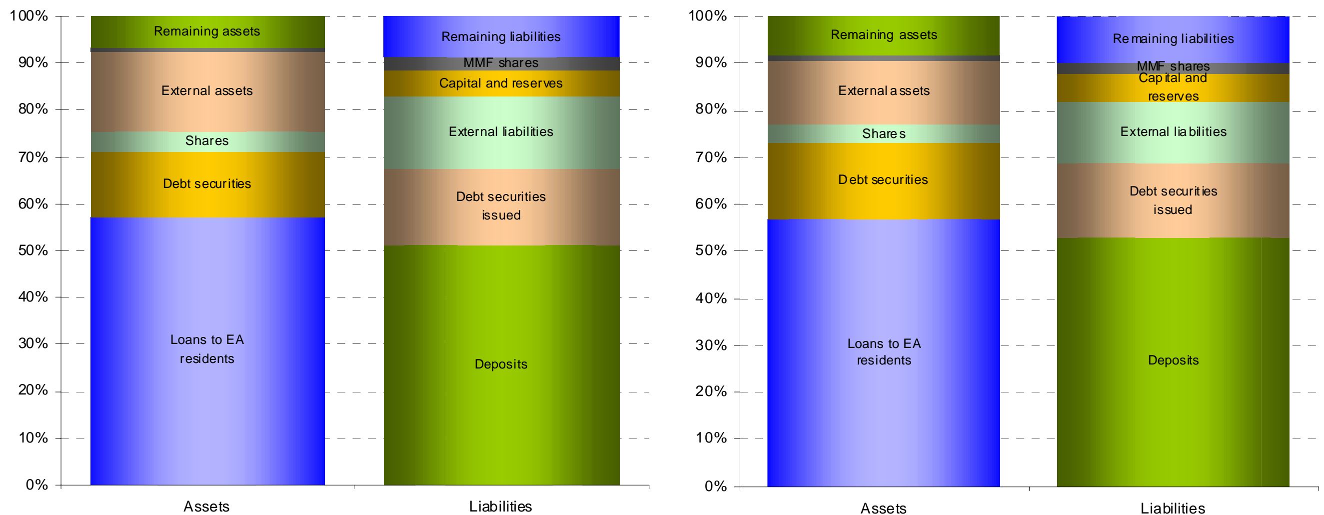
Note: Data for bonds and shares issued outside official markets are not available.

Source: European Central Bank and own calculations.

Chart 5: Aggregate balance sheet of Euro Area MFIs

MFIs excluding the Eurosystem

2006 *2009*



Source: European Central Bank and own calculations.

The importance of financial regulation for financial stability and sustainable growth

While the banking sector generally contributes to economic and financial development, the financial crisis has painfully revealed its weaknesses and the risks it bears for the entire economy. This section briefly reviews the theory and empirical evidences regarding the role of regulation (for example minimum capital requirement), the capacity to lend and the economic activity.

A growing body of empirical research on the links between financial development and economic growth produces a remarkably consistent narrative: The services provided by the financial system exert a first-order impact on long-run economic growth.[58]

First, countries with better-developed financial systems tend to grow faster. Specifically, countries with (i) large, privately-owned banks that funnel credit to private enterprises and (ii) liquid stock exchanges tend to grow faster than countries with corresponding lower levels of financial development. The level of banking development and stock market liquidity each exerts an independent, positive influence on economic growth. Second, simultaneity bias (whether economic growth leads to financial development or vice versa) does not seem to be present, suggesting that it is indeed financial development that contributes to economic growth. Third, better-functioning financial systems ease the external financing constraints that impede firm and industrial expansion. Thus, one channel through which financial development matters for growth is by easing the ability of financially constrained firms to access external capital and expand.

Building on this last point, some studies suggest this is due to a "broad credit channel" (Oliner and Rudebusch, 1996), where the supply of funds comes from all financial intermediaries and markets, not just banks. This view is supported by Discroll (2004) who finds that for U.S. states, bank loans themselves have small, often negative and statistically insignificant effects on output. This could be due to the fact that firms are not in fact bank-dependent, and are able to substitute other forms of finance, such as bond or equity financing for firms with ready access to such markets, trade credit or other kinds of borrowing from other firms in the case of firms which do not have such access.

The existence of a credit channel operating through the banking system cannot be denied however. Kroszner, Laeven and Klingebiel (2007) analyse the effects of financial crisis on externally dependent sectors in both, well- and poorly-developed financial systems. They show that in times of crisis, externally dependent sectors (comprised of young firms or firms with a large fraction of hard-to-measure intangible assets) tend to experience a greater contraction of value added in well-developed, financial systems than in countries with shallower financial systems. Their reasoning is that a deeper financial system allows sectors dependent on external finance to obtain relatively more external funding in normal periods, so a crisis that significantly impairs the functioning of banks has a disproportionately negative effect on externally dependent firms in such systems. In contrast, since externally dependent firms tend to obtain relatively less external financing in shallower financial systems, a crisis in such countries has less of an effect on the growth of these sectors. Similarly, the authors find a disproportionately negative impact of banking crises on real growth in sales, real growth in earnings, and real stock returns for firms in externally dependent industries. While these results might suggest a dark side of financial development, the authors do not find evidence that on net the externally dependent firms fare worse in deep financial systems.

Overall, while the finding that **financial development has a positive impact on economic growth is generally accepted**, an important limitation of almost all studies on financial development and growth should be noted: There is a significant difficulty in designing empirical proxies for “financial development” (Levine and Demirgüç-Kunt, 2008).

[58] The following paragraph builds on work by Bagehot (1873), Gurley and Shaw (1955), Goldsmith (1969), and McKinnon (1973), recent research has employed different econometric methodologies and data sets in producing three core results (Levine and Demirgüç-Kunt, 2008)

There are two reasons for this difficulty: First, researchers do not have very good cross-country measures of the ability of financial systems to provide their services (to facilitate the screening of firms before they are financed, the monitoring of firms after they are financed, the managing of idiosyncratic project risk and liquidity risk, as well as the exchange of goods, services, and financial claims) to the economy. Second, international financial market integration makes the size of a domestic financial system an inadequate indicator of efficiency gains in terms of accessibility to credit and financial services, intermediation costs, or productivity of capital employed (Guiso et al. 2004).

Traditional approaches to bank regulation emphasize the **positive features of capital adequacy requirements** (Dewatripont and Tirole, 1994). Capital serves as a buffer against losses and hence failure. Furthermore, with limited liability, the proclivity of banks towards higher risk activities is curtailed with greater amounts of capital at risk. Capital adequacy requirements, especially with deposit insurance, play a crucial role in aligning the incentives of bank owners with depositors and other creditors (Berger et al., 1995).

As reviewed in Santos (2001) and Gorton and Winton (2003), however, theory provides conflicting predictions as to whether the imposition of capital requirements will have positive effects on stability and growth. For instance, Kim and Santomero (1988), Besanko and Kanatas (1996), and Blum (1999) argue that capital requirements **may increase risk-taking behaviour**. Furthermore, Thakor (1996) models the impact of an increase in risk-based capital requirements and concludes these reduce banks' willingness to screen and lend. In a general equilibrium context, Gorton and Winton (2000) show that raising capital requirements forces banks to supply fewer deposits, reducing the liquidity-providing role of banks.

Barrell et al. (2009) argue that **changing capital and liquidity ratios changes the probability of financial crises**. They show that it would have been beneficial in terms of output to have had a one or even two percentage point higher level of capital and liquidity requirements in the UK prior to the current crisis. These results do not hold for the Euro Area or the US as they argue that a crisis in the UK was more likely, suggesting that with higher probabilities for a crisis, higher capital requirements are beneficial for long-term economic output.[59]

As banking sector plays a central role in economy any changes in regulatory environment that have impact on banking sector should indirectly affect also economic activity. The existing literature suggests the following relationships between the regulation and economic growth:

- Effects of capital requirements and leverage ratios on sustainable financial development are ambiguous; yet it is suggested that combining these policies may yield positive results.
- Effects of deposit insurance in terms of financial stability are ambiguous as they can reduce the systemic risk associated with bank runs but may reduce incentives for risk management in covered institutions and incentives for private sector oversight.
- Strong supervisory power on banks is beneficial for building robust legal systems.
- Evidence on the effectiveness of private sector monitoring of banks is ambiguous.
- Bank governance is found to be relevant to financial stability in two important respects:
- Bank risk is generally higher in banks that have concentrated ownership with substantial cash flow rights.

[59] They also refer to the case of Spain where the robustness of the banks shows the value of higher capital

- The relation between risk and regulation depends critically on each bank's ownership structure, because it can determine whether the impact of regulation is either positive or negative with regard to stability.

- While private ownership of banks entails risks and needs careful design, government ownership of banks usually yields lower levels of financial development and growth, yet more concentrated lending and higher systemic fragility.

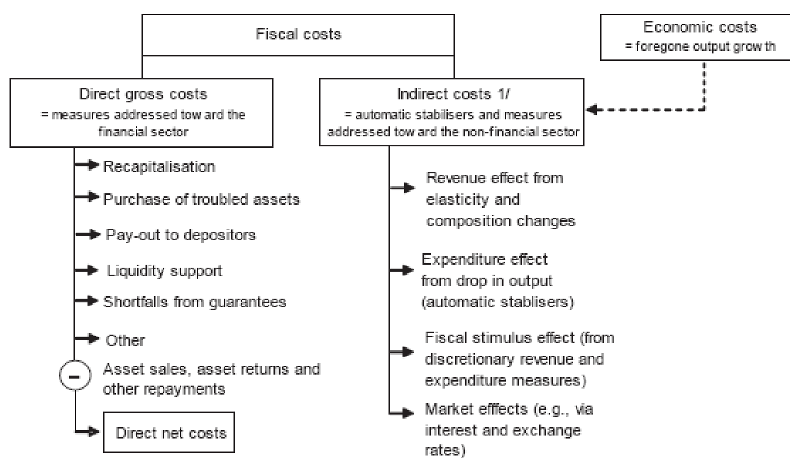
Available evidence from the cost of financial (banking) crisis

As illustrated in the previous section, financial and banking regulation is crucial to the stability of the sector and eventually the long-term economic growth. These findings are further underlined by the evidence on the cost of past (and current) financial and banking crisis and provide a good rationale for designing and implementing appropriate regulation.

Financial crises, defined as systemic banking crises[60], which can be aggravated by foreign exchange or sovereign debt crises, are particularly socially costly, not only for the rescue of ailing institutions but also in terms of opportunity costs and foregone growth. The traditional computations of the cost of such a crisis for a country are based on a calculation of its direct and indirect fiscal costs, as described in the graph below.

[60] Following the definition of Leaven and Valencia (2008) cited by the "Public Finances in EMU 2009" of the European Commission

Chart 6: *The costs of a financial crisis*



Source: European Commission, DG Economic and Financial Affairs (2009): "Public Finances in EMU 2009", European Economy 5, 10th edition

However, these fiscal costs do not include costs borne by depositors and borrowers, stemming from exposure to failed banks, or when facing higher costs for services provided by banks that compensate for losses.

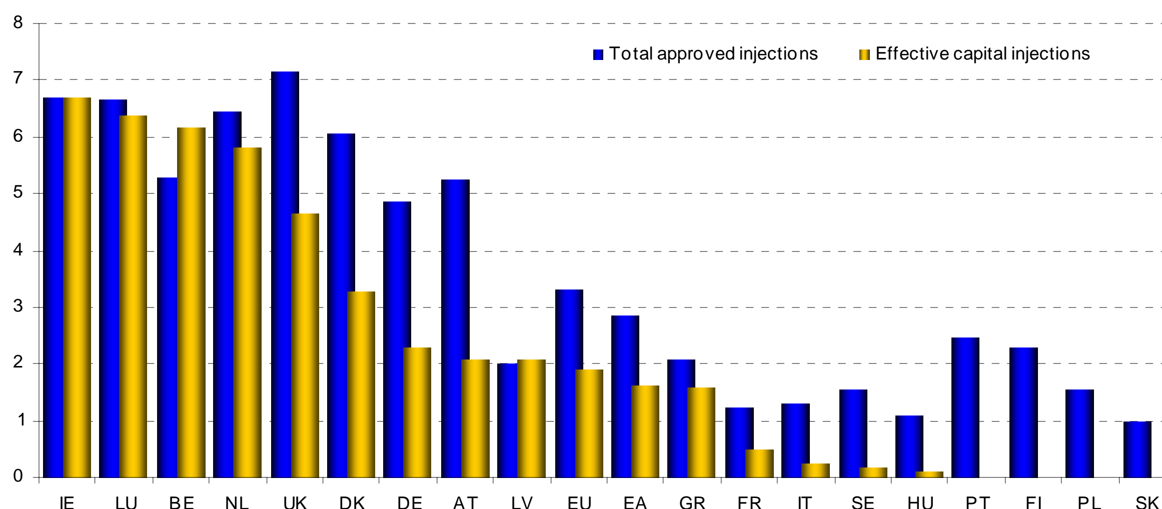
The debate also focuses on the best way to compute the economic costs of a banking crisis and the extent of what is referred to as the output gap caused by this crisis. The literature offers different means to conduct such calculations. On the one hand, it would be possible to approximate output losses as the difference between output growth before and a few years after the crisis – usually the time that it returns to its trend; on the other hand, to be more accurate, the difference could be computed in levels rather than in growth rates of GDP. Finally, econometric estimations of output gaps allow controlling for the bias that could come from "normal" cyclical output variations.

The European Commission analysed empirically in its publication, *Public Finances Report in the EMU 2009,* the costs of 49 crises that occurred in emerging and market economies since the 1970s. Consistent with the figures found by Leaven and Valencia (2008), the Commission reported an average direct net cost of 13%, i.e. expenses due only to the rehabilitation of the banking sector and already accounting for the recovery that the government can get from the sale or repayment of impaired assets that it had to buy – even though the average recovery rate did not exceed 18% of the initial gross outlays. Focusing only on the EU27, these figures show an average net fiscal cost of 6.6% of GDP, with a 23.9% recovery ratio, both under the OECD averages (respectively 11.4% of GDP and 29.7%).

All in all, the net fiscal costs of the last financial crisis should be rather greater than those of past crises, mainly because of its global nature, and given the recent expansion of the banking sector and low laid down recovery of impaired assets. In the EU, according to the Commission report, these net fiscal costs could reach 16.5% of GDP on average, with higher figures for some Member-States taken individually.

Indeed, as it appears in the graphs below, the extent of capital injections and of guarantees on bank liabilities, in terms of percentage of GDP, varied greatly from one European country to another, respectively from 1% to 7% and from 1% to almost 240%.

Chart 7: *Public interventions in the banking sector (% of GDP)* **-** *situation at 31/12/2009*



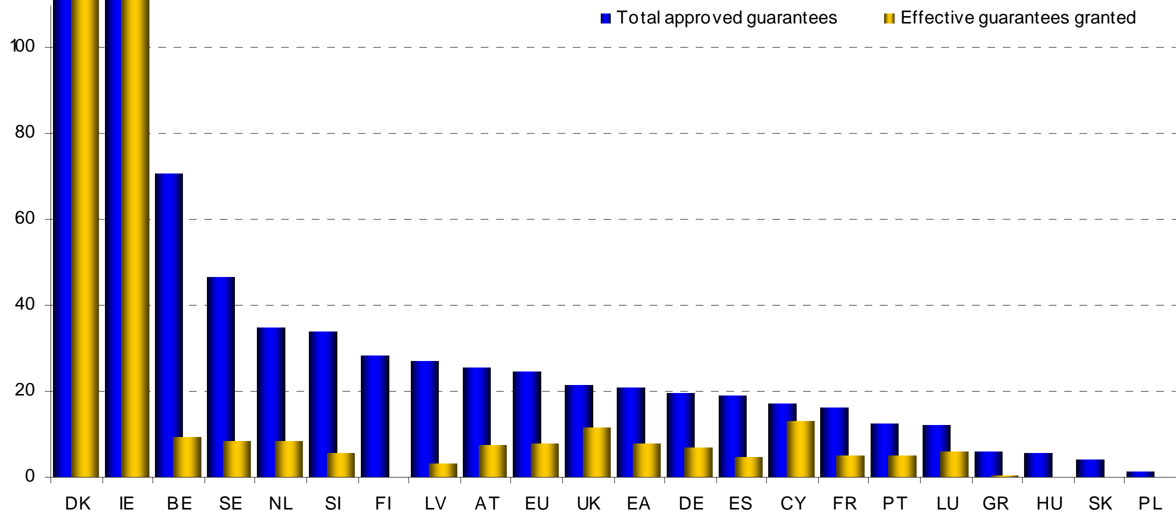
Source: Commission Services

Beyond the direct burden of the banking rescue measures, the indirect costs of past financial crises have also weighted significantly on social wealth. The gross public debt-to-GDP ratio has on average grown by 18% in the course of the years when past crises occurred, under the multiple pressures of automatic stabilizers and fiscal stimuli. In addition to this expenditure effect (+1.1% of GDP in EU27 on average), financial crises also trigger a loss through the revenue effect (on average -0.9% in the EU27), notably in

terms of foregone tax payments, as well as a potential strong market effect leading to higher premia on interest payments.

This consequence is particularly worrying because of its long-term implications. Indeed, in the sample analysed by the Commission, it took governments at least eight years to come back to pre-crisis levels of debt-to-GDP ratios, driven up both by the changes in the primary deficit and by the "snow-ball effect" of interest payments.

Chart 8: *Guarantees on bank liabilities (% of GDP)*



Notes: Denmark: 237.5% approved guarantees and 205.3% effective guarantees granted.
Ireland: 167.5% approved and effective guarantees granted.

Source: Commission services

ANNEX III

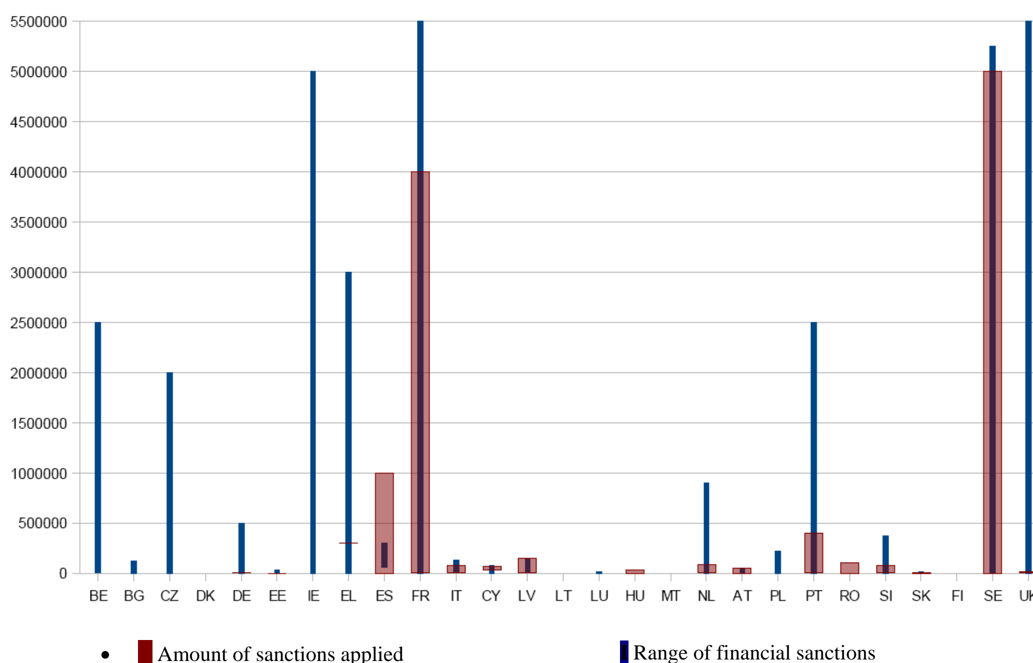
Sanctions applied in the banking sector

Range of (financial) administrative sanctions against legal persons

(Data included in the Impact Assessment on the Sanctions Communication)

Chart 1, compiled from input from Member States, gives an overview of the amount of administrative financial sanctions imposed in the banking sector (compared with the range of sanctions, that is the minimum and maximum levels provided for in the legislation).

Chart 1 – Range of (financial) administrative sanctions against legal persons, and sanctions applied from 2005 to 2007 (in Euros)



Comments: there is no maximum set amount in FR and ES, but the fines are linked to the minimum capital (FR) or equity capital (ES). Correction: SK applied 195 000 - Source: CEBS report, reply sheets from national authorities.

Sanctions applied in the banking sector in 2008-2010

Charts 2 and 3, compiled based on information from Member States, shows the number of sanctions imposed in 2009 in comparison to the value of banks' assets and to the number of credit institutions in these Member States

Chart 2 – Number of sanctions compared to banks' liabilities

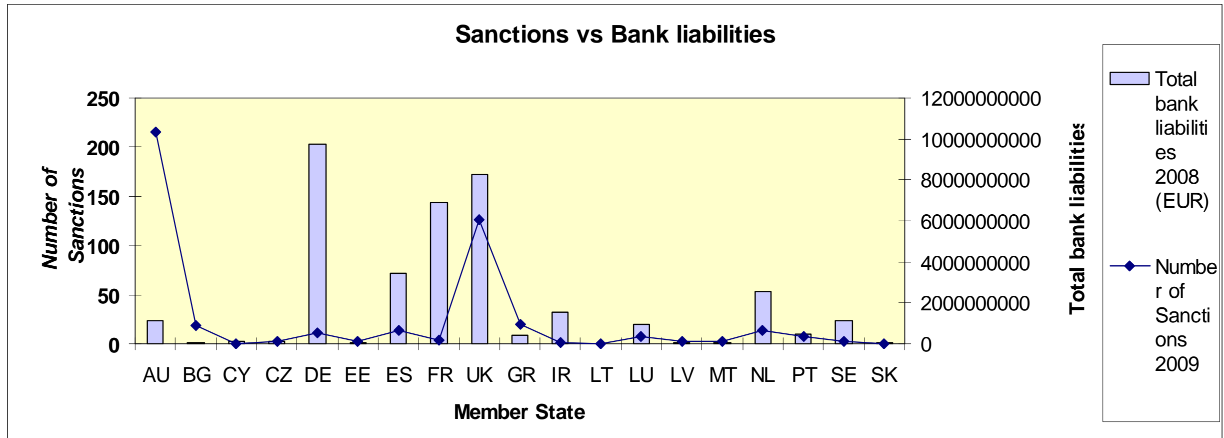
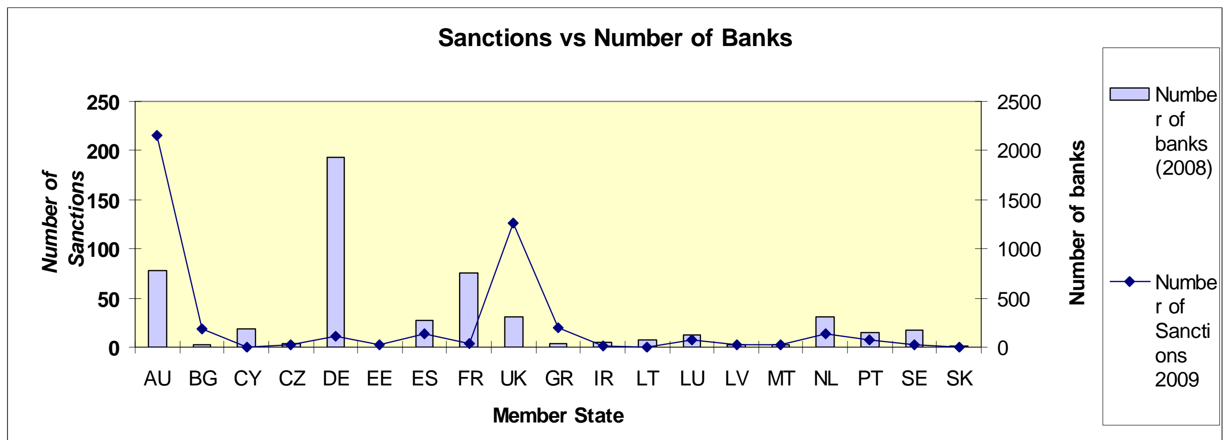


Chart 3 – Number of sanctions compared to number of banks



Source: CEBS report, page 55, ECB statistics

Among the Member States which make indications as to the types of violations sanctioned, the following violations occur most frequently during that period:

	Unauthorised provision of banking	Large exposures requirements	Capital requirements	Governance requirements	Reporting requirements	Acquisitions of qualifying holdings	Public disclosure requirements
Number of MS having imposed	3	5	5	10	4	4	2

sanctions for violations of these requirements							

ANNEX IV

I. Current Legislative framework

The CRD contains a general clause requiring Member States to provide that "competent authorities may, as against credit institutions or those who effectively control the business of credit institutions, which breach laws, regulations or administrative provisions concerning the supervision or the pursuit of their activities, adopt or impose penalties or measures aimed specifically ad ending the observed breaches or the causes of breaches" (Art. 54 Directive 2006/48/EC). This provision refers to administrative sanctions and it is without prejudice to the provisions of criminal law.

In addition, some specific rules are provided for on the use of the sanctioning powers available to competent authorities in certain cases. For instance, Article 17[61] of the Directive 2006/48/EC lists the cases where competent authorities may withdrawal the authorisation granted to a credit institution (e.g. when it no longer fulfils the conditions under which the authorisation was granted or has obtained the authorisation through false statements). A specific provision concerning the violation of obligations on acquisition of qualifying holdings requires competent authorities to take appropriate measures to put an end to the unlawful situation, and it specify that such measures may consist in injunctions, sanctions against directors and managers, or the suspension of the exercise of voting rights (Art. 21 Directive 2006/48/EC).

Finally, the CRD contains provisions on the coordination of the power to impose sanctions between Member States concerned by a violation (e.g. Art. 30 Directive 2006/48/EC), and on the cooperation between competent authorities (e.g. Art. 132 Directive 2006/48/EC). The power to impose sanctions is exercised principally by the competent authorities of the Member State in which the credit institution has been authorised ("home" Member State) acting in coordination with the authorities of the Member State where it has a branch or it provides services ("host" Member State).

Key violations of the CRD:

Violations relating to prior authorisation

– Unauthorised provision of banking services (Artt. 5-6 of Directive 2006/48/EC)

– Authorisation obtained through false statements/irregular means (Art. 17.1, b of Directive 2006/48/EC)

Violation of prudential requirements

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[61] This text refers to the numbers of the articles in the existing Directives 2006/48/EC and 2006/49/EC. As the proposal will recast these texts, the numbers will be subject to modification in the recasted legislative acts

- Failure to have in place sound and robust governance arrangements (Art 22 of Directive 2006/48/EC, see also Art. 109 of Directive 2006/48/EC and Art 34 of Directive 2006/49/EC)

- Failure to comply with "fit and proper" conditions of authorisation (11, 135 of Directive 2006/48/EC)

- Violation of own capital requirements (Art. 10, 75, 76 of Directive 2006/48/EC; Art 5-9; 18 of Directive 2006/49/EC)

- Violations of obligations on acquisition of qualifying holdings (Art 19-21 of Directive 2006/48/EC, as amended by Directive 2007/44/EC)

- Failure to comply with limits on large exposure (Art 111 of Directive 2006/48/EC; Art 28 of Directive 2006/49/EC)

- Failure to meet requirements as to exposures to transferred credit risk (Art 122a of Directive 2006/48/EC

Violation of reporting obligations

- Violation of reporting obligations on the persons responsible for the legal control of accounts (Art.53 of Directive 2006/48/EC)

- Failure to report information to the competent authorities (Art.74(2), 110 of Directive 2006/48/EC; Art 35 of Directive 2006/49/EC; newly introduced reporting requirements on liquidity and leverage)

- Failure of public disclosure (Art 145-149 of Directive 2006/48/EC; Art 39 of Directive 2006/49/EC)

- Failure to comply with limits on qualifying holding outside the financial sector (Art 120)

II. Sanctioning powers provided for by Member States in the transposition of the CRD in relation to three types of violations

In certain Member States different provisions on sanctions are applicable to different categories of violations. However, in several of them the same provisions apply to all the above-mentioned violations (e.g. FR, UK).

Charts 1 and 2, based on the information collected by the Commission in 2011, show the differences in the types of administrative sanctions and the level of administrative fines provided for by national legislation in case of violations relating to prior authorisation (Unauthorised provision of banking services, Art. 5-6 of Directive 2006/48/EC):

Chart 1: types of sanctions applicable for violations relating to prior authorisation

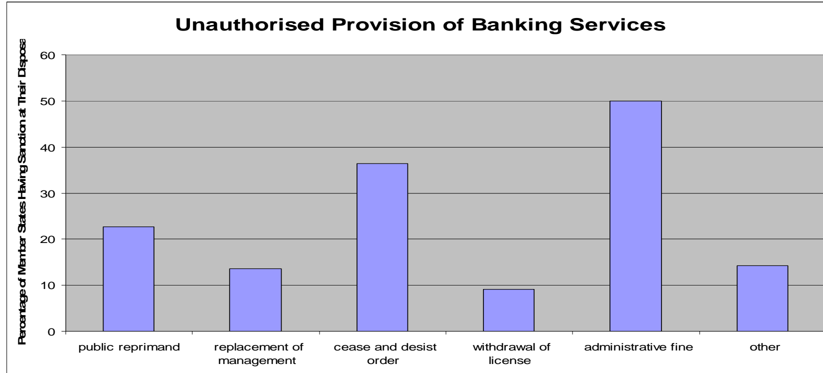
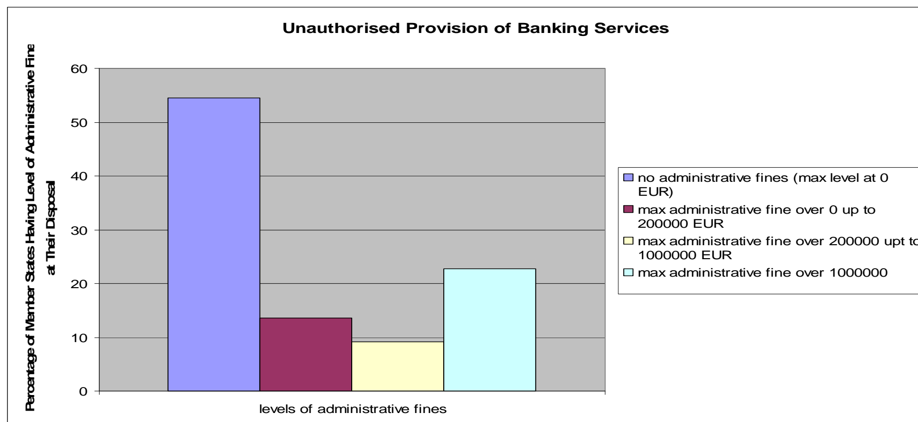


Chart 2: administrative fines applicable for violations relating to prior authorisation



Charts 3 and 4 based on the information collected by the Commission in 2011, show the differences in the types of administrative sanctions and the level of administrative fines provided for by national legislation in case of violations of prudential requirements (Failure to have in place sound and robust governance arrangements, Art 22 of Directive 2006/48/EC, see also Art. 109 of Directive 2006/48/EC and Art 34 of Directive 2006/49/EC):

Chart 3: types of sanctions applicable for violations of prudential requirements relating to governance

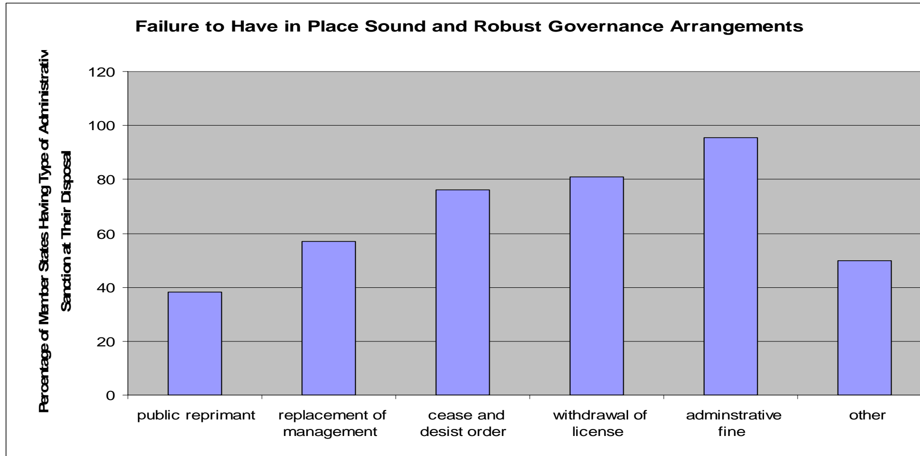
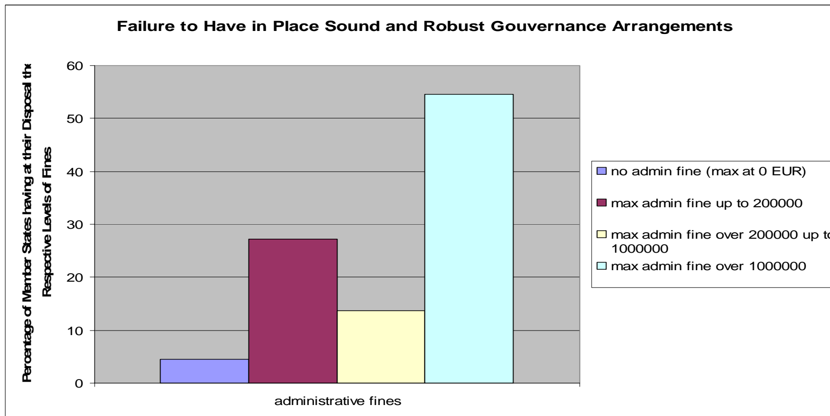


Chart 4: administrative fines applicable for violations of prudential requirements relating to governance



Charts 5 and 6, based on the information collected by the Commission in 2011, show the differences in the types of administrative sanctions and the level of administrative fines provided for by national legislation in case of violations of reporting requirements (Art.74(2), 110 of Directive 2006/48/EC; Art 35 of Directive 2006/49/EC):

Chart 5: types of sanctions applicable for violations of reporting requirements.

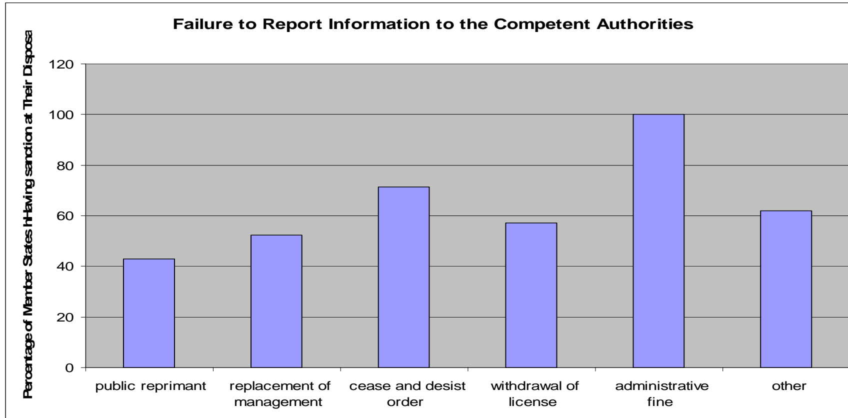


Chart 6: administrative fines applicable for violations of reporting requirements

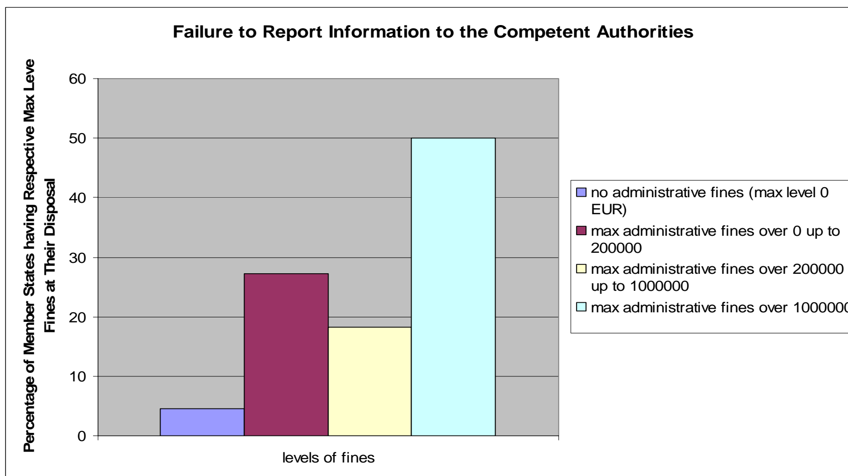


Table 1, based on the CEBS report and responses received by Member States, shows the divergences in the criteria taken into account in different Member States to calculate the administrative fine, to be imposed in a specific case.

Table 1: criteria taken into account when calculating fines in the banking sector (i*n SK all factors taken into account in practice although not explicitly provided for by law).*

	Gravity of the infringement	Cooperation with the authorities	Financial strength of the firm or responsible person concerned (e.g. own funds)	Loss inflicted by the infringement	Benefit / Profit derived from infringement	Amount imposed in previous cases
Number of Member States taking account of each criterion	All	BE, CZ, DE, AT, ES, EE, FI, HU, EI, LT, LU, LV, MT, NL, PL, PT, SE, SI, UK, IE	BE, BG, ES, EL, HU, IE, IT, NL, PL, RO, SE, CY, UK, PT, CZ, SI	AT, BG, CY, CZ, DE, EE, ES, EL, HU, IE, MT, NL, PL, PT, SE, SI, SK, UK, LU, SL, LU	AT, BE, BG, CY, CZ, DE, EE, ES, EL, IE, LU, NL, PT, SI, SK, UK, HU	AT, BE, BG, CY, CZ, DE, EE, FI, EL, HU, IE, IT, LT, LU, LV, NL, PL, PT, RO, SE, SI, UK, MT, DK,

ANNEX V

Detailed analysis of the impacts of the policy options concerning appropriate administrative sanctions

(1) No EU action

(2) Uniform rules on types and level of administrative sanctions

This option would imply that administrative sanctions are fully harmonised and that the violation of any of the key provisions of the CRD would be subject to the same type and level of sanction across all Member States.

Analysis of impacts in relation to sanctions for unauthorised provision of banking services

Uniform types and levels of sanctions for unauthorised provision of banking services would in particular increase consumer confidence in the internal market for banking services, as consumers could be sure that a bank offering banking services to them from any Member State without being authorised and supervised would be subject to the same effective and deterrent sanctions.

The availability of high fines for unauthorised provision of banking services will make such misconduct - which due to the circumvention of any prudential supervision poses considerable risks to customers' deposits- less attractive even where high benefits can be expected.

Requirements for authorisation limit the freedom to conduct a business as provided for in the Charter of Fundamental Rights (Art.16), and uniform types and levels of sanctions for violations of these requirements reinforce this limitation. However, ensuring prudential supervision is exercised over all banks is necessary to mitigate the risks banking activities can pose for deposit-holders, and in view of the importance of these risks for the means of consumers (including provision for their retirement) and businesses, also proportionate.

(a) Analysis of impacts in relation to sanctions for violations of prudential requirements

Empowering competent authorities in all Member States to be able to impose uniform types and levels of sanctions for violations of prudential requirements would contribute to ensure credit institutions in all Member States effectively meet banking capital requirements.

The power to issue public warnings/reprimands in case of violations of prudential requirements relating to governance is appropriate to encourage public pressure by deposit holders and investors on the credit institution to adjust its governance arrangements, and will thereby reduce the likelihood that credit institutions do not have in

place appropriate risk management to anticipate situations of financial stress which can lead to an increase risk of failure.

The possibility to impose high fines for violations of prudential requirements relating to governance will reduce the likelihood that credit institutions do not have in place appropriate risk management to anticipate situations of financial stress which can lead to an increase risk of failure.

The possibility to impose high fines for violations of prudential requirements is important to ensure that sanctions for violations of banking capital requirements are sufficiently high to exceed the economic benefits from such violations for the banks concerned which can be very important.

As prudential requirements contribute heavily to credit institutions' operating costs, this option would assist the development of a level playing field in the European banking market. It could also increase consumer confidence that credit institutions are stable, and improve mutual trust between supervisors, leading to more efficient cross-border supervision.

Prudential requirements limit the freedom to conduct a business as provided for in the Charter of Fundamental Rights (Art 16), and uniform types and levels of sanctions for violations of these requirements reinforce this limitation. However, as underlined by the events of the financial crisis in 2007/2008,[62] ensuring that banks make the necessary financial provisions for situations of stress is essential to mitigate the risk of a bank failure, leading to losses of deposits wiping out all or most of the financial means of consumers (including provision for their retirement) and businesses, but also avoid that taxpayers money has to be used to restore the bank's financial health. While preventative supervisory action is a key tool to ensure violations of prudential rules are not continued after their detection, appropriate types and levels of sanctions are necessary to ensure that credit institutions incur actual and important cost for past violations, making commitment of such violations less attractive.

(b) Analysis of impacts in relation to sanctions for violations of reporting requirements

Empowering competent authorities in all Member States to be able to impose uniform types and levels of sanctions for violations of reporting requirements would contribute to ensure credit institutions in all Member States fully inform competent authorities about their financial situation which enables the authorities to require appropriate levels of prudential provisioning. The power to dismiss the managers or the persons responsible for the legal control of accounts can effectively prevent repeated violations of reporting requirements which will in turn reduce the likelihood that credit institutions avoid to hold the necessary capital by not reporting disadvantageous financial information to supervisors, leading to an increased risk of failure.

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62 See analysis and recommendations of the De Larosière Report, reference see above.

As prudential requirements, which credit institutions can avoid by failing to report information to the authorities, contribute heavily to credit institutions' operating costs, this option would assist the development of a level playing field in the European banking market. It could also increase consumer confidence that credit institutions are stable, and improve mutual trust between supervisors, leading to more efficient cross-border supervision.

Reporting requirements limit the freedom to conduct a business as provided for in the Charter of Fundamental Rights (Art 16), and uniform types and levels of sanctions for violations of these requirements reinforce this limitation. However, as underlined by the events of the financial crisis in 2007/2008,[63] full information of the authorities about credit institutions' financial situation is key to ensure that supervisors can require the necessary financial provisions for situations of stress, and is a precondition for competent authorities to be able to apply any preventative supervisory powers. As violations of reporting requirements can be addressed by preventative supervisory powers only to a limited extent, appropriate types and levels of sanctions are necessary to ensure respect of these rules, and proportionate in view of the importance of these risks.

(2) Minimum common rules on the type of administrative sanctions to be available to competent authorities

This option would contribute to the objective of improving the deterrent effect of administrative sanctions by ensuring that all competent authorities have at their disposal certain sanctioning powers which can be particularly effective for the different violations of the CRD. For instance, the power to dismiss the managers or the persons responsible for the legal control of accounts can effectively prevent repeated violations of reporting obligations.

Analysis of impacts in relation to sanctions for unauthorised provision of banking services

Ensuring that certain key types of administrative sanctions are available in case of unauthorised provision of banking services, even though not providing for a full harmonisation, would increase consumer confidence in the internal market for banking services, as consumers could be sure that a bank offering banking services to them from any Member State without being authorised and supervised would be subject to a core set of effective and deterrent types of sanctions, including administrative fines, and public warning/reprimand.

Limitations of the freedom to conduct a business as provided for in the Charter of Fundamental Rights (Art. 16) are similar in nature than under option (1), but would be less accentuated given that only a limited list of core sanctioning powers would be made available across the EU, while further sanctioning powers would be decided on by

[63] See analysis and recommendations of the De Larosière Report, reference see above.

Member States and would be available only in the Member States where this is the case already today.

(a) Analysis of impacts in relation to sanctions for violations of prudential requirements

Empowering competent authorities in all Member States to be able to impose certain core types of sanctions for violations of prudential requirements, while not achieving full harmonisation, would contribute to ensure competent authorities in all Member States have at least certain key powers to ensure credit institutions effectively meet banking capital requirements.

This option would contribute to the development of a level playing field in the European banking market, of consumer confidence that credit institutions are stable, and of improved mutual trust between supervisors, leading to more efficient cross-border supervision.

Limitations of the freedom to conduct a business as provided for in the Charter of Fundamental Rights (Art. 16) would be similar in nature than under option (1), but would be less accentuated given that only a limited list of core sanctioning powers would be made available across the EU, while further sanctioning powers would be decided on by Member States and would be available only in the Member States where this is the case already today.

(b) Analysis of impacts in relation to sanctions for violations of reporting requirements

Empowering competent authorities in all Member States to be able to impose certain core types of sanctions for violations of reporting requirements, while not achieving full harmonisation, would contribute to ensure competent authorities in all Member States have at least certain key powers to ensure that credit institutions fully inform competent authorities about their financial situation which enables the authorities to require appropriate levels of prudential provisioning.

This option, while not achieving full harmonisation, would still ensure that key types of sanctions can be imposed for violations of reporting requirements. As prudential requirements, which credit institutions can avoid by failing to report information to the authorities, contribute heavily to credit institutions' operating costs, this option would assist the development of a level playing field in the European banking market. It could also increase consumer confidence that credit institutions are stable, and improve mutual trust between supervisors, leading to more efficient cross-border supervision.

Limitations of the freedom to conduct a business as provided for in the Charter of Fundamental Rights would be similar in nature than under option (1), but would be less accentuated given that only a limited list of core sanctioning powers would be made available across the EU, while further sanctioning powers would be decided on by

Member States and would be available only in the Member States where this is the case already today.

(2) Minimum common rules on minimum and maximum levels of pecuniary administrative sanctions

This option would significantly contribute to the objective of improving the deterrent effect of the administrative fines, as it would ensure that fines applied are sufficiently high, and improve convergence of national regimes, as the levels of administrative sanctions would be based on common rules. Those rules would be based on objective factors including the benefit that can be derived from a violation and the turnover of the perpetrator.

Analysis of impacts in relation to sanctions for unauthorised provision of banking services

This option would ensure the availability in all Member States of high fines for unauthorised provision of banking services. This would make such misconduct - which due to the circumvention of any prudential supervision poses considerable risks to customers' deposits - less attractive even where high benefits can be expected.

Minimum rules on minimum and maximum levels of administrative pecuniary sanctions for unauthorised provision of banking services would be very conducive to increase consumer confidence in the internal market for banking services. Consumers could be sure that a bank offering banking services to them from any Member State without being authorised and supervised would be subject not only to high potential fines but would also be sure about the minimum fine applied to each violation in each case. This will send a clear signal and will make such misconduct less attractive even where high benefits can be expected.

Limitations of the freedom to conduct a business as provided for in the Charter of Fundamental Rights would be similar in nature than under option (2). The minimum harmonisation character of these rules would not mitigate those impacts, as minimum amounts for administrative pecuniary sanctions would prevent Member States from fixing lower amounts of sanctions.

(a) Analysis of impacts in relation to sanctions for violations of prudential requirements

Minimum rules on minimum and maximum levels of administrative pecuniary sanctions for violations of prudential requirements would contribute to ensure credit institutions in all Member States effectively meet banking capital requirements. The possibility to impose high fines for violations of prudential requirements relating to governance will reduce the likelihood that credit institutions do not have in place appropriate risk management to anticipate situations of financial stress which can lead to an increase risk of failure. The requirement that fines shall not in any case be below a certain minimum will further contribute to this objective, in particular for smaller credit institutions.

However, depending on the level where the minimum is set, in case of bigger credit institutions such a minimum level will necessarily be too low to have any dissuasive effect.

Limitations of the freedom to conduct a business as provided for in the Charter of Fundamental Rights would be similar in nature than under option (2). The minimum harmonisation character of these rules would not mitigate those impacts, as minimum amounts for administrative pecuniary sanctions would prevent Member States from fixing lower amounts of sanctions.

(b) Analysis of impacts in relation to sanctions for violations of reporting requirements

Minimum rules on minimum and maximum levels of administrative pecuniary sanctions for violations of sanctions for violations of reporting requirements would contribute to ensure credit institutions in all Member States fully inform competent authorities about their financial situation which enables the authorities to require appropriate levels of prudential provisioning.

For example, this option would move up the maximum level pecuniary sanctions applicable in case of failure to have in place sound and robust governance arrangements: in several Member States that level is lower than 150.000, which does not seem sufficiently high to be deterrent for a credit institution. Raising that level can contribute to prevent violations of reporting requirements which will in turn reduce the likelihood that credit institutions avoid to hold the necessary capital by not reporting disadvantageous financial information to supervisors, leading to an increased risk of failure.

However, a minimum level would reduce the possibility of adapting the amount of the actual pecuniary sanction to the circumstances of the specific case concerned, which could make more difficult to ensure proportionality. For example, if a small credit institution does not report to the supervisory authorities with the required information, but this violation relates to information which is of minor supervisory relevance, it may be disproportionate to require imposition of a significant fine.

Limitations of the freedom to conduct a business as provided for in the Charter of Fundamental Rights would be similar in nature than under option (2). The minimum harmonisation character of these rules would not mitigate those impacts, as minimum amounts for administrative pecuniary sanctions would prevent Member States from fixing lower amounts of sanctions.

(2) Minimum common rules on maximum level of pecuniary administrative sanctions

Similarly to option 4, this option would contribute to the objective of improving the deterrent effect of the administrative fines, as it would ensure that competent authorities

have the power to apply fines which are sufficiently high to be deterrent even on the larger credit institutions.

(a) Analysis of impacts in relation to sanctions for unauthorised provision of banking services

Minimum rules on maximum levels of administrative pecuniary sanctions for unauthorised provision of banking services would be conducive to increase consumer confidence in the internal market for banking services, albeit to a lesser extent than option (4). While Consumers could be sure that a bank offering banking services to them from any Member State without being authorised and supervised would be subject not only to high potential fines, they would not be sure about the minimum fine applied to each violation in each case.

Limitations of the freedom to conduct a business as provided for in the Charter of Fundamental Rights would be similar in nature than under option (2). However, minimum rules limited to the issue of maximum levels of sanctions will limit the impact on that right especially in cases of lesser economic importance or where mitigating effects are present.

(b) Analysis of impacts in relation to sanctions for violations of prudential requirements

Minimum rules maximum levels of administrative pecuniary sanctions for violations of prudential requirements would contribute to ensure credit institutions in all Member States effectively meet banking capital requirements, albeit to a lesser extent than option (4). The possibility to impose high fines for violations of prudential requirements relating to governance will reduce the likelihood that credit institutions do not have in place appropriate risk management to anticipate situations of financial stress which can lead to an increase risk of failure.

Limitations of the freedom to conduct a business as provided for in the Charter of Fundamental Rights (Art. 16) would be similar in nature than under option (2). However, minimum rules limited to the issue of maximum levels of sanctions will limit the impact on that right especially in cases of lesser economic importance or where mitigating effects are present.

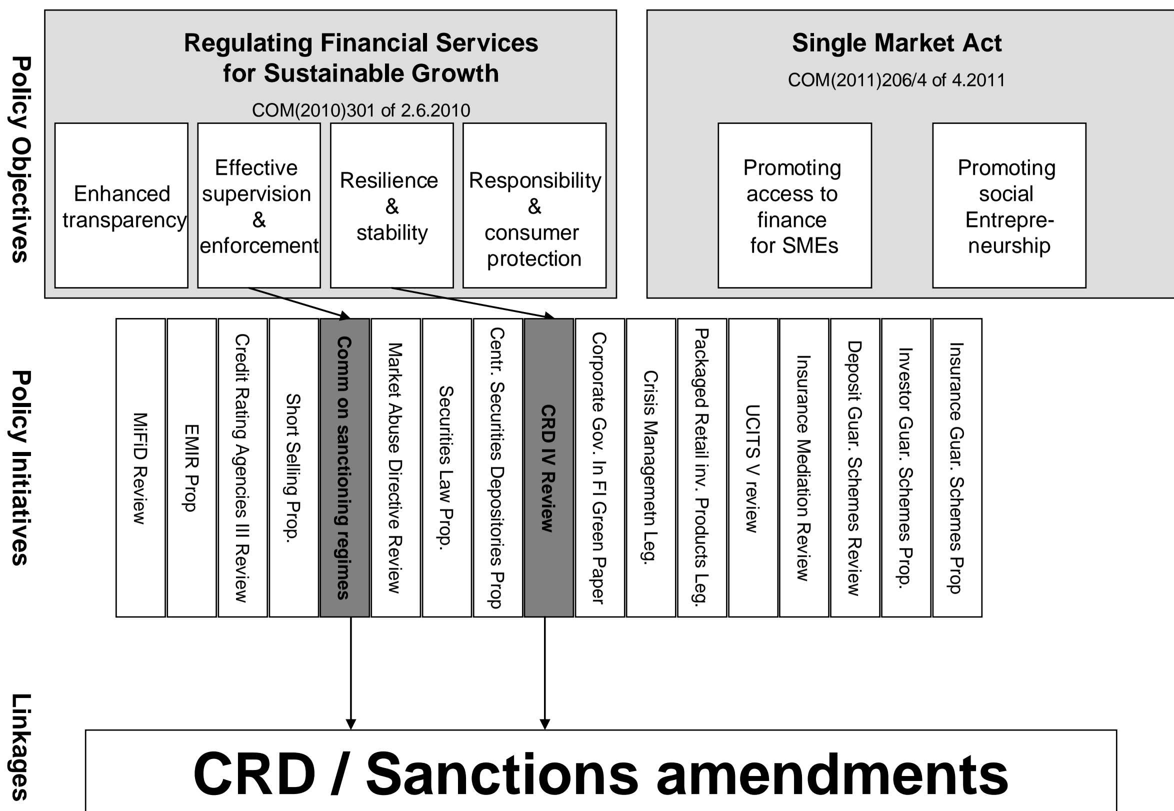
(c) Analysis of impacts in relation to sanctions for violations of reporting requirements

Minimum rules maximum levels of administrative pecuniary sanctions for violations of reporting requirements would - albeit to a lesser extent than option (4) - contribute to ensure credit institutions in all Member States fully inform competent authorities about their financial situation which enables the authorities to require appropriate levels of prudential provisioning.

Limitations of the freedom to conduct a business as provided for in the Charter of Fundamental Rights would be similar in nature than under option (2). However, minimum rules limited to the issue of maximum levels of sanctions will limit the impact on that right especially in cases of lesser economic importance or where mitigating effects are present.

ANNEX VI

Interaction of this initiative with other initiatives in the Financial Services Sector



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PART II

CORPORATE GOVERNANCE OF FINANCIAL INSTITUTIONS

TABLE OF CONTENTS

1. Introduction....................92
2. Procedural issues and consultation of interested parties....................94
3. Policy context and Problem definition....................97
4. Baseline scenario and Subsidiarity....................110
5. Objectives....................113
6. Policy options, analysis of impacts and comparison....................113
7. Monitoring and Evaluation....................133

1. INTRODUCTION

This document is the impact assessment accompanying the initiative for the reform of corporate governance in credit institutions aimed at preventing excessive risk-taking. It presents solutions to improve corporate governance systems in credit institutions to have a more resilient banking sector. It does not prejudge the final form of any decision to be taken by the European Commission.

The collapse of financial markets in autumn 2008 and the credit crunch that followed can be attributed to multiple, often inter-related, factors at both macro- and micro-economic levels, as identified in the De Larosière Report[64], and in particular to the accumulation of excessive risk in the financial system. This excessive accumulation of risk was in part due to the weaknesses in corporate governance[65] of financial institutions, especially in banks[66]. Whilst not all banks suffered from systemic weaknesses of governance arrangements, the Basel Committee on Banking Supervision (BCBS) Basel Committee on Banking Supervision (BCBS) referred to "a number of corporate governance failures and lapses"[67].

Strengthening corporate governance is at the heart of the Commission's programme of financial market reform and crisis prevention. Sustainable economic growth cannot exist without proper awareness of and effective management of risks within a company. The activities of some international organizations and standard setters, (including the Organisation for Economic Co-operation and Development (OECD), Financial Stability Board and Basel Committee on Banking Supervision (BCBS)), and Member States[68], who have launched several reviews on the role of corporate governance in the crisis and are updating their principles and guidelines accordingly, demonstrates the recognition of

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64 The Report of the High-Level Group on Financial Supervision in the EU published on 25 February 2009. The Group was chaired by Mr Jacques de Larosière.

65 Corporate governance is understood in this document as encompassing the standards for decision-making within a financial institution, the duties of the Board and the management, the internal structure of the financial institution and the relationships between the financial institution and its stakeholders. This concept is in line with the Basel Committee's understanding of corporate governance as embodied in its *Principles for Enhancing corporate governance*, October 2010 and also OECD *Principles of Corporate Governance*, June 1999.

66 For all these issues, see, for instance, OECD*, Corporate Governance Lessons from the Financial Crisis, February 2009;* OECD, *Corporate Governance and the Financial Crisis: Key Findings and Main Messages,* June 2009; Walker, D.*, A Review of Corporate Governance in UK Banks and Other Financial Industry Entities, Final Recommendations*, 26 November 2009; Institute for International Finance (IIF), *Reform in the Financial Services Industry: Strengthening Practices for a More Stable System*, December 2009; De Larosière report (2009).

67 Basel Committee on Banking Supervision (BCBS), *Principles for enhancing corporate governance*, October 2010.

68 For instance, UK Financial Services Authority adopted in 2009 a more intensive supervisory approach of firms and individuals with renewed focus on the quality of governance. German financial supervisor (Bafin) issued in 2010 several circulars with minimum requirements for risk management and governance.

the importance of good governance. In particular, the BCBS revised its bank governance principles in October 2010 (revised Basel Principles), with a key focus on Board practices, risk governance, transparency, and “know your structure".

In its Communication of 4 March 2009[69], 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 propose regulatory measures, in order to remedy any weaknesses in the corporate governance system in this key sector of the economy.

As a first step, the Commission presented a proposal to regulate remuneration policies in credit institutions which has been adopted by the European Parliament and the Council in 2010[70] and is preparing other measures to align remuneration policies with sound risk management in the remaining sectors of the financial services industry. As a second step, in June 2010 the Commission published a Green Paper on corporate governance in financial institutions and remuneration policies[71] and an accompanying staff working document[72] which analysed the deficiencies in corporate governance arrangements in the financial services industry and proposed possible ways forward. The results of this public consultation demonstrated a broad consensus on the deficiencies identified.

The Commission Green Paper and the responses received to the public consultation show that the main weaknesses in corporate governance systems concerned to large extent credit institutions as opposed to insurance companies and investment funds. The vast majority of respondents to the public consultation underlined that corporate governance mechanisms in these latter sectors of financial services have recently been reformed and the existing legislation is quite comprehensive. Consequently, the priority should be enhancing corporate governance systems in credit institutions, where the main failures were observed and where the legislation contains only very general principles on internal governance. There is clearly room for improvement and more detailed and specific principles in banking sector, in particular in the light of the recently revised Principles for enhancing corporate governance of Basel Committee on Banking Supervision[73]. More detailed principles would provide industry with a clear model for corporate governance standards and supervisors a more resilient framework within which to exercise their supervisory power. In order to ensure consistency between other sectors of financial services industry and to ensure that all appropriate lessons are learnt from the financial crisis, as a second step, a revision of other relevant sectoral directives could be envisaged, where necessary.

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69 COM (2009) 114 final

70 Directive 2010/76/EU of the European Parliament and of the Council of 24 November 2010 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, *OJ L 329, 14.12.2010.*

71 COM(2010)0284 final

72 Commission staff working document - Corporate Governance in Financial Institutions: Lessons to be drawn from the current financial crisis, best practices, SEC(2010) 0669 final

73 BCBS, *Principles for enhancing corporate governance*, October 2010

In the context of the reform of the European supervisory architecture, the enhancement of capital requirements and crisis management and resolution, the proposed reform of corporate governance in credit institutions is an integral part of an overall reform of the financial services sector. As regards the general issue of implementation, corporate governance reform should also be seen in the context of the recent Commission Communication on reinforcing sanctioning regimes in the financial services sector[74].

2. PROCEDURAL ISSUES AND CONSULTATION OF INTERESTED PARTIES

2.1. Procedural issues

In July 2010, a **Steering Group** was set up by Directorate General Internal Market and Services to monitor the progress of the impact assessment report. The Steering Group comprised representatives of a number of services of the European Commission, namely the Directorate General Internal Market and Services, the Directorate General Competition, the Directorate General Economic and Financial Affairs, the Directorate General Enterprise and Industry, the Directorate General Trade, the Directorate General Justice, the Legal Service and the Secretariat-General. The Steering Group met 3 times (21 September 2010, 16 December 2010 and 28 January 2011). In accordance with the rules for the elaboration of impact assessments, the minutes of the final meeting of the steering group have been submitted to the Impact Assessment Board together with this impact assessment.

The **Impact Assessment Board** delivered its opinion on 11 March 2011. Following the Board's opinion several changes were made to this IA, in particular the following:

- the report now provides greater evidence of the problem drivers, with illustrative examples, and examines their relative importance; it discusses more in detail the problem linked to the failure to sanction inadequate risk oversight;

- the argumentation for EU action is strengthened, the measures taken by Member States and the private sector in response to the crisis are incorporated more explicitly into the baseline scenario, illustrating how the EU action would have an added value to the work of national authorities and the European Banking Authority;

- the proportionality of the options is analysed in more detail and the degree of flexibility and discretion of supervisory authority is made more clear;

- the assessment of impacts is improved, especially the cumulative impact of the options on the supply of suitable candidates for board membership is analysed, implementing costs for supervisors and their distribution across Member States are described and impact on competitiveness of EU banks is further discussed; employee participation on boards is presented;

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[74] COM(2010) 716 final

- stakeholders' views are presented more extensively, the summary of the results of the public consultation is annexed to the report;

- some information has been moved from Annex I to the main text;

- other technical adjustments have been made to incorporate suggestions from the Impact Assessment Board.

Agenda planning or WP reference: 66.

2.2. Consultation of interested parties

The review of the Directive 2006/48/EC and this impact assessment have been prepared in accordance with the Commission's approach to applying the **better regulation** principles. The initiative and impact assessment is the result of an extensive and continuous dialogue and consultation with all major stakeholders, including securities regulators, market participants (issuers, intermediaries and investors), and consumers. It is built upon the observations and analysis contained in the **Commission Green Paper** on corporate governance in financial institutions and the more detailed Commission staff working document which accompanies it. The Green Paper describes the deficiencies in corporate governance systems in financial institutions revealed by the financial crisis; and explores possible solutions to remedy these deficiencies.

The Green Paper is based on the analysis and studies that have been performed or are still carried out by public or private organisations, at the international level as well as the European and national levels[75]. In their work, the Commission staff benefited from the advice of the European Corporate Governance Forum (ECGF) and of the ad hoc advisory group on corporate governance composed of some members of the ECGF and other renowned corporate governance specialists.

Questionnaires on their corporate governance practices were sent to a diverse cross-section of 10 major listed banks or insurance companies established in the EU. The questionnaires were augmented by 30 follow-up interviews with Board members, company secretaries, chief financial officers, chief risk officers, internal controllers.

A questionnaire on their views and role regarding corporate governance of financial institutions was also sent to the European banking, insurance and securities markets supervisors. Similarly, a cross-section of major European institutional investors and shareholders' associations received a questionnaire on their practices and expectations regarding corporate governance of financial institutions. A follow-up meeting with about 30 investors was held on 2 February 2010. A limited series of open interviews also took place with a few financial analysts, asset managers, and statutory auditors.

[75] See, for instance, OECD (June 2009); Walker, D., (November 2009); IIF (December 2009); De Larosière report (2009).

As part of the consultation process, and in the course of preparation of the Green Paper, the Commission services also organised on 12 October 2009 a **public conference**, a number of stakeholders participated. Discussion focused on the role and competence of the Board of directors, governance issues related to internal control and risk management, the respective role of shareholders, supervisors and statutory auditors.

The Green Paper launched a **public consultation** from 2 June 2010 to 1st September 2010 on the possible ways forward to deal with failures in corporate governance in financial institutions. The Commission services received 214 replies. The comments were taken into account in this impact assessment. The analysis of the results of the consultation is annexed to this report (see Annex V). Non-confidential contributions can be consulted on the Commission website:

http://ec.europa.eu/internal_market/company/modern/corporate_governance_in_financial_institutions_en.htm#consultation2010

The **respondents agree** with the analysis in the Green Paper regarding the weaknesses in corporate governance in financial institutions. They support the Commission's goal of promoting effective corporate governance as well as the policy intent underlying the principles articulated in the Green Paper. The respondents also support **a more effective supervision** of the implementation by credit institutions of principles on good corporate governance. Although many respondents highlight that certain failures in corporate governance in financial institutions were to a large extent due to a lack of effective implementation of existing rules**,** a number of respondents think that **regulatory framework could be improved** further. A number of respondents think that any future proposals of the Commission should **be principle-based and proportionate** in order to take account the differences in business models of financial institutions, the nature of their activity, their size, complexity, legal form and different corporate governance systems and arrangements. Many respondents are of the opinion that future action at European level should focus on **desired outcomes** and the detailed implementation of the principles could be dealt with at national level through legislation, supervisory review, increased transparency or codes of best practice with "comply or explain" approach. The views of the respondents have been taken account of in this impact assessment.

The Green Paper received support from different public authorities and Member States. European Parliament has also recognised the importance of strengthening corporate governance standards and practices in financial institutions[76].

[76] Report on remuneration of directors of listed companies and remuneration policies in the financial services sector (2010/2009(INI) calls on the Commission to investigate strengthening the roles of non-executive directors, including ensuring that firms provide on-going training and independent remuneration packages that reflect the independent role of non-executive directors, as well as providing the powers to supervisors to conduct 'approved persons' interviews.

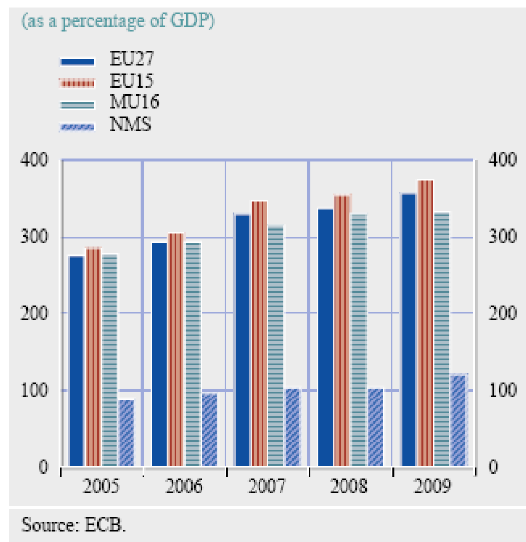
3. POLICY CONTEXT AND PROBLEM DEFINITION

3.1. Background and context

3.1.1. Nature and size of the market concerned

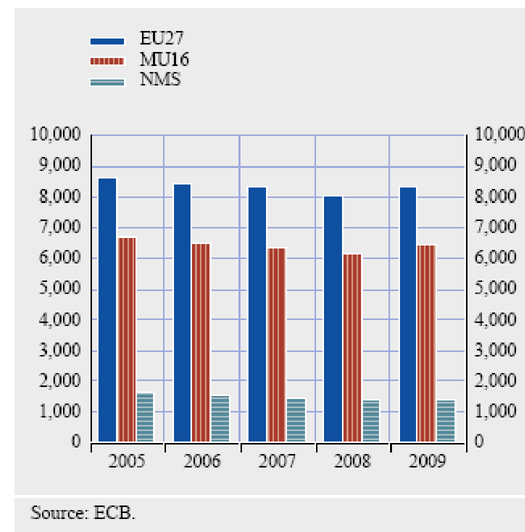
The reform of the corporate governance is aimed at credit institutions and investment firms. At the end of 2009, the number of credit institutions in 27 Member States, amounted to 8,358 and their total number of assets exceeded 350% of GDP.

Figure 1: total assets of the European banking sector



Source: ECB.

Figure 2: total number of credit institutions



Source: ECB.

EU27: European Union (27 countries after enlargements in 2004 and 2007
EU15: European Union (15 countries before enlargement on 1 May 2004)
MU16: Monetary Union (16 countries participating in the euro area as at 31 December 2009)
NMS: New Member States (12 new countries of 1 May 2004 enlargement)

The total amount of loans to non-credit institutions in 2009 neared €20,000 billion, credit institutions being the remained the dominant suppliers of financing. This shows the importance of the banking sector in the European economy and the impact any failures may on the other sectors of economy.

3.1.2. Overview of legislative framework

The following table summarises the existing legislative framework on corporate governance.

Binding	Article 22 CRD, paragraph 1	"Home Member State competent authorities shall require that every credit institution have robust governance arrangements, which include a clear organisational structure with well defined, transparent and consistent lines of responsibility, effective processes to identify, manage, monitor and report the risks it is or might be exposed to, and adequate internal control mechanisms, including sound administrative and accounting procedures, and remuneration policies that are consistent with and promote sound and effective risk management".
	Article 11 CRD, paragraph 1	"The competent authorities shall grant an authorisation to the credit institution only when there are at least two persons who effectively direct the business of the credit institution. They shall not grant authorisation if these persons are not of sufficiently good repute or lack sufficient experience to perform such duties".
	National company laws	National company laws define the rules for the setting up and the functioning of a company, including rules on the functioning and the composition of Boards
Non-binding	Revised Basel Principles	Revised Basel Principles provide guidance at international level to credit institutions and supervisors on sound corporate governance in credit institutions.
	EBA guidelines on internal governance	EBA guidelines on internal governance provide guidance to European supervisors and credit institutions on the implementation of principles on internal governance contained in CRD
	Corporate governance codes	Corporate governance codes are focused on best practices for listed companies, therefore they apply to listed credit institutions only.

As showed in the table, CRD contains very general principles in EU legislation which do not define roles and responsibilities of different actors within credit institutions, especially of Board and management, or specify what the governance arrangements should look like. This is left to national supervisors, guidelines, national legislation, non-binding domestic corporate governance codes and to auto-regulation. National supervisors monitor the compliance of credit institutions with national legislation implementing CRD rules and can sanction non-compliance. EBA is currently preparing guidelines for credit institutions and national supervisors on internal governance which would provide credit institutions with supervisory expectations on the implementation of Article 22 and Article 11. National corporate governance codes are non-binding in nature and are focused on "comply or explain" principle: companies should either comply with the recommendations of a code or explain why they do not comply. The monitoring of the "comply or explain" principle is usually left to the market and investors.

3.2. Problem definition

The financial crisis triggered by the bankruptcy of Lehman Brothers in autumn 2008 necessitated a massive injection of public funding into credit institutions in the US and Europe – up to 25% of GDP. The resulting credit contraction and increasing public debt had a strong negative impact on the real economy. Banking stock prices soured.

The financial crisis was caused largely by accumulation of excessive risk in the financial system. The De Larosière Report[77] notes that there were fundamental failures in assessment of risk, both by financial firms and those who regulated and supervised them. These failures were due to misunderstandings about the interaction between credit and liquidity, weaknesses in model-based risk assessments, which led to an overestimation of the ability of financial firms as a whole to manage their risk and a corresponding underestimation of the capital they should hold. As showed in the Commission Green Paper and its accompanying Staff Working Document, the failures were also due to weaknesses in the governance aspects of risk management.

Credit institutions that failed or encountered difficulties and had to be bailed out by governments were generally lacking an appropriate risk culture. To illustrate, in many cases, credit institutions were not able to identify and control risk internally due to inefficient risk oversight by Boards of directors and ineffective internal risk management as well as the consequences of the unsound remuneration structures that encouraged excessive risk-taking which had been put in place.

These weaknesses were also due in part to the lack of effectiveness of the existing rules on corporate governance and the failure of shareholders and supervisors to effectively monitor risk. Statutory auditors had a limited role with regard to risk issues. In fact, the general consensus[78] is that the principles on corporate governance existing prior to the crisis, namely the OECD principles, the recommendations of the Basel Committee, and European legislation, already covered to a certain extent the problems highlighted by the financial crisis. However, the financial crisis revealed the lack of genuine effectiveness and implementation of the corporate governance principles and mechanisms in the financial services sector, particularly with regard to banks. This was due to different factors.

First, it seems that the existing principles were too general, too broad in scope and were not sufficiently precise. As a result, they do not seem to have been well understood in practice and they left a wide margin of appreciation for financial institutions. In most cases, this seems to have led to a purely formal application of corporate governance principles (i.e., a box-ticking exercise), with no real qualitative assessment. Existing rules on governance of credit institutions were not sufficient to prevent behavioural excesses that contributed to the crisis because Boards failed to challenge management.

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[77] De Larosière Report (2009), pp. 8 to 9.

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

Second, the non-binding nature of most of the corporate governance principles in Europe and the fact that there was no legal obligation to comply with recommendations by international organisations or the provisions of corporate governance codes contributed to the lack of effective compliance by financial institutions with the corporate governance principles[79].

Finally, in the absence of legal requirements, there are three principal drivers in the banking sector towards compliance with the codes of corporate governance: voluntary self-regulation, investor pressures and regulatory oversight. However, as showed below, neither of these mechanisms worked in practice. In particular, there was a clear lack of effective monitoring of implementation of corporate governance principles by shareholders and supervisory authorities, partly due to insufficient information from credit institutions.

The detailed problem analysis which follows is based on the findings of the Commission Green Paper on Corporate Governance in Financial Institutions and Remuneration policies (COM(2010) 284 final) and its accompanying staff working document Corporate Governance in Financial Institutions: Lessons to be drawn from the current financial crisis, best practices (SEC(2010) 669).

3.2.1. Weaknesses in internal oversight of risk strategies

The Board and senior management are primarily responsible and accountable for the governance and performance of credit institutions. Notwithstanding the differences in Boards' structures across Europe, part of the Board's responsibility is to monitor the performance of the company, supervise the management and, as a consequence, to act as a counter-weight to the often risk-laden growth aspirations of some management teams[80]. Boards of a credit institution have explicit and implicit obligation to safeguard the monies credit institution receives from the public (deposits, investments etc.) and consequently to ensure that credit institution is managed in a safe and sound manner[81]. However, in many instances this responsible oversight did not occur due Board failures but also to inappropriate standing and authority of the risk management and control function. As a consequence, government intervention was required to protect stakeholders and the stability of the financial system.

3.2.1.1. Inadequate risk oversight by Boards

The current financial crisis revealed serious flaws and shortcomings in risk oversight by Boards at a number of financial institutions. According to the Basel Committee, these

[79] 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.

[80] See *Comparative study on corporate governance codes relevant to the EU and its Member States,* Weil, Gotshal & Manges LLP, on behalf of the European Commission, March 2002.

[81] See, for instance, J. Palmer, C.S. Hoong, *How can financial supervisors improve the effectiveness of corporate governance?*", October 2010.

shortcomings were mainly attributable, to insufficient Board oversight of executive management[82]. In addition, Board was not adequately involved in strategy and consequently gave low priority to risk issues as compared to other topics. Finally, Boards did not receive adequate and timely information on risk. As a result of these failures, credit institutions were allowed and, in some cases, even encouraged, by their Boards to take excessive risks that included unprecedented levels of leverage and high-risk business strategies[83].

A) Lack of effective challenge of senior management decisions by Boards

Credit institutions are, by definition, complex entities with different types of risks linked to their activity. In order for the Board to fulfil its duties and to be able to understand fully all relevant risks and constructively challenge management decisions, members of the Board should devote sufficient time to their duties and possess the appropriate expertise.

However, in many cases, non-executive Board members did not devote **sufficient time** to fulfil their duties, mainly due to the accumulation of a large number of mandates in different companies. For instance, a non-executive director without any committee membership would, until recently, typically expect to work about fifteen days per annum in a credit institution[84], whereas it is now recognised that a board member should spend from 30 to 60 days per annum, depending on the complexity of the financial institution. For example, at Bear Stearns, in the seven-member audit committee, three directors held among them 18 board seats on listed companies. The audit committee chairman served on the boards of five listed companies in addition to Bear Stearns. Two members of the audit committee served on the audit committees of 11 public companies between them. This model of part-time Boards with Board members combining a number of mandates in different companies has proved unworkable, particularly in large complex financial institutions. The crisis has revealed the difficulties which non-executive directors face understanding all dimensions of risks being taken by financial institutions within the time commitments typically required from them.

As shown by different studies[85], the presence of a sufficient number of experienced and informed non-executives encourages challenge, as opposed to Boards whose members do not question management decisions because the subject is too technical for them. However, the crisis showed that many non-executive Board members lacked relevant **expertise** and skills to be able to perform their duties and efficiently challenge dominant chief executives pursuing aggressive growth strategies. As an example, at Lehman Brothers, there was a notable absence of financial services expertise on the board. There

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82 BCBS, October 2010.

83 J. Palmer, C.S. Hoong.

84 See for instance, report was prepared for the OECD by R. C. Anderson, *Risk management and Corporate governance*, where it results from the interviews conducted with that few non-executive directors have more than an absolute maximum of 20% of their year to devote to any given Board, and in many cases their attendance at meetings may be as little as fifteen days a year.

85 See, for instance, Walker, D. (November 2009).

was also an absence of current business experience. The chairman of the audit and of the risk committees was a trustee of a non-profit foundation[86]. In many cases, lack of expertise of non-executive Board members prevented them from carrying out checks on the plausibility of information presented to them and explains in part the over-reliance on ratings. In addition, the nomination process for non-executives often did not sufficiently assess their capacity to carry out non-executive functions, including the ability to challenge the management.

Although insufficient time commitment and inadequate expertise were the main drivers of the lack of effective challenge by Boards of management decisions, other factors contributed to this situation. Several reports[87] 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 of the management due to a lack of technical expertise and/or confidence (**management dominance**). The results of the public consultation show that combining functions of Chairman and Chief Executive Officer in the same financial institution disregards the divergence of duties and capacities and concentrates an unwarranted amount of power and dominance in the hands of one person. Also, due to the amount of work, especially in systemically important financial institutions, cumulating both functions does not allow for sufficient time-commitment.

Finally, the selection of candidates for non-executive positions in financial institutions has drawn on a too narrow pool of people, non-executive directors being often recruited through an “old boy network” from among business and personal contacts of current board members. For instance, the Higgs Review in the UK of 2003 found that the majority of non-executive directors in UK companies, including financial institutions, were white, middle-aged males of British origin with previous plc director experience. Non-British nationals accounted for only 7% of non-executive positions, while British citizens from ethnic minority backgrounds accounted for only 1% of such positions. The survey also found that although about 30% of managers in the UK corporate sector were female, women held only 6% of non-executive positions. Recent research shows that this situation has not evolved. This **lack of diversity** in the composition of Boards with regard to cultural, educational, professional and legal background and also with regard to age and gender resulted in Boards being dominated by a narrow group-think which, in many cases, contributed to the failure of non-executive Board members to effectively challenge management decisions[88].

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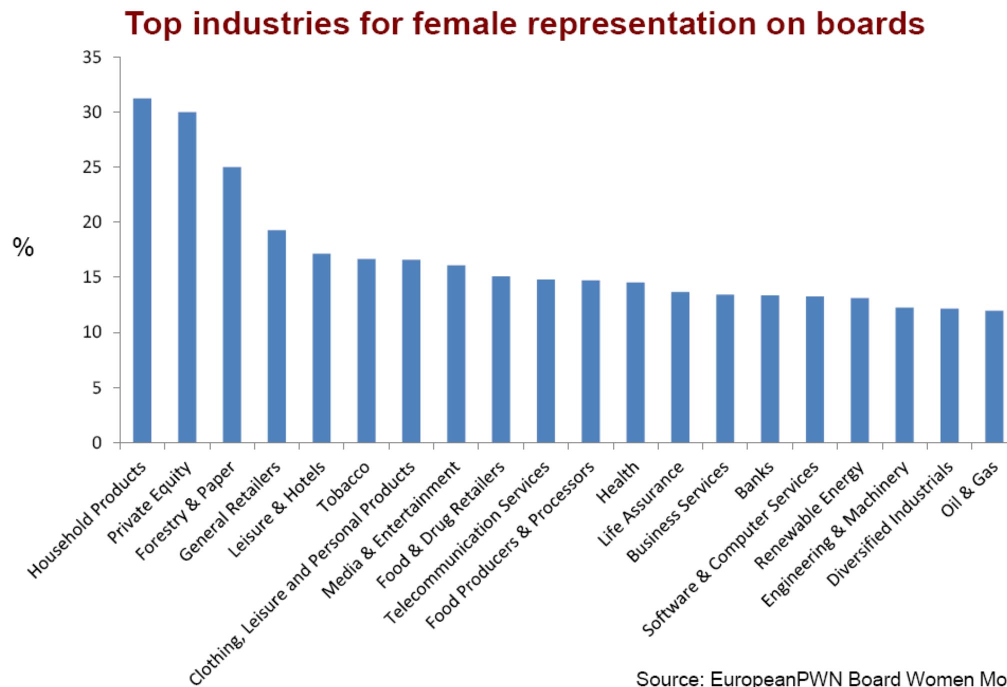
[86] For a detailed analysis of Lehman Brothers Board composition, see *Lehman Bothers: Peaking under the Board Façade*, Stanford Graduate School of Business, CGRP-03, April 2010.

[87] See for instance, report by R. C. Anderson where many interviewees have referred to CEO’s as dominant, persuasive individuals who are used to getting their own way within their organisations. Some have been described as “imperial”, others have been described as “bullying”. See also Walker D. (2009).

[88] For instance, the British Treasury Select Committee report *Women in the City*, July 2010, said that: "We believe the lack of diversity on the Boards of many, if not most, of our major financial

Whilst it is not exclusive to credit institutions, lack of diversity and, in particular, gender gap, on Boards of credit institutions is particularly acute, as showed in the charter below.

Figure 3: Women representation on Boards in corporate sector in Europe



An increasing number of reports indicate, however, that there is a positive correlation between diverse Boards and the companies' performance[89]. Agency theory suggests that a more diverse Board is a better monitor of management because Board diversity increases Board independence. People with different gender, cultural background might ask questions that would not be asked by directors with more traditional backgrounds. A report commissioned by the California Public Employees' Retirement System (CalPERS) for example, found that companies that have diverse Boards perform better than Boards without diversity[90]. The report stated that companies without ethnic minorities and women on their Boards eventually may be at a competitive disadvantage and have an under-performing share value. A plethora of European studies came up with the same

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institutions may have heightened the problems of 'group think' and made effective challenge and scrutiny of executive decisions less effective".

89 Baumgarten, P., Desvaux, G., & Devillard-Hoeillinger, *Women Matter 1: Gender diversity, a corporate performance driver*, McKinsey & Company, 2007; The Bottom Line: Connecting Corporate Performance and Gender Diversity', by Catalyst, 2004; 'Women to the Top!', 2007, by EVA.

90 Deborah L. Rhode and Amanda K. Packel, *Diversity on Corporate Boards,* Stanford Centre on the Legal Profession, September 2009.

result no matter the number of companies surveyed in each report[91]. For example, research conducted by McKinsey in 2007 of over 500 European companies with a market cap over 150 million euros, found greater profitability of companies with a higher proportion of women executives and Board directors[92].

In addition, there is substantial economics literature on the effect of gender on attitudes toward risk, and most of it appears to support the idea that men are less risk averse than women in their financial decision making[93].

Nevertheless, this positive correlation between gender balance and performance of companies has not led to an improved situation as regards diversity on Boards of credit institutions. Competitive pressure apparently does not suffice to bring change through the relative advantages offered by gender diversity with regard to profitability and economic growth. This seems to be undermined in particular by co-optation in the process for selection of Board members, i.e. when candidates for Board membership are selected by existing Board members. This perpetuates selection of candidates of similar profile and background.

B) Lack of ownership by Boards of risk strategy

In addition to the lack of effective challenge by Boards of management decisions, excessive risk-taking in credit institutions has been partly due to lack of adequate Board involvement in approving and overseeing the risk strategy (risk appetite) and risk management structure. Board members did not feel themselves sufficiently concerned by risk issues which resulted in lack of ownership of risk matters by Boards. Often, there were no clear lines of responsibility with regard to risk identification and management. The evidence gathered[94] shows that in several credit institutions, there was a lack of acknowledgement at the Board level of the risk certain transactions implied, while the risk appetite was either not properly defined or not defined at all. There was also no effective monitoring of whether the limits set by the risk strategy and the risk appetite were respected. This can be illustrated by the example of UBS, where there were no clear guidance on front desk on the limits of risk exposure and lack of coordination of risk strategy.

C) Low priority given by Boards to consideration of risk issues

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[91] See, for instance, S. Nielsen and M. Huse, *The Contribution of Women on Boards of Directors: Going beyond the Surface,* Corporate Governance: An International Review, 2010, 18(2): 136–148.

[92] McKinsey and Company, Women Matter: Gender Diversity, A Corporate Performance Driver, October 2007.

[93] See, for instance, Powell, M. and Ansic, D, *Gender difference in risk behaviour in financial decision making: an experimental analysis*, Journal of Economic Psychology, 1997; Jianakopolos, N. A. and Bernasek, A., *Are women more risk-averse*?, Economic Enquiry 1998.

[94] See, for instance, evidence of former Chairmen and Chief Executives to the Treasury Select of the House of Commons.

In credit institutions, risk is at the core of the company business models. Many banks run complex businesses with many different business lines. It takes both skill and time to understand all the risks to which these institutions are exposed, how these risks interrelate and how they could expose the banks to losses beyond the risk tolerance. Without this awareness and understanding it is difficult for the Board to provide effective checks and balances to the bank's management. However, it was reported that Boards did not spend sufficient time in meetings discussing issues related to risk[95]. For instance, at Lehman Brothers, the finance and risk committee met only two times during the course of 2008. This was partly a consequence of the lack of a clear role of the Board in overseeing a company's risk management, insufficient time commitment and inadequate expertise. Also, during the market boom, risk was generally not considered as an issue of high relevance to the Board, and low priority was given to discussion of risk matters as compared to other subjects, such as growth strategy or mergers and acquisitions. In addition, due to internal organisation structure, Boards tended to focus mainly on financial reporting risk (i.e. risk linked to accounting misstatements) and tasked the audit committees to handle most of the risk management activities, thereby failing to see the need for a separate risk committee to manage risks on an enterprise-wide level[96]. This insufficient attention by Boards to risk issues prevented them from efficiently overseeing risk on the broad company level.

D) Inadequate information of Boards on risk issues

Even where all necessary systems to oversee risk are in place, it is essential that Boards receive timely and accurate information in order to be able to take informed decisions. However, the crisis revealed that Boards did not always have a clear understanding of what information on risk they actually needed. Reporting on risk has not been in all situations timely, comprehensive and understandable for decision-making or control bodies, limiting thereby the capacity of analysis and critical review of executive management and/or the Board[97].

According to corporate governance professionals, "Boards tend to live in a partial assurance vacuum. The risks are known by management but the Board does not get to hear about them. The Board only gets the assurance that management chooses to give

[95] See, for instance, the *Beyond box-ticking: A new era for risk governance*, a report from the Economist Intelligence Unit Sponsored by ACE and KPMG, 2009, where many respondents to the survey – across geographies and company sizes – admit that their companies do not spend enough time at Board level discussing risk issues.

[96] See, for instance, General Counsel Roundtable, *Chief Risk Officers and Risk Committees, Key Findings,* August 2007.

[97] According to report the Economist Intelligence Unit *Beyond box-ticking: A new era for risk governance,* the communication of risk information to the Board is seen as a problem area, with only 40% believing that their organisation is good at ensuring clear lines of reporting to allow risk information to be escalated.

them. It is relatively rare that managers report candidly to the audit committee and the Board because of the disincentives of doing so.[98]"

There was a lack of direct lines of reporting of the risk management function to the Board. For instance, the Senior Supervisors Group (SSG) found that "in some cases, hierarchical structures tended to serve as filters when information was sent up the management chain, leading to delays or distortion in sharing important data with senior management".

Moreover, in a number of cases there has been a general lack of appropriate presentation of information on risks to the Board. Management rarely compiled for their Boards relevant measures of risk, a view of how risk levels compare with limits, the level of capital that the firm would need to maintain after sustaining a loss and the actions that management could take to restore capital after sustaining a loss.

3.2.1.2. Inappropriate standing of the risk management function

The risk management and control functions together with the Board play an important role in efficient risk oversight. However, many banks saw the corporate governance aspects of risk management as "a paper pushing exercise that adds little value" and institutions were reported to lack fundamental risk culture[99]. In many cases, the risk management function in credit institutions has not been given proper weight in decision-making process. Moreover, the risk function as such has often not been respected and regarded at the same level as the operational/trade function.

The highest representative, generally the Chief Risk Officer (CRO), was not always in a position to speak up or raise concerns due to hierarchical constraints[100] and did not have sufficient levers to either sanction or veto investment decisions. As a result, risk issues were often not given appropriate consideration in major management decisions. Furthermore, there was a lack of existing structures at Board level, within which the CRO was able to interact and to ensure that the all dimensions of risk were appropriately considered.

As described in the report of the OECD[101], at a number of banks, the lower prestige and status of risk management staff vis-à-vis traders played an important role. For example, Société Générale noted that "the general environment did not encourage the development of a strong support function able to assume the full breadth of its responsibilities in terms of transaction security and operational risk management. An imbalance therefore emerged between the front office, focused on expanding its activities, and the control

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[98] See, for instance the interview of Andrew Chambers, head of the corporate governance committee at the Association of Chartered Certified Accountants in the *Beyond box-ticking: A new era for risk governance.*

[99] See, for instance, the report from by R. C. Anderson to OECD.

[100] For example, the CRO was placed under rather than at equal level to the CFO.

[101] OECD, February 2009.

functions which were unable to develop the critical scrutiny necessary for their role"[102]. The inability of risk management staff to impose effective controls was also noted at Credit Suisse[103].

3.2.2. Lack of effective external control

Until now, very general and/or non-binding nature of most existing principles on corporate governance has meant that external control of effective implementation of these principles has been crucial. However, the financial crisis has shown that neither the shareholders nor the supervisory authorities were effectively monitoring and controlling the implementation by credit institution of these principles.

Shareholders did not fulfil their role of "responsible owners", which entails actively monitoring companies and using shareholder rights to ensure long-term value creation of companies and improve their corporate governance and strategy. Consequently, market discipline which is essential for effective implementation of corporate governance principles did not work properly.

In additional, in many instances, the serious difficulties and failures of banks occurred only a few months after their accounts had been issued without any qualification, emphasis of matter or even indication in the auditors' reports regarding such risks in the financial statements.

Whilst lack of shareholders engagement and auditor's involvement were one of the drivers of the corporate governance failures in credit institutions, they are out of the scope of this impact assessment and will be dealt with in other Commission initiatives (See Section 6.4.). Inadequate supervisory review of internal governance is analysed below.

3.2.2.1. Inadequate supervisory review of internal governance

The financial crisis revealed a lack of sufficient dialogue between Boards and supervisors regarding corporate governance issues. This lack of supervisory oversight did not allow the timely identification of the financial institutions that were experiencing weaknesses in their corporate governance practices.

Inadequate supervisory control of governance practices in credit institutions was mainly due to the lack of clear role for supervisors in overseeing corporate governance structures and no clear guidance on the methodology. National supervisors took varying degrees of interest in the governance of credit institutions. While some supervisors took steps to assess compliance with the exiting national principles and guidelines, the majority were too much focused on formal compliance by financial institutions with some limited

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[102] Société Générale, Report of the Board of Directors to the General Shareholders Meeting, 2008, company website.

[103] Financial Services Authority, Final notice to Credit Suisse First Boston, 13 August 2008, London

requirements rather than on the proper functioning of the Boards and on effective implementation by financial institutions of sound corporate governance principles[104].

In many cases, supervisors did not monitor whether the risk governance frameworks and internal organisation could easily adapt to changes in the business model or risk profile of the credit institution. They also failed to ensure appropriate expertise of Boards and to apply "fit and proper" test, focusing essentially on probity test[105]. In addition, the majority of supervisors had few interactions with Boards and Board committees, preferring to deal directly with management[106].

Moreover, due to the lack of clarity in their role in overseeing corporate governance in credit institutions and to the non-binding nature of a significant part of corporate governance principles, most supervisors were unable to apply sanctions for corporate governance failures in financial institutions or their Boards on grounds of lack of appropriate risk oversight. They also did not possess adequate tools to monitor the functioning of Boards (e.g. no access to performance evaluation, no competence with regard to diversity).

Finally, the financial crisis revealed serious limitations in the existing supervisory framework globally, both in a national and cross-border context. Supervisors did not have sufficient resources nor did they have an adequate mix of skills. The consequence was a lack of understanding of and proper monitoring of financial institutions' activities. Also, the existence of different national systems of supervision has led to inconsistent supervisory powers across Member States, regulatory competition and supervisory capture. This prevented the authorities from exercising efficient supervision in the context of expansion of investment bank business model[107]. In general, the evidence tends to show that the crisis prevention function of supervisors has not been performed well. However, these problems are of a more general nature and are out of the scope of the analysis of this document. This document will only focus on the role of the supervisors in risk governance of credit institutions.

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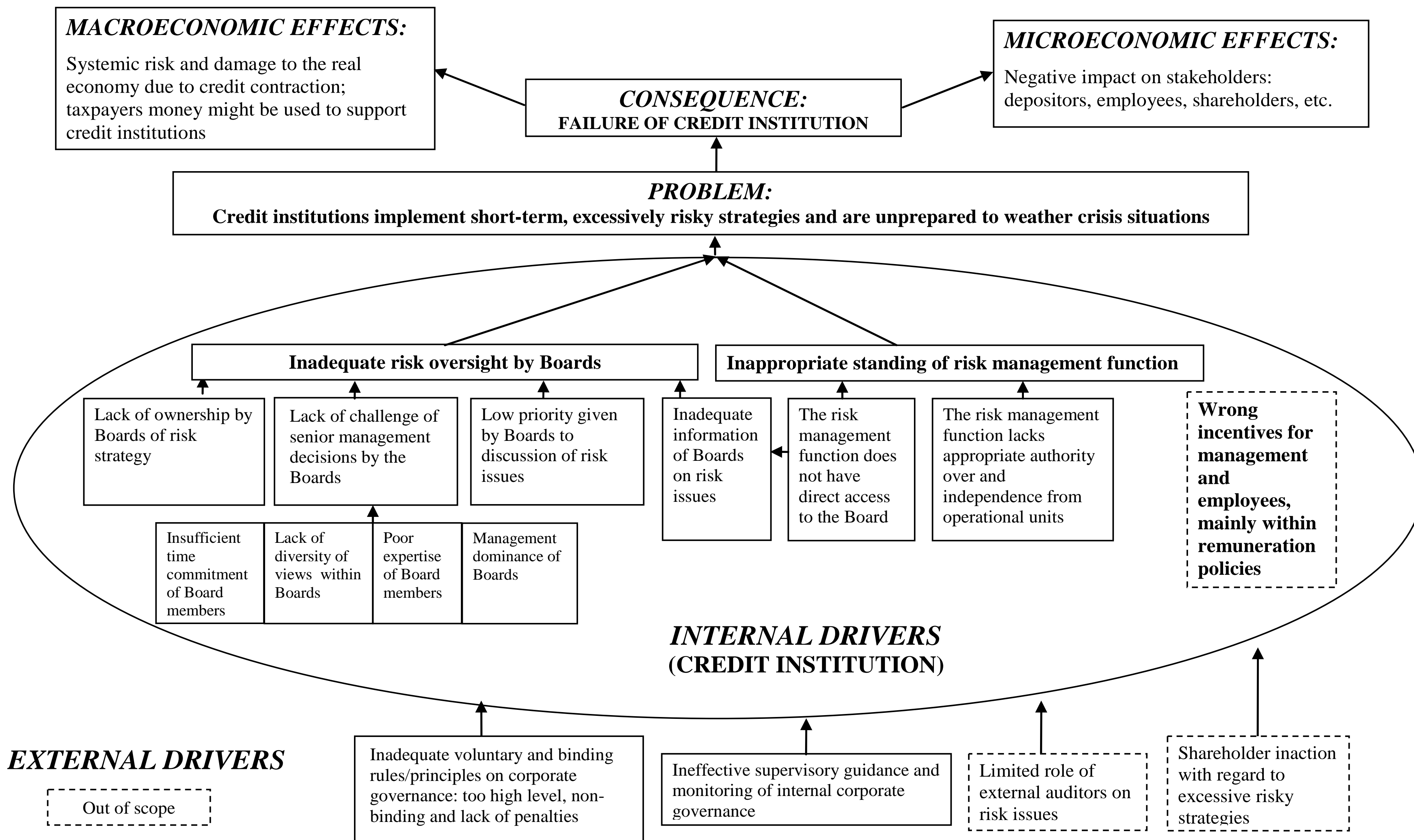
[104] For instance, under the UK FSA supervisory approach before the crisis, governance of credit institutions was evaluated according to a set of criteria, compliance with which could be assessed using a box-ticking approach. See *The FSA's Risk-based approach: guidance for non-executive directors*, November 2006.

[105] See, for example, OECD (November 2009), p.27.

[106] See J. Palmer, C.S. Hoong

[107] See De Larosière report (2009), pp. 41 to 42; Guido Tabellini, *Why did bank supervision fail?* in The First Global Financial Crisis of the 21st Century, June 2008;



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4. Baseline scenario and Subsidiarity

The issue of corporate governance is currently being addressed both at an international and European level, and by Member States and credit institutions. However, the existing initiatives risk not being sufficient to change the behaviours.

4.1. Baseline scenario: expected development if no EU action is taken

Excessive risk-taking by credit institutions has been or is in process of being addressed by different reforms at EU level, in particular the new capital adequacy requirements and the past and future amendments to the Capital Requirements Directive. These measures will contribute to avoiding excessive risk exposures and strengthen the European financial system. However, these new capital requirements rules should be complemented by reforms to corporate governance practices within credit institutions and change in corporate behaviour. Credit institutions are in the process of changing their risk oversight and management practices, demonstrating recognition of the importance of improving governance standards as a consequence of the financial crisis.[108] Moody's report of March 2010[109] which reviewed board composition at 20 large global banks in North America and Europe since the beginning of the crisis in July 2007 shows, for instance, that experience in the financial industry is now more prominent factor in building bank boards as compared to pre-crisis situation: 46% of the banks' outside directors now have financial backgrounds, as opposed to 32% pre-crisis, on average; and 13 banks had split the roles of chairman and CEO. However, the same report also recognises that there is still need for improvement and that the changes are far from complete: financial industry experience among outside directors remains weak at some banks, such as the BNP Paribas, Deutsche Bank or KBC where 20% or fewer of the outside directors possess relevant experience. A number of banks do not have any form of independent board leadership (either via an independent chairman or independent lead director / senior independent director role), such as BNP Paribas, Credit Suisse, Deutsche Bank, KBC, Santander Group and Société Générale. Also, this report only analyses the situation of large institutions that have by definition strong capacities to rapidly respond to corporate governance challenges and shareholders' expectations. The progress of small banks in changing their corporate governance practices has not been subject to a detailed survey.

Additionally, as demonstrated by past experience, corporate governance practices tend to be subject to procyclicality. Immediately after the crisis, companies focus their attention on enhancing corporate governance standards but when the market recovers and there is a new economic boom, sound risk governance often gives way to profit-maximising strategies driven by investor's appetite and herd effect[110]. Boards tend to become

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[108] See IIF Report *Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations,* July 2008.

[109] Moody's, *Bank Boards in the Aftermath of the Financial Crisis,* March 2010.

[110] As Alan Greenspan has admitted, "the innate human responses […] result in swings between euphoria and fear that repeat themselves generation after generation with little evidence of a

"cheerleaders of […] unlimited liquidity, low interest rates, perpetual growth, and rapidly growing profits, bonuses and stock-option benefits."[111] People generally underestimate risks that have not materialised for a long time—a phenomenon known as disaster myopia—and are biased towards information that is in line with their a priori beliefs[112].

This issue could be addressed through the introduction of new corporate governance framework at national, international or European level.

At national level, some Member States are undertaking their own initiatives to improve corporate governance in financial institutions. A major initiative to improve corporate governance in the German banking sector was the introduction of new *Minimum Requirements for Risk Management,* which required banks to develop a risk strategy for the entire group, regulated executive remuneration and aimed at further professionalizing the supervisory board (the supervisory board must now include at least one person that has the required knowledge, abilities and expert experience to properly fulfil his monitoring task). However, the new regulation is limited and does not, for example, encompass explicit criteria to assess the competence and experience of supervisory board members. Other reforms focused on listed companies only. This suggests that the recent changes would be unlikely to address all weaknesses of the German corporate governance system.

In UK, FSA has strengthened its requirements with regard to selection of candidates for Board membership and other key persons, improved their selection procedure and published guidance with regard to Risk Committees and Chief Risk Officers. Financial Reporting Council (FRC) has published a Stewardship Code for institutional investors and introduced changes to the UK Corporate Governance Code to help company boards become more effective and more accountable to their shareholders. These measures could help ensuring shareholders' engagement and thus contribute to improved external control of corporate governance. However, they remain limited to listed companies.

At international level, the revised Basel Principles aim at addressing fundamental deficiencies in bank corporate governance which became apparent during the financial crisis. At a European level, the European Banking Authority (EBA) is in process of revising its principles on Internal Governance with a view to enhance and consolidate supervisory expectations in order to improve the sound implementation of internal governance arrangements in financial institutions. These revisions may contribute to the avoidance of excessive risk-taking by credit institutions in the future, help them better withstand financial turmoil and finally lower the risk of future crises. However, the change is neither far from complete nor is it clear whether it will remain embedded so far as to guarantee the necessary changes in the culture towards sound corporate governance.

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learning curve." , *We will never have a perfect model of risk*- FT - By Alan Greenspan, 16 March 2008.

111111 See J. Palmer, S.C. Hoong.

112 See A. Houben and J. Kakes, *Risk identification and mitigation: lessons from the crisis*, September 2010.

In fact, the existing international standards and future EBA guidelines are non-binding in nature. Although they should usefully elaborate on existing high-level principles in European legislation and provide detailed guidance to financial institutions as regards supervisory expectations, their implementation will depend on each financial institution and on the effective supervision by competent authorities. These guidelines will not solve the problems outlined in Part 3, that stem from the ineffective implementation by financial institutions of existing rules due to the non-binding nature of the principles in EU legislation themselves, which left corporate governance issues to non-binding domestic codes, auto regulation and failed to clearly define the roles and responsibilities of different actors.

If no action is taken, the problems related to the lack of effective control of risk will remain. In addition, unclear and open-ended rules will continue to generate legal uncertainty, which might find only temporary and partial clarification through guidelines, coordination and convergent application by national competent authorities within the European Banking Authority.

4.2. The EU's right to act and subsidiarity

The EU has the right to act in the field of corporate in credit institutions according to Article 53(1) TFEU and to Article 114 TFEU.

Although, as described above, some Member States have taken some actions to reform corporate governance of credit intuitions, these actions fall short of introducing a comprehensive reform of corporate governance throughout the European Union. However, due to integrated capital markets and interrelatedness of the European financial sector, no reform could be successful unless adopted by the majority of EU jurisdictions. Whilst some Member States are taking specific measures to improve corporate governance in their credit institutions, these actions remain limited, as described in paragraph 4.1. above. Member States are hesitant to act at national level and adopt stricter rules due to the first mover disadvantage which could jeopardize a country's competitive position as a financial centre. This 'level playing field' argument is frequently used to resist regulatory reform. Credit institutions will threaten to move to other, more lenient, countries. Moreover, they will use their influence on politicians and the media to dilute reform efforts and protect their freedom to manage credit institutions as they want. Certain shareholders will join in these efforts, as they aim at inducing management to maximize shareholder wealth through increased risk taking. This would result in regulatory arbitrage and undermine or create new obstacles to the good functioning of the internal market.

In addition, unilateral reforms would not prevent contagion from other countries choosing not to regulate corporate governance in credit institutions. Assuming that failures in corporate governance would be possible in one Member States and would lead to the failure of a large credit institution as a result of excessive risk taking, the negative externalities from such a failure would easily impact on other countries, including those that have reformed corporate governance in their own institutions.

Finally, it results from the contributions to the public consultation that a uniform and consistent approach at European level is crucial to effectively deal with corporate governance weaknesses in credit institutions. Common standards at EU level are necessary to promote a well functioning internal market and avoid the development of different rules and practices in the Member States.

5. OBJECTIVES

The general, specific and operational objectives of the reform of corporate governance in credit institutions are presented in the following table.

Figure 5: Objectives

<table>
<tr><th>General</th><th>Specific</th><th colspan="3">Operational</th></tr>
<tr><td rowspan="9">Prevent failure of credit institutions

Reduce systemic risk</td><td rowspan="9">Prevent excessive risk-taking by credit institutions by remedying the weaknesses in risk governance system.</td><td rowspan="7">Increase the effectiveness of risk oversight by Boards</td><td rowspan="4">Improve effective challenge by Board of management decisions</td><td>Improve time-commitment of Board members</td></tr>
<tr><td>Improve expertise of Board members</td></tr>
<tr><td>Counterbalance management dominance</td></tr>
<tr><td>Improve diversity of Board composition</td></tr>
<tr><td colspan="2">Improve ownership by Board members of risk strategy</td></tr>
<tr><td colspan="2">Increase the priority given by Board members to consideration of risk issues</td></tr>
<tr><td colspan="2">Improve the information flows to Board on risk</td></tr>
<tr><td colspan="3">Improve the standing of the risk management function</td></tr>
<tr><td colspan="3">Ensure efficient monitoring of risk governance by supervisors</td></tr>
</table>

6. POLICY OPTIONS, ANALYSIS OF IMPACTS AND COMPARISON

In this part, options will be identified and analysed for policies which could target the problems described in Part 3 and could realise the objectives set out in Part 5. Then the choice of instrument will be discussed.

6.1. Substantive policy options: description, analysis of impacts and comparison

The substantive policy options that will be discussed are: A (baseline scenario), B (better implementation of existing EU framework) and C (new provisions on corporate governance). The options are discussed and measured against the general and specific objectives set out in Part 5. In the first section, option A, option B and option C will be discussed and compared. The second section will examine different sub-options under option C.

6.1.1. Discussion and comparison of options A, B and C

6.1.1.1. Option A - No action at EU level (baseline scenario)

This option implies a do-nothing policy which leaves the existing EU-measures as they are, without introducing new measures to remedy the identified weaknesses in risk governance in credit institutions. This option leaves a very high degree of flexibility to credit intuitions and to national supervisors which result in insufficient and diverging implementation of existing requirements. This option seems unlikely to achieve the underlying objective to improve the effectiveness of the risk governance and prevent excessive risk-taking by credit institutions and therefore reduce systemic risk.

6.1.1.2. Option B - Better implementation of existing EU framework

This option implies the better implementation of the existing EU legislative framework, i.e. the Directive 2006/46/EC, the Capital Requirements Directive and the new EBA guidelines on internal governance, as well as national corporate governance codes by credit institutions and supervisory authorities. This option would leave as similar degree of flexibility to credit institutions and to supervisory authorities as compared to the baseline scenario.

One method to incentivise credit institutions to put in place adequate risk governance arrangements is the possibility of credit institutions' arrangements being benchmarked and the results being put into the public domain. Another option would be to organise training seminars for banking supervisors in order to ensure uniform and effective supervisory review of the exiting corporate governance practices.

However, most existing risk governance provisions are part of corporate governance and are, for the time being, part of national corporate governance codes which are non-binding in nature. Future EBA guidelines would not be binding either. Therefore, the effectiveness of this option relies solely on market discipline and the effectiveness of supervisory monitoring, which, as shown in Part 3, do not work sufficiently.

Market discipline does not appear to have worked as shareholders tend to be passive with regards to excessive risk-taking by credit institutions or encourage short-term risk strategies. Supervisors do not necessarily have appropriate tools to effectively monitor the implementation of corporate governance principles by credit institutions, in many cases because their role is not specified in a legal instrument. Competent authorities can

also be subject to regulatory capture, applying their supervisory powers in order to favour their national financial centre. This could result in regulatory arbitrage, credit institutions choosing Member Sates with more lenient requirements as their headquarters.

The respondents to the public consultation, whereas recognising the importance of and the scope for improved implementation of existing principles, thought that this option will not be sufficient to achieve the underlying objective of sound risk governance. In their opinion, the existing rules need to be further specified and clarified in order to avoid future corporate governance failures.

Option B is therefore not the preferred option to achieve the objective of improved risk governance.

6.1.1.3. Option C - New provisions on risk governance

This option goes beyond the existing framework on corporate governance in credit institutions and implies the development of additional and enhanced provisions and guidelines to improve risk governance. These additional provisions will contain measures to achieve the underlying operational objectives, i.e. increase the effectiveness of risk oversight by Boards, improve the standing and independence of the risk management function and ensure efficient monitoring of risk governance by supervisors. The detailed sub-options under option C are further examined in Section 2 below and in Annex I.

This option will consist of measures which enhance transparency of corporate governance practices, principles-based, outcome-focused rules and more specific organisational requirements. It will leave less flexibility to credit institutions and supervisory authorities and thus avoid regulatory arbitrage. This option seems the most likely to achieve the specific objective of improved risk governance in credit institutions and therefore contribute to achieve the more general objective of preventing failures of credit institutions and reduce systemic risk. It will enshrine best practice in hard requirements, set minimum standards, and give clear guidance to credit institutions and to supervisors on what is expected with regard to sound risk governance. At the same time, this option will still leave enough flexibility to credit institutions and supervisory authorities to take apply new requirements in proportionate manner, taking into account, the nature, scale and complexity of activities of a credit intuition. The level playing field will be ensured by EBA guidelines which will provide for a common approach on the application of the proportionality principle and specify the detailed application of the new principles to ensure their uniform implementation. The results of the public consultation show a general support for the reform of the existing corporate governance framework and the introduction of new principles at European level, provided that future proposals of the Commission are sufficiently flexible and proportionate in order to take account the differences in business models of financial institutions, the nature of their activity, their size, complexity, legal form and different corporate governance systems and arrangements, and avoid box-ticking exercise. .

Option C is therefore the preferred option as compared to options A and B.

6.1.2. Discussion and analysis of sub-options under option C

Option C contains sub-options that relate to the operational objectives as identified in Part 5. This section shortly describes and analyses these sub-options. A detailed description, analysis and comparison of the sub-options are provided in Annex I.

The different sub-options have been chosen following the results of the public consultation on the Commission Green Paper as most likely to achieve the underlying operational objectives: **I**. Increase the effectiveness of risk oversight by Boards; **II.** Improve the standing and independence of the risk management function; **III**. Ensure efficient monitoring of risk governance by supervisors.

For the purposes of the discussion, the sub-options will be grouped according to the three operational objectives. Within each group, the sub-options will be measured against the corresponding more specific operational objectives set out in Part 5 and also, where relevant, the following criteria will be used:

Impact on effectiveness	The sub-options should achieve the operational objectives
Impact on flexibility	Credit institutions should be able to adapt the principles to their structures and the specific nature of their activities
Impact on enforceability	The transposition and implementation of the principle should be easy to monitor
Impact on the level playing field	Regulatory arbitrage between Member States and at international level should be avoided.

The different sub-options could be further classified into the following types: (i) measures which enhance transparency of corporate governance practices to the market and to the supervisors, (ii) principles-based, outcome-focused rules, leaving to credit institutions high degree of flexibility to achieve the underlying objective and (iii) specific and organisational rules, leaving credit institutions a limited degree of flexibility. In fact, given the nature of the problems identified in Part 3, a combination between measures enhancing transparency, outcome-focused principles and more specific rules establishing minimum standards will be mutually reinforcing and present an appropriate combination. For further details, see section on methodology in Annex I.

6.1.2.1. Sub-options to increase the effectiveness of risk oversight by Boards

The following table shows the sub-options under option C aimed at improving risk oversight by Boards of credit institutions. These sub-options are classified according to different specific operational objectives they aim to achieve. A detailed description, analysis and comparison of the sub-options are provided in Annex I together with the reasons why some of the sub-options have been rejected.

Figure 6: Sub-options to increase the effectiveness of risk oversight by Boards

Operational objectives	Retained sub-options	Rejected sub-options
Improve challenge by Board of management decisions		
Improve time commitment of Board members	- disclose the number of mandates of Board members in the annual report* - Board members must spend sufficient time to exercise their duties ** - limit the number of mandates a Board member may hold in different companies at the same time***	- disclose in the annual report the actual time spent by each Board member annually to exercise his/her function* - specify the minimum number of days that a Board member must spend per year to exercise its function***
Improve expertise of Board members	- disclose recruitment policy and the actual expertise of Board members in the annual report* - Board members shall be subject to an enhanced "fit and proper" test ** - Board members should receive appropriate induction and continuous training** - Nomination Committee at Board level***	- Board members must possess individually and collectively appropriate expertise** - set up detailed requirements with regard to the expertise of Board members***
Counterbalance management dominance	- prohibit cumulating mandates of Chairman and Chief Executive Officer in the same credit institution***	- disclosure of the existing practice* - Board members must behave independently from management** - minimum number of non-executive directors***
Improve diversity in Board composition	- disclose policy on diversity in annual report* - benchmarking of different practices at national and European level* - diversity must be one of the criteria of Board composition** - credit institutions shall establish a policy with regard to diversity** - put in place a quantitative target for gender balance***	- positive discrimination*** - increase employee participation***
Improve ownership by Boards of risk strategy	- Boards must produce a declaration on the adequacy of risk management systems* - Boards must publish on an annual basis a risk statement*	- Board must determine or approve the risk profile and strategy and any changes** - Board must approve new financial products***
Improve priority given by Boards to risk issues	- disclose policy and practice with regard to discussion and analysis of risk issues during Board meetings* - Boards must devote sufficient time to risk issues** - Risk Committee at Board level***	- minimum time that Board must be spend to discuss risk issues***
Improve the information flows to Board on risk	- disclose policy and practice with regard to the information flow on risk to the Board* - Board must determine the content, format and frequency of risk information it should receive ** - risk management function must be able to report directly to the Board or risk committee **	- specific structures and formats for information flows to the Board and specific escalation procedures***

** measures which enhance transparency, ** principles-based, outcome-focused rules, *** specific rules*

The following table shows the different impacts of the retained sub-options to improve risk oversight by Boards as compared to the baseline scenario. For detailed analysis of the impacts, see Annex I.

Figure 7: Analysis of impacts of retained sub-options: risk oversight by Boards

Sub-options	Effectiveness	Enforceability	Flexibility	Impact on level playing field	Estimation of related costs per credit institution
Improve time-commitment of Board members					
Disclosure of number of mandates	+	+	=	=	€600 - €1,000
Board members must spend sufficient time to exercise their duties	+	=	=	=	? linked to the process of recruitment and possible increase in remuneration
Limit the number of mandates, with exceptions on proportionality grounds	++	++	-	++	
Improve expertise of Board members					
Disclosure of existing practice	+	+	=	=	€600 - €1,000
Appropriate expertise	+	+	=	=	? linked to the process of recruitment and possible increase in remuneration
Enhanced "fit and proper" test	++	++	-	++	? linked to the process of recruitment and possible increase in remuneration
Induction and continuous training	++	+	=	+	€20,000 - 30,000
Nomination Committee with exceptions on proportionality grounds	+	++	-	++	€8,000 - 15,000
Counterbalancing management dominance					
Prohibit cumulating mandates of Chairman and Chief Executive Officer with exceptions on proportionality grounds	++	++	-	++	0
Improve diversity of Board composition					
Disclosure and benchmarking	+	+	=	=	€600 - €1,000
Diversity as one of the criteria of Board composition	+	=	=	=	0
Policy with regard to diversity	+	+	-	+	? linked to the process of recruitment and possible increase of Board members
Quantitative target for gender balance	++	++	--	++	
Improve ownership of Board for risk strategy					
Declaration on the adequacy of risk management systems	++	+	-	=	? could be significant and linked to the underlying internal process
Risk statement	++	+	-	=	€600 - €1,000
Improve priority given to consideration of risk issues					
Disclosure of existing practice	+	+	=	=	€600 - €1,000
Board shall devote sufficient time to risk issues	+	=	=	=	? should not be significant
Risk committee at Board level with exceptions on proportionality grounds	++	++	-	++	? should not be significant
Improve the information flow to Boards on risk					
Disclosure of existing practice	+	+	=	=	€600 - €1,000
Board must determine the content, format and frequency of risk information	+	+	=	+	0
Risk management function must be able to report directly the Board or risk committee	++	++	-	+	0

Magnitude of impact as compared with the baseline scenario: ++ strongly positive; + positive; – – strongly negative; – negative; = marginal/neutral; ? uncertain; n.a. not applicable

The retained sub-options aim at implementing at European level the recommendation of the revised Basel Principles that "the Board has overall responsibility for the bank, including approving and overseeing the implementation of the bank's strategic objectives, risk strategy, corporate governance and corporate values. The Board is also responsible for providing oversight of senior management". They have been chosen as most effective, proportionate, enforceable and efficient to achieve the underlying operational objective.

In order to increase effectiveness of risk oversight by Boards, the combination between different sub-options (measures enhancing transparency, outcome-focused principles and more detailed rules establishing minimum standards) seems necessary. These different sub-options will be mutually reinforcing and will not entail disproportional costs for credit institutions and supervisory authorities.

Sub-options with regard to disclosure will allow the market and the supervisors, at limited costs to credit institutions, to easily evaluate whether the existing practice is adequate taking into account the size, the nature and the complexity of activities of a credit institution. Disclosure of the number of mandates of Board members will allow the market and the supervisors, at limited cost to credit institutions, to easily evaluate whether a Board member has too many mandates, hampering his/her ability to devote sufficient time to the credit institution, thus facilitating supervisory review. Disclosure of recruitment policies and of expertise of Board members will inform the market and the supervisors on the required and actual expertise of Board members and allow them to verify that this expertise is adequate. Disclosure of exiting diversity and benchmarking of practices will make public credit institutions which do not have an appropriate diversity policy and thus will have a positive impact on the improved diversity in Boards. Disclosure of existing practice with regard to time devoted by Boards to risk will help supervisors to easily evaluate whether the Boards devote sufficient time to risk issues. Disclosure of the exiting policy (with regard to information flows will help supervisors to easily check what kind of information Board receives and on the timeliness of that information and asses whether this information flow is adequate. This facilitates supervisory review and contributes to reduce costs of supervision because competent authorities do not have to sear for information.

The sub-option limiting the number of mandates of Board members seems the most effective to achieve the underlying objective as compared to the sub-option specifying the minimum number of days a Board member must spend per year to exercise its function, which would be difficult to monitor and enforce .Limiting the number of mandates sets a minimum standard and provides clear guidance to credit institutions and supervisors on the number of mandates which would exceed the reasonable capacity of a Board member to spent sufficient time on the Board of a credit institution. It is therefore easy to monitor and facilitates supervision. On the other hand, providing exceptions to this limitation allows to take account of the different types of credit institutions and different situations of Board members. However, to avoid box-ticking, the sub-option limiting the number of mandates need to be combined with a general principle that a Board member should spend sufficient time to exercise his/her duties, which will allow supervisors to check

whether a Board member does in fact spend sufficed time, although the number of directorship he/she holds does not exceed the maximum.

The enhanced "fit and proper" test with minimum criteria although less flexible than a general principle that Boards should possess appropriate expertise, without minimum criteria, is effective and easily enforceable and ensures a level playing field. Although the two sub-options would have similar impacts and costs, enhanced "fit and proper" test seems to better achieve the underlying objective, provides more guidance to credit institutions and supervisors, and therefore reduces the risk of different national practices, whilst still remaining proportioned compared. This sub-option will be usefully complemented by induction and continuous training of Board members. In addition, setting a Nomination Committee at Board level will help prepare the decisions of the Board as regards the selection of candidates for Board membership and will ensure the independence of the selection process from management dominance. The proportionality of this requirements will be ensured by possible exceptions where establishing a separate Nomination Committee would not be appropriate.

As regards management dominance, the most effective way to ensure the independence of the Board in its oversight function and which is most easy to monitor and enforce is the separation of the function of the Chairman and the CEO, with possible exceptions in order to take into account particular circumstances. Sub-options requiring disclosure of the existing practice in the credit institutions as regards independence of Board members, that Board members must behave independently from management and to have a minimum number of non-executive directors on a Board of a credit institution, seem in fact either difficult to monitor, unenforceable or unduly inflexible and disproportionate.

Quantitative target for gender balance seems the most effective option to achieve the underlying objective of improved gender diversity as compared to positive discrimination. The latter sub-option seems in fact to be very difficult to monitor and enforce and would discriminate against men. Increasing employee participation in Boards, whilst contributing to enhance diversity would be difficult to implement, giving the existing differences in Member States regarding co-determination and employee participation regimes, which are subject to company law rules. However, quantitative targets for gender diversity are not flexible and cannot be adopted to particular situations of instituions of different types and sizes. It would also be inconsistent with the more general strategy of the Commission with regard to gender equality which forsees a two step approach, first encouraging self-regulation and eventually imposing hard quotas if the results of this self-regulation do not prove sufficient. A more principle-based sub-options on diversity policy and diversity as a criteria of Board composition would therefore be more appropriate. Although less effective than quantitative targets, these sub-options are more flexible, less costly and would help avoiding box-ticking and allow supervisors to ensure that credit institutions include diversity of views as one of the criteria of board composition, at the same level as time-commitment and expertise. This latter sub-option will also cover types of diversity other than gender balance for which a quantitative target is very difficult to foresee.

As regards risk ownership by Boards, only sub-option on risk statement and declaration on the adequacy of internal control systems seem to effectively achieve the underlying objective and remain proportionate. In fact, sub-option requiring systematic approval by the Board of all new products would be disproportionate, as it would entail involvement of Boards in operational issues, which is the responsibility of executive management. Sub-option requiring that Board must determine or approve the risk profile and strategy and any changes is superfluous as the existing EU legislative framework already prides for such duty.

The sub-option establishing a mandatory risk committee at Board level accompanied by exceptions to take account of different types of credit institutions seems to be the most effective, easily enforceable and proportionate to achieve the underlying objective of improved priority given to the consideration of risk issues. Alternative sub-option requiring minimum time that Board must be spend to discuss risk issues, although equally effective, would be disproportionate and difficult to put in place in practice as the minimum number of days necessary to fully cover all risk matters will vary enormously according to different types of credit institutions. However, in order to avoid box-ticking, the sub-option requiring a mandatory risk committee will be usefully complemented by the general principle that Board devote sufficient time to risk issues, which will allow supervisors to check that, even if there is a stand-alone risk committee, Boards of credit institutions spend adequate time to discuss risk issue taking into account the nature of the activities of the credit institution.

As regards information on risk, requiring specific templates and procedures for the information flow seems unduly inflexible and will not necessarily be effective. However, general principles that Board must determine the content of the information and that the risk management function should be able to report directly to the Board seem to be effective, flexible and efficient in order to achieve the underlying objective.

Most requirements should be immediately applicable except for limitation of mandates of Board members and separation of functions Chairman/CEO, where a transitional period could be appropriate to leave credit institutions sufficient time to implement these requirements.

The costs for credit institutions of the combined sub-options to increase the effectiveness of risk oversight by Boards should mainly be linked to the publication of required information, recruitment of suitable Board members and updating internal processes to take account of new requirements. Whilst costs linked to the publication of the information are easy to estimate and do not appear to be significant, other costs, such as those linked to recruitment and selection of Board members and eventual increase in their remuneration, are more difficult to quantify. However, it results from the questionnaire on costs sent to credit institutions that these costs would remain proportionate to the underlying objectives. For small credit institutions, any potential increase in costs could be further mitigated by applying the exceptions provided for by different sub-options and by the general principle of proportionality which already exists in the EU legislation.

The costs and impacts are further analysed in detail in Annex I and in Annex II.

6.1.2.2. Sub-options to improve the standing of the risk management function

The following table shows the sub-options under option C aimed at improving the standing of the risk management function. A detailed description and analysis of the sub-options is provided in Annex I together with the reasons why some of the sub-options have been rejected.

Figure 8: Sub-options to improve the standing of the risk management function

Operational objective	Retained sub-options	Rejected sub-options
Improve the standing and the authority of the risk management function	- disclose in the annual report their policy with regard to the standing and authority of risk management function* - head of risk management function must have an appropriate status and authority to influence risk strategy and risk-relevant management decisions** - risk management function must be created and have an appropriate status and authority and be independent from the operational and business units** - appoint an independent Chief Risk Officer *** - removal of the Chief Risk Officer must be subject to prior approval by the Board***	- head of risk management function must be member of executive management or Board***

** measures which enhance transparency, ** principles-based, outcome-focused rules, *** specific and organisational rules*

The retained sub-options aim at implementing at European level the recommendation of the revised Basel Principles that "banks should have an effective internal controls system and a risk management function (including a chief risk officer or equivalent) with sufficient authority, stature, independence, resources and access to the Board." They have been chosen as most effective, enforceable, proportionate and efficient to achieve the underlying operational objective. The following table shows the different impacts of the retained sub-options to improve the standing of the risk management function. For further analysis of the impacts, see Annex I.

Figure 9: Analysis of impacts of retained sub-options: standing of the risk management function

Sub-options	Effectiveness	Enforceability	Flexibility	Impact on level playing field	Estimation of related costs per credit institution
Disclose in the annual report their policy with regard to the standing and authority of risk management function	+	+	=	=	€600 - €1,000
Head of risk management function must have an appropriate status and authority to influence risk strategy and risk-relevant management decisions	++	=	=	=	0
Risk management function must be created and have an appropriate status and authority and be independent from the operational and business units	++	=	=	=	0
Appoint an independent Chief Risk	++	++	-	++	? limited cost

Officer					
Removal of the Chief Risk Officer must be subject to prior approval by the Board	+	++	-	++	0

Magnitude of impact as compared with the baseline scenario: ++ strongly positive; + positive; – – strongly negative; – negative; = marginal/neutral; ? uncertain; n.a. not applicable

It results from the analysis of the sub-options that a combination between measures enhancing transparency, outcome-focused principles and minimum standards is an appropriate combination. Different sub-options will be mutually reinforcing.

The disclosure of existing practice with regard to the status of the risk management function will allow supervisors to easily evaluate whether this stature is appropriate. This option could incentivise credit institutions to give the appropriate status to the risk management function as public disclosure allows for benchmarking of different practices in different credit institutions and for having a public view on whether a credit institution gives sufficient independence and authority to its risk management function as compared to its peers.

The sub-option regarding the establishment of a risk management function and its independence seems very effective to achieve the underlying objective and flexible enough. Sub-options requiring credit institutions to appoint a chief risk officer (with possible exemptions) with appropriate status and authority to be able to influence risk strategy and which should not be removed without prior approval of the Board, are very effective to achieve the underlying objective of having a strong and independent risk management function. In addition, these sub-options would contribute to a consolidated approach to risk management and minimize potential for compliance failures. At the same time these sub-options remain flexible enough to allow credit institutions to determine the appropriate position of the CRO according to their size and the nature of their activities. In comparison, sub-option requiring CRO to be part of the executive management or Board seems unduly inflexible and disproportionate. .

As regards different potential costs related to these sub-options, they seem to be marginal according to the responses to the questionnaire on costs sent to credit institutions and should mainly be linked to the setting up of the necessary internal processes. This is due to the fact that most credit institutions, especially the largest one, do already have a risk management function or equivalent and therefore should not recruit a significant number of additional staff to perform this function. For small credit institutions, any additional costs should be mitigated due to proportionality principle which aligns the necessary structures with the nature and complexity of the activities of the credit institution. . The costs and impacts are analysed in detail in Annex I and in Annex II.

6.1.2.3. Sub-options to ensure efficient monitoring of risk governance by supervisors

The following table shows the retained sub-options under option C aimed at improving supervisory review of corporate governance practices. A detailed description, analysis and comparison of the sub-options are provided in Annex I together with the reasons why some of the sub-options have been rejected.

Figure 10: Sub-options to ensure efficient monitoring of risk governance by supervisors

Operational objective	Retained sub-options	Rejected sub-options
Ensure efficient monitoring of risk governance by supervisors	- corporate governance issues must be part of a dialogue with supervisors and the adequacy of corporate governance structures must be part of supervisory review** - extensive supervisory review which must examine the ability of Board members to exercise their oversight function** - supervisors must review agendas and supporting documents for meetings of the Board and Board committees*** - supervisors must review the evaluation of the Board performance***	- supervisors must attend Board meetings***

*** principles-based, outcome-focused rules, *** specific and organisational rules*

The retained sub-options aim at implementing at European level the recommendation of the revised Basel Principles that "supervisors should regularly perform a comprehensive evaluation of a bank's overall corporate governance policies and practices and evaluate the bank's implementation of the principles." They have been chosen as most effective, proportionate and efficient to achieve the underlying operational objective.

The following table shows the different impacts of the retained sub-options to ensure effective monitoring by supervisors of risk governance. For further analysis of the impacts, see Annex I.

Figure 11: Analysis of impacts of retained sub-options: Ensure efficient monitoring of risk governance by supervisors

Sub-options	Effectiveness	Enforceability	Flexibility	Impact on level playing field	Estimation of related costs for a supervisory authority
Corporate governance issues must be part of a dialogue with supervisors and the adequacy of corporate governance structures must be part of supervisory review	++	=	=	=	0,000 €- 1,500,000 €
Extensive supervisory review which must examine the ability of Board members to exercise their oversight function	++	+	=	+	40,000 €- 12,000,000 €
Supervisors must review agendas and supporting documents for meetings of the Board and Board committees	+	++	-	++	? no precise estimation, costs are part of the general cost of corporate governance review
Supervisors must review the evaluation of the Board performance	+	++	-	++	? no precise estimation, costs are part of the general cost of corporate governance review

Magnitude of impact as compared with the baseline scenario: ++ strongly positive; + positive; – – strongly negative; – negative; = marginal/neutral; ? uncertain; n.a. not applicable

The combination of retained sub-options seems effective to achieve the underlying objective of effective monitoring by supervisors of risk governance. The overall impact on the level playing field and enforceability is positive. Some sub-options are less flexible for supervisory authority but this negative impact is mitigated by enhanced enforceability and positive impact on the level playing field. In addition, requiring supervisors to monitor corporate governance practices for compliance with new principles will allow supervisors to apply the whole range of sanctions available to them under the Capital Requirements Directive, such as requiring credit institutions to modify their practices or, in more extreme cases, withdraw the license of the institution or impose capital add-ons.

As regards different costs related to the sub-options, they appear to be relatively more important for some financial supervisors with large banking sectors with a big number of credit institutions to supervise, such as Germany, and that will have to put in place new internal processes and devote staff to the new tasks. These costs should remain limited for other financial supervisors with small banking sectors, such as Greece or Lithuania. However, those costs are inherent to improved supervision of corporate governance of credit institutions and thus could not be avoided if the underlying objective is to be achieved. Effective supervision of risk governance in credit institution which is followed by effective enforcement is crucial for the correct implementation of new principles. Furthermore, the potential costs could be mitigated by the future guidelines of EBA on internal governance which will give concrete guidance to supervisory authorities on their role in the monitoring of the implementation of the new principles, how to simplify the work for supervisors and methods to reduce unnecessary costs. Consequently, it seems that the potential increase in administrative burden for supervisors is justified by the underlying objective.

The costs and impacts are analysed in detail in Annex I and in Annex II.

6.1.3. Cumulative impact of sub-options under Option C

6.1.3.1. Impact on effectiveness to achieve the specific objective of preventing excessive risk-taking by credit institutions by remedying the weaknesses in risk governance system

The different sub-options under Option C are mutually reinforcing and present synergies which are most likely to contribute to improve risk governance of credit institutions with a view to efficiently controlling risk within credit institutions and prevent excessive risk-taking. They effectively respond to the underlying specific objectives and aim and changing the risk culture within credit institutions. Improved oversight by Boards of management decisions and risk strategies will not be sufficient without improved authority of the risk management function which monitors risk-taking on day-to-day basis and is the first barrier to excessive risk exposures. Internal control of risk will not be efficient without appropriate external oversight and eventual sanctioning of non-compliance by supervisors. Therefore, Option C seems to be the most likely to address the problems described in Part 3 o this document.

6.1.3.2. Impact on the available pool of suitable candidates for Board membership

The following policy options under Option C could have a potential impact on the availability of suitable candidates for Board membership:

- limiting the number of mandates of Board members;
- enhanced "fit and proper" test;
- quantitative target with regard to gender diversity;

Limiting the number of mandates and introducing a quantitative target for gender balance on Boards could potentially have a negative impact on the pool of experiences people available for Board membership, and thus on the objective of Board expertise. On the other hand, as a result of enhanced standards for selection of potential candidates (enhanced "fit and proper" test), the number of suitable candidates may also decrease accordingly. However, this would only be true if there were not enough experienced women and men to populate the Board rooms of credit institutions. But there is evidence of sufficient expertise within credit institutions, and the pool of selection of candidates for Board membership is currently artificially reduced as a consequence of networking and glass ceilings. According to a study[113], in Europe it is becoming considerably easier to recruit high-quality directors. In 2005, 54 % of respondents said that they were having difficulty recruiting, but by 2007 that figure had fallen to 42 %. In addition, opening the Board to more diverse candidates within credit institutions might give opportunity to people who were for the time being absent from Board rooms for many different reasons to become members of the Board. It would enlarge the pool of suitable candidates for board membership and improve expertise. In addition, induction and training of Board members would contribute to form more experienced pool of candidates. There is also evidence of a growing market of professional Board members with appropriate skills to populate Board rooms. Therefore, the potential negative impact on the pool of suitable candidates of the preferred policy options should not be significant.

6.1.3.3. Impact on costs for credit institutions and supervisors

As regards different costs for credit institutions linked to the sub-options under Option C, they mainly relate to the possible increase of administrative burden due to the preparation and publication of related information, to establishing the necessary internal processes and to a possible increase in remuneration of Board members. With regard to information disclosure, actual costs seem to be rather limited and would depend on whether the publication is on group or subsidiary level. Costs will be lower for publication at group level and higher for publication at subsidiary level for groups with a significant number of subsidiaries. According to the responses to the questionnaire on costs sent to credit institutions, recurrent disclosure costs and costs linked to internal processes are estimated at €33,000 - 55,000 per annum and one-off costs at €65,000 - 100,000. Other costs are difficult to estimate and their actual amount would depend on the way each individual

[113] Korn/Ferry Institute, *3rd Annual Board of Directors Study*, 2007

financial institution chooses to ensure the implementation of the policy options. These costs could be linked to the need to recruit additional Board members or to remunerate HR specialists or head hunters that will search for Board members with adequate time-commitment and expertise. Additional costs could result from a possible need to increase remuneration of the Board members with specific expertise and because the Board members will be able to cumulate a lower number of mandates. The average Board in Europe consists of 12 directors, the majority being non-executive directors with an average annual remuneration of €77,000. This means that recruitment of additional Board members or any potential increase in remuneration should not be significant. It cannot be excluded that there could be a potential impact of Option C on profitability of credit institutions and therefore on lending activities.

However, all these potential costs seem to be insignificant compared to the annual operational expenses for credit institutions' in EU which reached €454 billion for the whole European banking sector in 2009[114].

For national supervisors, the policy options under Option C could entail additional costs. These costs are linked to additional time spent to review corporate governance practices of credit institutions and to check that candidates for Board membership are fit and proper.

<u>Compliance costs related to extensive supervisory review of board's fitness and propriety:</u> according to the questionnaire on costs sent to supervisors, 17 out of the 18 responding supervisors indicate that the measure would lead to adaptations of the existing practice and thus involve additional costs for the supervisors, notably being the recurring costs of having to conduct a review more detailed than the current one and doing it more frequently than at present, and in some cases that the potential new measure targets non-executive board members, whereas the current review is focused on executive board members (/management board members).

<u>Compliance costs related to benchmarking of practices on diversity of board composition:</u> 16 out of the 17 supervisors that responded to this question indicate that the measure would involve additional costs for the supervisors, since no such measure currently exists. The sources of the additional costs are related to the setting up of a data base (investments in IT and data collection from all banks) and updating it (data consolidation.

<u>Compliance costs related to the requirement that risk governance issues to be part of the dialogue with supervisors and the adequacy of risk governance structures to be part of the supervisory review:</u> 11 of the 17 supervisors that responded to this question indicate that this measure would lead to no additional costs or no material additional costs. The reason is that the requirement of the measure is already in place (or largely so). In addition some mention that they also already carry out reviews of the corporate governance structures, but that there might be room for improvement: some additional effort for the review of

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[114] ECB, EU banking Sector Stability Report, September 2010.

corporate governance issues that go beyond risk management, or an annual review on top of the current review at authorisation.

The one-off costs are estimated between €120,000 - €1,100,000 and recurrent costs between €20,000 - €1,630,000. They should be small for competent authorities with a limited number of credit intuitions under supervision and higher for some financial supervisors with large banking sectors that will have to put in place new internal processes and devote staff to the new tasks.

6.2. Summary of the impacts of Options A, B and C

6.2.1. Impacts on stakeholders

The following table summarises the impact of Options A, B and C on different stakeholders.

Figure 12: Comparison between options by categories of affected stakeholder groups

Options \ Stakeholders	Credit institutions	Supervisors	Shareholders	Depositors	Taxpayers
Option A	0	0	0	0	0
Option B	?	?	?	?	?
Option C	+	+	++	++	++
Sub-options to improve effectiveness of risk oversight by boards	+	+	++	++	++
Sub-options to improve the standing of risk management function	+	+	++	++	++
Sub-options to ensure efficient monitoring by supervisors of risk governance	+	-	++	++	++

Magnitude of impact as compared with the baseline scenario (the baseline is indicated as 0): ++ strongly positive; + positive; – – strongly negative; – negative; = marginal/neutral; ? uncertain; n.a. not applicable

Option C is likely to have a positive impact on different stakeholders and the society as a whole[115].

[115] From a generic perspective, credit institutions are viewed as any firm with a broad range of stakeholders. In the case of banks, the ***stakeholder groups*** includes shareholders, who contribute to the formation of capital, as well as other categories who have a direct interest, such as: governments and regulators, staff, depositors, creditors and the general public

Improved risk governance will help avoid excessive risk-taking by credit institutions. The risk of failure of credit institutions due to excessive risk could also be lowered. Therefore, the impact on credit institutions should be positive. Option C will however entail additional administrative burden for credit institutions. In addition, more stringent requirements at European level could have a negative impact on the competitiveness of European credit institutions at international level. Contrary to capital requirements rules, G20 member did not engage to implement revised Basel Principles in their national legislation. For instance, the financial crisis has not led to widespread changes in US, although the Dodd-Frank Act did introduce corporate transparency rules, including provisions to force companies to disclose information on executive pay and measures designed to give investors greater say in nominating directors. Nor has the financial crisis triggered a corporate governance reform across Asia. It has been argued therefore that banks could leave European markets for markets with less regulation.

However, the possible decrease in competitiveness due to more stringent requirements could be mitigated by a positive impact on investors, depositors and other stakeholders. Improved risk governance would contribute to the resilience of the banking sector and improve investor confidence. The need for additional capital to cover excessive risk exposures could be reduced. Therefore, shareholder value will be preserved, moneys of depositors will be safely kept (and therefore no recourse to the deposit guarantee schemes will be needed), other creditors will not lose their moneys and ultimately Member States will not have to bail out credit institutions.

In addition, EU is encouraging G20 to undertake a review of corporate governance in credit institutions at international level, therefore working towards for a level playing field between European banking sector and credit institutions from third countries.
At a macroeconomic level, sound risk governance system of credit institutions would contribute to avoid future crises, increase confidence in the banking system and the efficiency of credit institutions' funding mechanisms, which accelerates economic growth.

As regards supervisors, option C would entail additional administrative burden to supervise risk governance of credit institutions. However, the implementation of new principles is the responsibility of credit institutions at first place. Clear and more specific rules will facilitate supervisory review of existing practice.

If risk governance in credit institutions is not improved, credit institutions may in the future encounter the same problems as described in Part 3, that is excessive risk-taking which may result in need for recapitalisation[116] and loss of shareholder value[117], credit institutions' failures, financial system instability and the need for Member States to intervene and bail out credit institutions[118]. This will have a negative impact on different

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[116] [64] For instance, in 2008 Royal Bank of Scotland had to raise £12 bn and Dexia €6 bn; and BNP Paribas had to rise in 2009 €4.3bn in capital.

[117] For instance, Dexia share lost 90% of its value in from 2008 to 2009.

[118] See Annex IV on the detail of financial crisis measures adopted by Member States until 31 March 2010.

stakeholders. When the social costs of an outcome exceed the private costs of an outcome, there is a negative externality effect.

Consequently, the benefits linked to this option C for different stakeholders seem to outweigh the underlying costs.

6.2.2. Impacts on the environment, employment and third countries

It is not expected that the new principles on corporate governance in credit institutions are going to have any direct impact on the natural environment or on third countries.
Measures enhancing disclosures could have an indirect impact on the issuance of paper documents and thus on the environment. However, compared to the general volume of paper documentation already published by credit institutions, this impact should not be significant. Branches of third country credit institutions are not as such subject to the European requirements. Consequently, there should be no significant impact on third countries of new provisions on corporate governance, unless Member States impose the same obligations to these branches as for other EU subsidiaries. In this case the impact on the third countries will be the same as for EU Member States.
As explained in Annex I, the introduction of measures on diversity in Boards' composition is likely to have a positive impact on the gender policy of the EU, breaching glass ceilings and helping women to access leadership positions in companies and could have a positive impact on women employment.

6.3. Choice of instrument

The new EU principles on corporate governance in credit institutions could be included in a Commission Recommendation or in a legislative instrument (a Directive or a Regulation).

6.3.1. Recommendation

A Commission Recommendation could be envisaged to implement new principles on corporate governance in credit institutions. Such a Recommendation would have the advantages of flexibility that hard law lack. Soft laws have been described as "rules of conduct which, in principle, have no legally binding force but which nevertheless may have practical effects"[119]. Although credit institutions may choose to conform to soft law, there is an assumption that behaviour is more likely to be consistent with codified guidance and statements of best practice than with binding legislation. It has been argued that non-binding rules can have the same political and social effects and benefits as hard law[120]. But, because soft law is not legally binding, implementation rests solely on the goodwill of credit institutions and where such goodwill is absent, soft law could result in non-compliance.

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119 See Snyder, F., *Soft Law and Institutional Practice in the European Community,* Law Working Paper 93/5. Florence, European University Institute, 1993

120 Borchardt, G. M. and Wellens, K. C., *Soft Law in European Community Law*, European Law Review, 1989

The question thus is whether organisations would voluntarily pay the price for implementing adequate governance frameworks based on best practice and recommendations or whether more prescriptive rules are needed. The financial crisis has shown the limitations of the current self-regulating system of largely voluntary codes and high-level, principle-based legislation. As shown by the financial crisis, concerns for reputation alone are unlikely to deter each and every credit institution from misconduct. Risk-taking managers can depend on barriers to information, and information asymmetries, which will allow them to engage in unethical behaviour, for a considerable time, before being detected[121]. Even where detection takes place, this may have a limited effect on senior managers as they may simply switch jobs.

External pressures in the form of market forces and shareholder scrutiny can play a role in ensuring adequate governance structures. Market discipline could force credit institutions to implement adequate structures without necessarily having a binding legislative framework. However, as described in Part 3, the financial crisis has also shown the limitations of market and shareholders' control of corporate governance.

6.3.2. Legislative instrument

It could be argued that more rigid, prescriptive regulation would result in “form over substance” compliance while failing to achieve better risk governance and more effective Board and oversight structures. However, more detailed, prescriptive legislation could be seen as the only means of ensuring proper corporate conduct.

A Regulation does not seem to be an appropriate instrument for the implementation of principles on corporate governance. Although the objective of the Commission is to set up a comprehensible and sufficiently detailed framework for corporate governance, the diversity of corporate governance structures and company laws in Member States does not allow for a directly applicable "one size fits all" approach. There is a need for a degree of flexibility for the Member States as to the manner to implement the new legislation according to their national company law and corporate governance environment.

The Capital Requirements Directive already contains some high-level principles with regard to organisation of internal governance of credit institutions and gives the Commission the power to adopt delegated acts. This Directive also has the advantage of being a legally binding instrument which at the same time leaves to Member States the flexibility to adapt measures on corporate governance to their national legislative framework. It is also a suitable instrument to reinforce the role of the supervisors with a view to empower them to assess the corporate governance practices of financial institutions in a broader context of sound risk management. It also allows for effective application of the proportionality principle under the supervisory review. It seems therefore to be a suitable instrument for the new provisions on corporate governance.

[121] See, for example, Kerviel case at Société Générale.

Commission could either amend this Directive in order to specify existing principles and give supervisory authorities the power to oversee more effectively corporate governance practices in credit institutions or adopt implementing measures. It seems appropriate to amend this Directive rather than introduce new measures by a delegated act, as new provisions touch on some sensitive aspects of national company law, such as limitation of number of mandates and quantitative targets on gender balance.

6.4. Consistency

New principles on corporate governance will apply to all institutions which are covered by the requirements of the Capital Requirements Directive (credit institutions and investments firms). Although good corporate governance is essential for any type of financial institution, the main weaknesses in corporate governance revealed by the financial crisis were primarily witnessed in the banking and investment banking sector, rather than the **insurance and fund management industry**. This is why in the first instance it is proposed to limit the new provisions on corporate governance to financial institutions covered by the CRD. Furthermore, insurance and fund management have recently been subject to a legislative reform[122] which introduced, *inter alia*, detailed rules on internal governance arrangements for these types of financial institutions. These new rules were not introduced as a reaction to particular weaknesses in corporate governance in these institutions but were part of a more general reform of these sectors. The Commission will examine these rules and their practical appreciation in order to judge whether they provide an appropriate framework and, if so, whether, they need to be adjusted to ensure consistency amongst the financial services industry.

The **engagement of shareholders** is an issue of relevance not just for financial institutions, but also for companies more generally. On the basis of the evidence gathered during the preparation of the Green Paper on corporate governance in financial institutions, the findings regarding the lack of shareholder engagement and the reasons for this are, to a large extent, also relevant as regards shareholder behaviour in listed and non-listed companies generally. In this context, the Commission decided to publish a Green Paper on corporate governance framework which will consult specifically, *inter alia*, on different possible ways forward to improve shareholders involvement in companies and incentivise shareholders to act with regard to long-term interest of their companies. Consequently, the problem of shareholder inaction with regard to excessive risk-taking by credit institutions will be dealt with as a follow-up to that Green Paper. In addition, in its Communication on a possible regime for reorganising and resolving cross-border banking groups under a coordinated or integrated resolution framework envisages modifying existing EU rules in order to ensure that national authorities will be able to

[122] 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), *OJ L 335, 17.12.2009, p. 1–155*; Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), *OJ L 302, 17.11.2009, p. 32–96.*

carry out certain operations (as e.g. capital increases) without having to seek shareholder approval.

7. MONITORING AND EVALUATION

The Commission is the guardian of the Treaty and therefore will monitor how Member States have implemented the changes of the Capital Requirements Directive. Where needed, the Commission services will offer assistance to Member States for the implementation of the legislative changes in the form of transposition workshops with all the Member States or bilateral meetings at the request of any of them. When necessary, the Commission will pursue the procedure set out in Article 258 of the Treaty in case any Member State fails to respect its duties concerning the implementation and application of Community Law.

The evaluation of the consequences of the application of the legislative measure could take place three years after the entry into force of the legislative measure in the form of a Commission report to the Council and the European Parliament. The Commission will be monitoring the application of the Capital Requirements Directive, as amended, through EBA and an extensive and continuous dialogue with all major stakeholders, including market participants (credit institutions, investors). It may also use of the findings of studies carried out by stakeholders.

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ANNEX I DESCRIPTION, ANALYSIS AND COMPARISON OF SUB-OPTIONS UNDER OPTION C

Methodology

This Annex describes in more detail the sub-options under the substantive option C (New provisions on risk governance), includes a screening of the sub-options and performs an assessment of their impacts. Sub-options will be grouped according the underlying objectives: I) Increase effectiveness of risk oversight by Boards; II) Improve standing of the risk management function; and III) Ensure effective supervisory review of risk governance.

Within each group, the sub-options will be presented and discussed separately according to each more specific operational objective as described in Part 5 of the impact assessment. The sub-options for each operational objective are complementary and not mutually exclusive, so the preferred policy option to achieve an objective could be composed of a combination of different sub-options.

The sub-options will be further classified in three types: (i) measures which enhance transparency of corporate governance practices, (ii) principles-based, outcome-focused rules with high degree of flexibility and (iii) strict rules with limited degree of flexibility.

The sub-options are discussed and measured against the relevant operational objectives set out in Part 5 of the impact assessment and also, where relevant, the following criteria will be used:

Impact on the supply of candidates for Board membership and for risk management function	The pool of suitable candidates for Board membership and for risk management function should not be significantly reduced
Impact on the clear division of responsibilities	In order to avoid moral hazard, there should be a clear division of responsibilities between executive management, operational units and the risk management function
Impact on the enforceability	The implementation of the principle should be easy to monitor
Flexibility	Credit institutions should be able to adapt the principles to their structures and the specific nature of their activities
Impact on the level playing field	Regulatory arbitrage between Member States and at international level should be avoided.
Efficiency	A measure of cost/benefit comparing the effectiveness to reach the objectives with the costs of reaching them

The sub-option improving disclosures are useful and efficient but their effectiveness depends to a large extent on implementation and supervision. Transparency requirements contribute to market discipline, facilitate monitoring and enforcement and reduce the cost of financial supervision as supervisors will not need to search for information. However, market discipline presupposes that a firm has private sector stakeholders who are at risk of financial loss from the firm's decisions and who can take actions to ''discipline'' the firm, that is, to influence its behaviour. But, as described in Part 3 of the impact assessment, the financial crisis has shown the limits of shareholders' and other stakeholders' control of credit institutions and their incapacity to effectively influence management behaviour. Supervisors also must be able to enforce the implementation of sound risk governance. If they do not have the necessary powers, transparency of existing practices will not serve its purpose. Therefore, transparency could be a useful tool to inform the market and the supervisors of the credit institutions practices but it would not be sufficient on its own to remedy the weaknesses in the corporate governance in credit institutions. Consequently, it seems appropriate to combine enhanced disclosure with substantive rules and improved supervisory review.

Sub-options which consist in more specific and organisation rules have a positive impact on enforceability and on the level playing field as they provide minimum standards, allow for a consistent approach by credit institutions, Member States and supervisory authorities, give clear guidance of what is expected and facilitate supervision and enforcement. Supervisors can easily verify that the minimum rules have been complied with. Although these sub-options could have a negative impact on the flexibility left to credit institutions, this negative impact could be mitigated by the application of the proportionality principle according to which credit institutions should comply with the rules according to their size, the nature and the complexity of their activities.

As corporate governance is about behaviour, the cultural change is essential. Consequently, there is a need to accompany specific rules which set minimum standards by principles which focus on the desired outcome that is on the underlying objectives. In that way, credit institutions will have to implement the principles in their spirit and supervisors will be able to verify that even in the situation where a credit institution complies with minimum requirements, its practice is adequate with regard to the complexity and the nature of its the activities. The sub-options which are outcome-focused may not have a positive impact on the enforceability and on the level playing field between different credit institutions and Member States as compared to the baseline scenario. However, these principles leave the necessary flexibility to credit institutions to adapt their practices to their specific structures and avoid box-ticking.

I. OPTIONS TO INCREASE EFFECTIVE RISK OVERSIGHT BY BOARDS

Section 1: Lack of effective challenge of senior management decisions by Boards

A) Board time-commitment

1) Measures to improve transparency of corporate governance practices

1. a. Disclose the number of mandates of Board members in the annual report. This sub-option would entail a public disclosure in the annual report of the number of mandates a Board member holds in different companies.

1. b. Disclose in the annual report the actual time spent by each Board member annually to exercise his/her function in the credit institution. It could also be foreseen to disclose the time each Board member commits per year to the credit institution (Board meetings attendance, time spent to prepare the Board meetings, etc.)

For the time being, there is no disclosure requirement in CRD regarding the time commitment of Board members. Greater transparency is aimed at fostering market discipline through public disclosure and at the same time providing supervisory authorities with the information required for effective, risk-based and proportionate supervision. Consequently, both sub-options could be envisaged to encourage Board time commitment in credit institutions. However, to achieve the underlying objective and be truly informative, the information provided needs to be accurate. With this respect, the second sub-option (1.b.) seems to be less easy to put in place in practice. Obtaining information on exact time spent by each Board member to exercise its functions and verifying its accuracy could be time-consuming. Whereas the number of Boards meetings per annum and the minutes of those meetings could be an indication, the declaration of Board members themselves is the main source of such information. Consequently, the accuracy of those declarations needs to be checked externally which entails additional costs. By comparison, information on the number of mandates of Board members is much easier to obtain and to verify. At the same time it gives useful information on the time available to Board members and provides valuable insight into the internal structure and management policies of a firm. Consequently, option 1.a. is a preferred option and option 1.b. should be discarded.

The primary costs of increased disclosure are the cost of preparing and disseminating the information. As credit institutions do already have to publish a lot of periodic information for public use but also for supervisory review, the additional cost of preparation and dissemination of information under option 1.a. will not be very high. This cost could be relatively higher for small companies as compared to larger ones, but they remain low in any case. It results from the responses to the questionnaire on costs sent to credit institutions that annual cost of option 1.a. per legal unit could vary between 600 and 1,000 euros, which does not seem disproportionate compared to the expected benefits, i.e. facilitated monitoring by supervisors who do not have to search for information and thus reduced cost of supervision. Moreover, for listed credit institutions which already

disclose such information under a corporate governance code, there will be no additional cost linked to this sub-option. For detailed description of costs, see Annex II.

2) Principles-based, outcome-focused rules with high degree of flexibility

2. a. Require that Board members spend sufficient time to exercise their duties as a criterion for recruitment and on an ongoing basis.

This sub-option would include requiring the ability of a Board member to devote sufficient time to his/her duties as a criterion for selection of the candidate by credit institutions. In addition, Board members would be required to devote sufficient time to their duties on an ongoing basis.

This sub-option implements the revised Basel Principles recommendation that in identifying potential Board members, the Board should ensure that the candidates are able to commit the necessary time and effort to fulfil their responsibilities. There is currently no such requirement in CRD. According to the results of the public consultation, such a principle focused on the desired outcome will avoid box-ticking, provide different credit institutions with enough flexibility to adapt their practices to their particular situation and at the same time is likely to achieve its underlying objective of improved time-commitment of Board members.

Compared to the baseline scenario, candidate Board members would in a flexible way be encouraged not to accept additional Board memberships if they do not have the sufficient time to devote, and incumbent Boards would be encouraged to implement the principle. Moreover, the principle would encourage that Board members actually spend the necessary time on the Boards where they have a seat.

However, such general principle, to be really effective to achieve the underlying objective, needs to be correctly implemented by credit institutions and therefore it would seem that there is also a need to have its implementation monitored by financial supervisors. It could be subject to different interpretations and practices in credit institutions but also by different Member States and thus allow for regulatory arbitrage. To mitigate this, there will be a need for coordination at European level but, as further explained below (see 4. Combination of different sub-options), some supplementing sub-options establishing minimum standards for Board members to commit sufficient time to their duties could also be envisaged.

Depending on the way the individual financial institution chooses to ensure the implementation of the principle, there could be costs both for the company and for the candidate Board member, but we have no cost estimates available.

The requirement for Board members to devote sufficient time to their duties in a credit institution may also result in the decrease in the number of Board positions a Board member can hold at the same time in different credit institutions. Consequently, there can be a negative impact on the number of people available for Board memberships. However, this negative impact can be mitigated by enlarged criteria for selection of

Board members breaking some glass ceilings, in particular with regard to the gender balance on Boards (see sub-options under point C below). Procedures to promote candidates within credit institutions could also mitigate this impact. Finally, the eventual negative impact on the pool of available candidates seems to be acceptable with regard to the overall objective which needs to be achieved.

The possible decrease in the number of Board positions a Board member can hold at the same time can also result in the need for credit institutions to pay more to its Board members. In fact, if a Board member cannot cumulate a large number of positions at the same time, he/she may need to be remunerated better for the reduced number of positions he/she can hold. However, the exact amount of this costs is difficult to measure and will depend on the market practice.

3) Strict rules with limited degree of flexibility

3. a. Limit the number of mandates a Board member of a credit institution may hold in different companies at the same time, subject to proportionality. This sub-option would set this limit at one executive mandate to be cumulated with maximum two non-executive mandates or maximum four non-executive mandates to be cumulated at the same time in different companies. Different mandates within the same group should be counted as one mandate. In order to take into account the size and the nature and the complexity of activities of a credit institution and specific situations which may occur during the life of the credit institution where this limit would not appear appropriate, a boar member could cumulate more mandates, subject to the control of supervisory authorities.

In fact, it results from the interviews with credit institutions that non-executive Board members are expected to spend at least two days a month to prepare Board meetings in addition to six Board meetings in average per annum. More time commitment is expected from directors which are members of different committees. It seems reasonable therefore to set a limit of four non-executive mandates, subject to proportionality.

Currently, a limit on the number of mandates of members of the Board is not foreseen in the CRD or in draft EBA guidelines. Such a limit would, however, effectively contribute to achieving the objective of improved time-commitment of Board members as it would avoid cumulating too many functions at the same time, where that would otherwise be the case[123]. Also, limiting the number of seats one person could be on would give more people the opportunity to get Board experience, including more women and other under-represented groups, and thus have a positive spill-over effect on the objective to increase Board diversity.

[123] For the time being, in Member States where legislation or a corporate governance code provide for a limitation in a number of mandates, this number is limited in average to five.

However, a large majority of respondents to the public consultation consider a general rule on limitation of the number of boards on which a director may sit as inappropriate. One argument expressed against such limitation is that there are not enough experienced women and men to populate the Board rooms of credit institutions. Consequently, limiting the number of mandates will have a negative impact on the pool of people available for Board membership, and possibly on the objective of Board expertise. However, as already mentioned above (see sub-option 2.a.), this negative impact can be mitigated. A limitation of mandates might give opportunity to people who were for the time being absent from Board rooms for many different reasons, including exclusion from networks, to become members of the Board. It might help breaching existing glass ceilings and bring more diversity. In this respect, one of the solutions might be changing the ways of working of nomination committees, in order to widen their perspective.

Another argument against such a measure would be that a strict limitation could be seen as too arbitrary and inflexible, and would not allow taking account of the situation of each particular financial institution and individual circumstances of each director. In fact, smaller credit institutions or those in smaller markets where the available "pool" of candidates can be limited may not be able to avoid cross-memberships on Boards of directors. Also, given the local focus of smaller banks, they may in fact find it most effective to have local businesspeople or customers on their Boards. Also, some Board members could be able to manage more mandates than the restriction allows. However, this issue may be easily solved by the proportionality principle which would allow for exceptions under the control of the national financial supervisor to take account of different situations of particular individuals and particular credit institutions. Also, limiting the number of mandates still leaves enough flexibility to Board members to divide their time between different memberships as needed and appropriate in particular circumstances.

Finally, some respondents to the public consultation were of the opinion that such a limitation would not in fact guarantee that a Board member will dedicate enough time for his/her position in each given situation and could result in a box-ticking exercise. It is true that the limitation would not directly target the time spent on each individual Board, but rather targets the situations where too many Board commitments in itself is a problem for the possibility to devote sufficient time to all the Boards. However, those two perspectives are part of the same root problem. Therefore, if a restriction on the number of mandates is combined with the general principle of sufficient time commitment described above, and both measures are made subject to effective supervisory review, it should effectively deal with this issue.

There would not be any material direct compliance costs for credit institutions implementing this sub-option, except, as mentioned in sub-option 2.a., that the limitation of Board memberships may result in the need for credit institutions to pay more to its Board members. This possible additional cost seems, however, justified compared to the underlying objective.

3. b. Specify the minimum number of days that a Board member must spend per year to exercise its function in a credit institution.

This option seems at first sight also to be able to contribute effectively to achieve the objective of improved time-commitment of Board members. However, such measure would be difficult to put in place in practice. Whilst it is expected that Board members should spend at least 2 days per month in a credit institution, it would be difficult to for credit institutions and supervisors to monitor that that each Board member actually commits at least this amount of time. Time commitment does not only consist of attendance at Board meetings but also comprises time spend to prepare these meetings, to read different documents and to understand the management decisions. However, whether a Board member performs all these tasks and devotes sufficient time to them would be very difficult to verify in practice, as opposed to the maximum number of mandates a Board member may hold (sub-option 2.b.). .. This sub-option is therefore discarded.

4) Combination of different sub-options

It results form the discussions of the sub-options that a combination between measures enhancing transparency, outcome-focused principles and more detailed rules establishing minimum standards is an appropriate combination. Each individual sub-option would not suffice alone to achieve the underlying objective of improved time commitment of Board members. Different sub-options will be mutually reinforcing and will not entail disproportional costs for credit institutions.

Disclosure of the number of mandates (sub-option 1.a.) will allow the market and the supervisors, at limited costs to credit institutions, to easily evaluate whether a Board member has too many mandates (including in cases it formally respects the maximum number of mandates), hampering his/her ability to devote sufficient time to the credit institution, thus facilitating supervisory review. Limiting the number of mandates (sub-option 3.a.), although not supported by majority of the respondents to the public consultation, seem very effective to achieve the underlying objective as it sets a minimum standard and provides clear guidance to credit institutions and supervisors on the number of mandates which would exceed the reasonable capacity of a Board member to spent sufficient time on the Board of a credit institution. However, to avoid box-ticking, a general principle that a Board member should spend sufficient time (sub-option 2.a.) allows supervisors to check whether a Board member with the number of mandates that does not exceed the limit does in fact commits sufficient time to its functions.

As a result, the following sub-options will be retained:

Sub-option 1.a. Disclose the number of mandates of Board members in the annual report

Sub-option 2.a. Require that Board members spend sufficient time to exercise their duties as a criterion for recruitment and on an ongoing basis

Sub-option 3.a. Limit the number of mandates a Board member of a credit institution may hold in different companies at the same time

Table 1: Comparison of the sub-options (time commitment)

	Effectiveness	Impact on supply of candidates	Flexibility	Enforceability	Impact on level playing field	Efficiency
Sub-option 1a	+	=	=	+	=	+
Sub-option 1b	=	=	=	=	+	-
Sub-option 2a	+	-	=	=	-	+
Sub-option 3a	++	-	-	++	+	++
Sub-option 3b	++	-	--	+	+	-

Magnitude of impact as compared with the baseline scenario: ++ strongly positive; + positive; – – strongly negative; – negative; = marginal/neutral; ? uncertain; n.a. not applicable

B) Expertise of Board members

1) Measures to improve transparency of corporate governance practices

1. a. Disclosure of recruitment policy and of expertise and skills of Board members in the annual report. This sub-option entails a requirement to disclose in the annual report the recruitment policies, the criteria chosen to select the candidates proposed for Board membership as well as the skills and expertise of current Board members. The results of the public consultation show a general support for such an enhanced disclosure. 101 out of 134 respondents that provided an answer to the relevant question favoured this sub-option. For the time being, there is not such disclosure requirement in the CRD.

This sub-option could incentivise credit institutions to set up a policy which would promote enhanced expertise of Board members as it would provide the public with the insight on the practices of the credit institution and allow for the benchmarking of the existing practices and thus compare the credit institution to its peers. However, as shareholders have the final say on the nomination of Board members, the recruitment policies could be overridden by shareholders will. In that case, this sub-option would have a limited impact on the increase in Board's expertise.

In addition, as already mentioned above, measures to improve transparency are a useful tool to inform the market and the supervisors of corporate governance practices but they are not necessarily sufficient by themselves if not properly sanctioned by the market. To be really effective, they need to be accompanied effective monitoring of their implementation but it is also possible to complement them by other sub-options establishing substantive provisions with regard to expertise requirements for Board members.

The primary costs of increased disclosure are the cost of preparing and disseminating the information. As credit institutions do already have to publish a lot of periodic information for public use but also for supervisory review, the additional cost of preparation and dissemination of information under option 1.a. will not be very high. This cost could be relatively higher for small companies as compared to larger ones, but they remain low in any case. It results from the responses to the questionnaire on costs sent to credit institutions that annual cost of option 1.a. per legal unit could vary between 600 and 1,000 euros, which does not seem disproportionate compared to the expected benefits, i.e. facilitated monitoring by supervisors who do not have to search for information and thus reduced cost of supervision.

2) Principles-based, outcome-focused rules with high degree of flexibility

<u>2. a. Board members must possess individually and collectively appropriate expertise on recruitment and on an ongoing basis.</u> This sub-option puts in place a general principle without specific criteria as regards the required skills and therefore leaves a high degree of flexibility to credit institutions and to supervisors to determine what the appropriate level of expertise of Board members is.

This sub-option would mean that credit institutions should select their candidates for Board membership taking into account their skills and expertise and ensure that these skills are appropriate to the nature and the complexity of the activities of the credit institution. Credit institutions should also ensure that once the Board members are appointed, their skills remain to be adequate to the nature and the complexity of the activities of the credit institution as it evolves over time. However, it leaves to the credit institution the responsibility to determine what the appropriate skills are.

Such a requirement seems at first sight likely to achieve the underlying objective of having a more experienced Board able to effectively challenge management decisions. At the same time, such a principle would provide different credit institutions with enough flexibility to adapt their practices to their particular situation.

However, as already mentioned above, such general principle to be really effective to achieve the objective of having experience and skilful Board needs to be correctly implemented by credit institutions and therefore it would seem that there is also a need to have it monitored by financial supervisors. Also, it could be subject to different interpretations and practices in different Member States and thus allow for regulatory arbitrage.

In addition, the Capital Requirements Directive already contains a provision in its Article 11 requiring that competent authorities shall not grant authorisation to the credit institution if the persons who effectively direct the business of the credit institution "are not of sufficiently good repute or lack sufficient experience to perform such duties". As described in Part 3 of the impact assessment, this provision did not ensure that Board members of credit institutions possessed sufficient experience and skills in practice. Therefore, there is a doubt that such a general principle would effectively achieve the underlined objective. Therefore, there is a need to examine other sub-options to

determine which one would be most effective and proportionate to achieve the underlying objective.

This option could have a negative impact on the supply of candidates for Board membership. As a result of enhanced standards for selection of potential candidates, the number of suitable candidates may decrease accordingly. It could also result in the need for credit institutions to remunerate better experienced and skilful Boards (see remarks under point A, sub-option 2.a.).

2. b. Create an enhanced "fit and proper" test for Board members that will specify the criteria that Board members must possess individually and collectively with regard to appropriate skills and expertise on recruitment and on an ongoing basis.

As compared to the previous sub-option, this sub-option would set general minimum criteria with regard to expertise for recruitment of Board members and require that these criteria should also be fulfilled during the duration of their mandates to enable Board members to effectively exercise their oversight function.

As for the previous sub-option 2.a., credit institutions should select their candidates for Board membership taking into account their skills and expertise and ensure that these skills match the minimum criteria of this sub-option and that they are appropriate to the nature and the complexity of the activities of the credit institution. Credit institutions should also ensure that once the Board members are appointed, their skills remain to be adequate to the nature and the complexity of the activities of the credit institution as it evolves over time.

In addition, the following criteria would be included in the sub-option: Board members should possess individual expertise and collective understanding of all material risks of the credit institution, independence of mind, honesty and integrity and be able to effectively and constructively challenge management decisions. As a supplement to this sub-option, the fulfilment of these criteria could be subject to extensive supervisory review which should examine the ability of Board members to exercise their oversight function on recruitment but also on regular basis. The sub-options regarding the supervisory review of Board expertise and skills are further described below (see chapter III).

This sub-option would align EU requirements with the revised Basel Principles recommendation that Boards should possess, both as individual Board members and collectively, appropriate experience, competencies and personal qualities, including professionalism and personal integrity. Currently, Article 11 of the CRD does not specify any criteria for suitability of Board members.

The results of the public consultation show support for extending the fit and proper test to include technical and professional skills as well as individual qualities of future members of the Board. 68 respondents out of 127 that provided an answer to the relevant question favoured this sub-option. Some respondents think that Boards should have expertise and knowledge collectively and should be able to challenge management as a team, instead of

each candidate possessing all set of specific skills and qualities. Some respondents mention the difficulty to find an appropriate test for individual qualities, the appreciation of which would always be subjective. A number of respondents emphasise that increased competence should not be detrimental to independence and diversity of board members.

This sub-option has the advantage of responding to the above-mentioned concerns, leaving sufficient flexibility to credit institutions to adapt the required skills to their particular situation while at the same time defining a precise framework and giving enough guidance to credit institutions and supervisors regarding the required profile of Board members of credit institutions.

However, it could have a negative impact on the supply of candidates for Board membership. As a result of enhanced standards for selection of potential candidates, the number of suitable candidates may decrease accordingly. However, as mentioned under point A, this negative impact can be mitigated by opening the Board to more diverse candidates and promoting people internally within credit institutions. In any case, such a negative impact seems proportionate to the underlying objective of having an experienced Board able to effectively challenge management decisions.

This sub-option could also result in the need for credit institutions to remunerate better experienced and skilful Boards (see remarks under point A, sub-option 2.a.). Nevertheless, these possible additional costs seem proportionate as compared to the underlying objective.

Also, some respondents to the public consultation were opposed to extending the fit and proper test to professional skills and individual qualities of candidates because supervisors are not better suited than shareholders to select board members and thus should not be excessively intrusive in the nomination process. One respondent considered that excessive intervention of supervisors could result in an undue transfer of liability to the supervisor. However, this sub-option leaves the responsibility to select board members to credit institution itself, supervisors checking that the criteria for suitability have been respected. Therefore, supervisors will not substitute themselves to shareholders or the credit institution.

2. c. Appropriate induction and continuous training of Board members. This sub-option would require credit institutions to set up specific training programmes for Board members depending on the needs of the credit institution and to devote sufficient resources to this training. There is no such requirement currently in the CRD.

Respondents to the public consultation that expressed their opinion on the subject (134) were all in favour of this sub-option. While this sub-option would not be sufficient in itself to achieve the objective of having competent Board members able to effectively challenge management, it could usefully complement the sub-option on enhanced "fit and proper "test" (sub-option 2.b.) and help Board members acquire, maintain and deepen their knowledge and skills and to fulfil their responsibilities. Therefore, it could be useful to ensure that Board members have access to programmes of tailored initial and ongoing

education on relevant issues and that the Board dedicates sufficient time, budget and other resources for this purpose, in addition to the sub-option 2.b.

The annual compliance costs related to this option would vary according to the size of the credit intuition's Board, the complexity of its activities and the extent to which the individual credit institution already has such a practice. At the same time, it could be relatively higher for small banks than for big ones. Annual costs seem to range between 20,000 and 30,000 € whereas a one bank thinks that it would incur significant additional costs. However, this sub-option seems to be proportionate as compared to the underlying objective. In particular, for small financial institutions with no complex activities and risk exposures it would be less costly to train their existing Board members in order for them to attain the required expertise level than to recruit already experienced new Board members.

3) Strict rules with limited degree of flexibility

3. a. Detailed requirements with regard to the expertise of Board members. This sub-option would entail to list all necessary skills Board members should have in order to be able to exercise his/her function in a credit institution.

Whilst this option at first sight could help achieve the objective of having competent Board members, it seems unduly inflexible and difficult to put in place in practice. In fact, credit institutions are very different throughout Member States and their size and the nature of their activities could vary enormously form a big investment bank to a small local savings bank. It seems therefore difficult to require all credit institutions irrespective of their size and the nature of their activity to have Board members with identical skills. Either the criteria will be too high and impossible to meet for small banks which will be unable to find suitable candidates or criteria will be too low and inappropriate for sophisticated credit institutions. In addition, excessive emphasis on specific qualifications (such as finance or risk management backgrounds for all Board members) could lead to the risk of "monoculture" which should be avoided. This sub-option is therefore discarded.

3. b. Require the creation of a Nomination Committee, subject to proportionality. This sub-option entails requiring credit institutions to create a nomination committee composed of non-executive Board members that will advise the Board on the selection of suitable candidates for Board membership. The main purpose of such a committee is to ensure that there is a transparent appointment process which is not under the control of management alone, and to ensure that the right balance of skills and experience is brought to the Board. For proportionality reasons, and to take account of different types of credit institutions, the size of their Boards and the complexity of their activities, this requirement should be subject to exceptions under the control of the supervisory authority. There is currently no requirement to establish a nomination committee in the CRD.

This sub-option was suggested by many respondents to the public consultation who thought that such a committee is an efficient mechanism for examination of the selection and appointment practices of the credit institution and is effective to evaluate the cognitive capacity of each candidate to comply with his/her duties.

This sub-option could also have a positive impact on the division of responsibilities within financial institutions. As Board as a whole would not necessarily have time to examine in detail all the proposed candidates, a nomination committee would avoid over-reliance on executives to assess the capacities of the candidates for Board membership, as is often the case in practice.

According to the responses to the questionnaire on costs sent to credit institutions, for credit institutions to set up a nomination committee, the additional annual costs would be between 8.000 and 15.000 euros per year, depending on how many times the nomination committee will meet. The related costs seem to be relatively low as compared to the time the whole Board would otherwise have to spend to search for the appropriate candidate. This spared time would be reallocated to discuss more strategic issues, such as risk profile and risk strategy. Consequently, this sub-option seems to be proportionate as compared to the underlying objective.

4) Combination of different sub-options

It results from the discussions of the sub-options that a combination between measures enhancing transparency, outcome-focused principles and more detailed rules establishing minimum standards is an appropriate combination. Each individual sub-option will not be sufficient to achieve the underlying objective of improved expertise on Boards. Different sub-options will be mutually reinforcing.

Disclosure of recruitment policies (sub-option 1.a.) will inform the market and the supervisors, at limited costs to credit institutions, on the required and actual expertise of Board members and allow them to verify that this expertise is adequate. Therefore, supervision will be facilitated.

The general principle that Boards should possess appropriate expertise (sub-option 2.a.) and the enhanced "fit and proper" test with minimum criteria (option 2.b.) could both effectively achieve the underlying objective. The two sub-options 2.a. and 2.b. have similar impacts and costs but sub-option 2.b. seems to better achieve the underlying objective, provides more guidance and therefore reduces the risk of different practices, whilst still remains proportioned compared to sub-option 2.a. Therefore, sub-option 2.a. should be discarded and sub-option 2.b. will be the preferred option. This sub-option will be usefully complemented by induction and continuous training of Board members (sub-option 2.c.) which will help to achieve the adequate level of skills and expertise. In addition, setting a Nomination Committee (sub-option 3.b.) at Board level will help prepare the decisions of the Board as regards the selection of candidates for Board membership and will ensure the independence of the selection process from management dominance.

As a result, the following sub-options will be retained:

Sub-option 1.a. Disclosure of recruitment policy and of expertise and skills of Board members in the annual report.

Sub-option 2.b. Enhanced "fit and proper" test for Board members with specific minimum criteria that Board members must possess individually and collectively with regard to appropriate skills and expertise on recruitment and on an ongoing basis, subject to supervisory review.

Sub-option 2.c. Require appropriate induction and continuous training of Board members.

Sub-option 3.b. Require the creation of a Nomination Committee, subject to exceptions.

Table 2: Comparison of the sub-options (expertise of Board members)

	Effectiveness	Impact on supply of candidates	Flexibility	Impact on level playing field	Enforceability	Efficiency
Sub-option 1a	+	=	=	=	+	+
Sub-option 2a	+	-	++	=	=	-
Sub-option 2b	++	-	-	+	++	++
Sub-option 2c	++	=	=	+	+	+
Sub-option 3a	++	-	--	++	++	-
Sub-option 3b	+	=	-	++	++	+

Magnitude of impact as compared with the baseline scenario: ++ strongly positive; + positive; – – strongly negative; – negative; = marginal/neutral; ? uncertain; n.a. not applicable

C) Counterbalancing management dominance

1) Measures to improve transparency of corporate governance practices

<u>1. a. Disclosure of the existing practice in the credit institutions as regards independence of Board members</u>. As mentioned previously, the disclosure of existing practice is a useful tool to inform market and supervisors of corporate governance practices but it is not necessarily sufficient by themselves. Moreover, what is an independent Board member is not easy to define. It is not enough that Boards are formally independent from management. To be able to effectively challenge management and reach an independent judgement, Board should not be subject in practice to an undue influence by executive management. Consequently, it seems difficult to describe in an annual report how a Board member acts independent from management and to effectively monitor and verify such information. This sub-option should therefore be discarded.

2) Principles-based, outcome-focused rules with high degree of flexibility

2. a. Board members must behave independently from management. Such a general principle could achieve its objective if effectively implemented in practice. However, it would be very difficult to monitor the correct implementation of such a principle. How Board members behave during Board meetings could be reflected in the minutes but how they effectively reach their decisions and whether they are exempt of any influence of executives is impossible to objectively monitor. Consequently, this sub-option should be discarded.

3) Strict rules with limited degree of flexibility

3. a. Prohibit cumulating mandates of Chairman and Chief Executive Officer (CEO) in the same credit institution, subject to proportionality. It might be envisaged to prohibit cumulating the mandate of Chairman of the Board with a mandate of CEO in the same credit institution.

Whilst most European governance codes[124] suggest that CEO/Chairman separation is key for the maintenance of appropriate checks and balances within the institution, for the time being, in the majority of Member States, the law does not forbid appointing the chairman as CEO[125]. There is no such prohibition in the CRD either.

A majority of respondents to the public consultation (75 out of 140) that provided an answer to the relevant question favour a mandatory prohibition on cumulating the functions of Chairman and of CEO. In their view, the separation of the roles of CEO and Chairman reduces the power of the CEO and the potential for management to dominate the Board. Combining both functions disregards the divergence of duties and capacities and concentrates an unwarranted amount of power and dominance in the hands of one person. Splitting the roles of Board chair and CEO promotes strong, independent Board leadership and operation. Separating the roles properly reflects the differences in the positions and offers a better balance of power between the CEO and the Board than combining the positions. In addition, 26 respondents consider that the separation of both functions should be best practice on comply or explain basis to take account of specific situations.

Therefore, due to proportionality considerations and taking into account particular situations when cumulating both mandates would be necessary, this prohibition may be subject to exceptions (certain credit institutions may cumulate the two functions) under the control of supervisory authorities. The results of the public consultation show that certain exceptions would be necessary to accommodate specific situations, especially for

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[124] For example, in Spain, the Netherlands, Ireland, United Kingdom.

[125] Such prohibition exists for instance, in Austrian and German laws which explicitly require the strict separation of the roles of the management Board and supervisory Board. In France the position of chairman is separated from the position of general manager in principle but the Board can decide to give the two functions to the same person. In other countries, such as Italy, the Netherlands, United Kingdom, Greece, Spain and Portugal, such prohibition does not exist.

small financial institutions given the difficulty of securing top executive leadership and temporary cumulating of functions in particular circumstances..

On the other hand, some respondents to the public consultation (26) opposed any prohibition to cumulate both functions. They considered that there was no conclusive evidence that financial institutions where the functions of Chairman and CEO were performed by different individuals performed better or have better withstood the crisis than those financial institutions where the two functions were performed by the same person. It has also to be recognized that, when the CEO also serves as the chairman, in some cases his or her role-duality could provide unified firm leadership, build trust and stimulate the motivation to perform[126]. Also some of the respondents were of the opinion that there is no single correct method of structuring the leadership of a bank and cumulating the roles of chairman and chief executive officer may be the best solution, or simply unavoidable, for a particular bank. Moreover, there are policies, procedures, and internal controls that can be put in place at banks to avoid excessive domination of the governance of the bank by the dual executive. Also, in some jurisdictions and in some specific instances such separation is not advisable or even legally allowed.

Nevertheless, taking into account the particular situation of credit institutions where executive management tends to adopt risky strategies in order to maximise profit, there is a need for a strong control by the Boards of the executive management decisions and hence the independence of the Boards members from management influence. The emerging practice in Member States and the results of the public consultation seem to show that, for credit institutions, separation of functions of Chairman and CEO is desirable and, subject to some exception, should be mandated by law. Most European countries strongly recommend the separation of duty between the CEO and the chairman, and many make it mandatory.

This sub-option should have a strong positive impact on the clear division of responsibilities. This sub-option should not have a significant impact on the supply of candidates to become Board members. There are no material direct compliance costs associated with this option.

3. b. Minimum number of non-executive directors. Whilst this sub-option seems at first sight to improve independence of Board oversight function, it seems to be too inflexible and does not take into account the different Board structures in Member States. While it could make sense in one-tier structure, it does not make sense in two-tier structure or mixed Boards with an independent supervisory Board. Furthermore, in a one-tier Board, the minimum number of non-executives will be too inflexible for small credit institutions with a limited number of Board members. Moreover, it is difficult to determine what the number of non-executives should be as compared to executives present on Board. This sub-option should therefore be discarded.

[126] Muth, M. M. and Donaldson, L. *Stewardship Theory and Board structure: A Contingency Approach*, Corporate Governance An International Review, 1998, Vol 6, No1.

4) Combination of different sub-options

It results form the discussion of the different sub-options that, whilst less flexible than other sub-options, the most effective way to ensure the independence of the Board in its oversight function and which is most easy to monitor seems to separate the function of the Chairman and the CEO. As a result, the following sub-option will be retained:

Sub-option 3.a. Prohibit cumulating mandates of Chairman and Chief Executive Officer (CEO) in the same credit institution

Table 3: Comparison of sub-options (counterbalancing management dominance)

	Effectiveness	Impact on supply of candidates	Impact on clear division of responsibilities	Flexibility	Impact on level playing field	Enforceability	Efficiency
Sub-option 1a	=	=	=	=	=	=	n.a.
Sub-option 2a	=	=	=	=	=	=	n.a.
Sub-option 3a	++	=	++	-	++	++	++
Sub-option 3b	=	=	=	--	+	+	n.a.

Magnitude of impact as compared with the baseline scenario: ++ strongly positive; + positive; – – strongly negative; – negative; = marginal/neutral; ? uncertain; n.a. not applicable

D) Diversity of Board composition

1) Measures to improve transparency of corporate governance practices

<u>1. a. Disclosure of internal policy on diversity in annual report.</u> The disclosure requirement could contain a requirement for credit institutions to disclose their diversity policy, objectives as to diversity and whether these objectives have been achieved. There is no such disclosure requirement in the CRD for the time being.

The following information should be disclosed: age and gender balance, educational and professional background of Board members, how they represent different regions in an international group, number of years spent in foreign countries as a professional or a student, etc.

The benefit of transparency with regard to diversity policy is that it allows for public insight and grows the perceived legitimacy of the actions of the credit institution which adopts a diversity policy and therefore the effectiveness of the efforts to address diversity challenges. Credit institutions which do not have a diversity policy or do not make the necessary efforts to achieve the objectives of such policy should be subject to public criticism. Therefore, this sub-option should encourage credit institutions to adopt ambitious diversity policies.

This sub-option was favoured by some respondents to the public consultation (66) which considered that such a soft requirement would encourage diversity but in the same time would not impose specific choices to the credit institution.

1. b. Benchmarking of different practices. Supervisory authorities could be required to collect information on the diversity policies and practices in the different credit institutions based on individual disclosures by credit institutions (see sub-option 1.a.) and to assemble (in a database) and disclose this information at national level annually. In addition, European Banking Authority could be required to make a similar disclosure annually at European level. There is no such requirement currently in the CRD.

This sub-option was favoured by some respondents to the public consultation as a useful tool to promote diversity in credit institutions as such a "name and shame" tool would impact the reputation of credit institutions and give them an incentive to adopt ambitious diversity policies. Also, benchmarking provides comparable data identifying common standards to aspire to and against which credit institutions can assess their diversity policies.

However, certain supervisors (ex: Belgium, Austria) in response to the questionnaire on costs commented that information on diversity in Boards is not relevant for supervisors as it is outside the scope of traditional prudential instruments.

Nevertheless, as described in Part 3 of the impact assessment, Board composition and especially the lack of diversity, could have an impact on the Board's capacity to effectively challenge management decisions. Therefore, information on diversity could be a useful tool for supervisors in their prudential supervision of credit institutions. Moreover, to encourage diversity at European level, EBA is the most suitable authority to benchmark the existing practices in different Member States and provide information to the public across Europe.

It is estimated that the compliance cost associated with option 1.a. would be around €600 - € 1,000 per company[127], whereas compliance with option 1.b. would involve some additional costs for all supervisory authorities involved. The additional costs for supervisors are related to the setting up of a data base (one-off cost) and the collection of data from all banks by copy-pasting the disclosures made in the annual reports (recurrent cost). The cost estimates for the one-off costs range from 1,600 € in Latvia to 191,000 € in Denmark. The cost estimates for the annual recurrent costs range from 600 € in Latvia to 130,000 in Germany.

[127] Although this potential sub-option was not included in the questionnaire, the cost estimates provided for the other potential measures involving a similar disclosure requirement in the annual report can be used as an estimate.

Whilst both sub-options 1.a. and 1.b. to improve transparency and benchmarking exercises are useful tools to inform the market and the supervisors of corporate governance practices and could incentivise credit institutions to put in place ambitious diversity policies, the costs related to option 1.b. could seem to be rather high as compared to option 1.a. However, as explained above, benchmarking of existing practices complements and strengthens transparency requirements as such. This additional cost could be mitigated by requiring to benchmark different policies for a limited period of time (e.g. three-five years), until credit institutions change their practices and the underlying goal in achieved. Therefore, the sub-option 2.b. seems proportionate when comparing costs to the expected benefits.

It could be argued that the two sub-options 1.a. and 1.b. could have a negative impact on the pool of people available for Board membership, and possibly on the objective of Board expertise because there are not enough experienced women or men from sufficiently different background to populate the Board rooms of credit institutions. However, as will be showed below (see sub-option 3.a.), there is evidence that, at least with regard gender balance, there is enough qualified women which cannot not for the time being reach leading positions in companies. In addition, the disclosure requirements leave sufficient flexibility to credit institutions to justify why the targeted diversity could not be achieved.

However, as already mentioned above, the sub-options 1.a. and 1.b. are not necessarily sufficient by themselves if not properly sanctioned by the market. To be really effective, they need to be accompanied by effective monitoring of their implementation but also other sub-options providing for more substantive requirements could be envisaged.

2) Principles-based, outcome-focused rules with high degree of flexibility

2. a. Diversity must be one of the criteria of Board composition. This sub-option includes diversity as one of the criteria which should be taken into account by the credit institution when selecting a Board candidate and by the supervisory authority when approving such a candidate. Diversity meaning age and gender balance, different educational, social, geographical and professional background. Currently, diversity does not form part of the criteria for selection of candidates for Board membership in the CRD.

This option was favoured by many respondents to the public consultation (131) as putting diversity criteria at the same level as expertise and integrity. This option has the advantage of being highly flexible leaving the method to achieve the underlying objective of more diverse Boards to credit institutions. However, such general principle might not achieve its objective in practice, as it relies in the first place on the appreciation by a credit institution of what is the appropriate diversity, on the trade-off between diversity and expertise and makes it difficult for supervisory authorities to monitor the effective implementation of this principle. It could be subject to different interpretations and practices by credit institutions but also in different Member States by different supervisory authorities and thus allow for regulatory arbitrage. Consequently, this general principle needs to be accompanied either by detailed guidelines coordinated at European

level by EBA or by other sub-options which provide for more strict requirements in European legislation. However, for the time being, draft EBA guidelines do not foresee any detailed guidance on this.

It could be argued that this sub-option could have a negative impact on the pool of people available for Board membership, and possibly on the objective of Board expertise because there are not enough experienced women or men form sufficiently different background to populate the Board rooms of credit institutions. However, as will be showed below (see sub-option 3.a.), there is evidence that, at least with regard gender balance, there is enough qualified women which cannot not for the time being reach leading positions in companies. In addition, the disclosure requirements leave sufficient flexibility to credit institutions to justify why the targeted diversity could not be achieved.

There should be no direct additional costs for credit institutions. Therefore, this option seems to be proportionate as compared to expected benefits and will be retained.

2. b. Requirement to establish a policy with regard to diversity. It could be required that credit institutions should establish a policy concerning diversity which should include requirements for the Board to establish measurable objectives and targets for achieving diversity and to assess annually both the objectives and the progress in achieving them. Credit institutions may also be required to introduce appropriate procedures to ensure that the policy is implemented properly and an internal review mechanism to assess the effectiveness of the policy.

According to the interviews conducted with credit institutions, increasingly large number of credit institutions is implementing diversity programs with particular emphasis on gender diversity but also on other aspects of diversity. Many respondents to the public consultation think therefore that this trend should be encouraged. This sub-option seems thus to be a useful tool to promote diversity in Board composition of credit institutions, leaving a sufficient degree of flexibility to adjust the diversity policy to different types of companies.

However, the effective implementation of this principle relies mainly on the credit institution itself and on the external scrutiny by shareholders. If the monitoring of the implementation is deficient or credit institutions do not derive any economic or other benefit from having in place an ambitious diversity policy, this sub-option may not be sufficiently effective to achieve its objective. Consequently, this sub-option could be combined with other sub-options setting more strict requirements with regard to diversity.

It could be argued that this sub-option could have a negative impact on the pool of people available for Board membership, and possibly on the objective of Board expertise because there are not enough experienced women or men form sufficiently different background to populate the Board rooms of credit institutions. However, as will be showed below (see sub-option 3.a.), there is evidence that, at least with regard gender balance, there is enough qualified women which cannot not for the time being reach leading positions in companies. In addition, the disclosure requirements leave sufficient

flexibility to credit institutions to justify why the targeted diversity could not be achieved. Consequently, this sub-option will be retained.

There are no significant direct costs linked to this option. Three could be indirect costs linked to internal processes and the recruitment and remuneration of HR specialists or head hunters that will search for required diversity as specified in the policy. But these costs are hard to estimate and will vary from one credit institution to another. Also, to achieve the objective of diversity, some credit institutions may increase the number of Board members. This could lead to additional costs linked to the need to remuneration additional directors. However, it is difficult to estimate the exact amount of this cost, as credit institutions may also choose to replace existing Board members to achieve the diversity objective. In any case, additional costs should not be significant as the average annual remuneration of non-executive directors in credit institutions is estimated at €77,000.

3) Strict rules with limited degree of flexibility

3. a. Put in place a quantitative target for gender balance. It could be possible to set a quantitative target of a certain percentage of Board members of each gender that credit institutions need to achieve in a certain period of time.

This option aims at harmonising the different rules recently adopted by Member Sates. The adoption of such a quantitative target mandating greater diversity was tested in some Member States. In 2003, Norway made a decision to enact legislation requiring 40% of Board membership of publicly owned companies to be female by 2007. State owned companies were already required to do this and successfully complied. Although Norway has been fairly progressive in gender equality, the corporate Board room remained a man's domain. In the years since Norway enacted the legislation, the percentage of women on the Board of directors climbed from 6% to 40.3% in 2010[128]. Spain followed Norway's lead and enacted similar legislation requiring the 40% quota in 2007. There are already signs of progress: the percentage of women on the Boards of Spain's largest listed companies has more than doubled, rising from 4% in 2006 to 10% in 2010[129].

In France, legislation was adopted in January 2011. It gives businesses six years to ensure that 40% of Boardroom positions are taken by women. Within three years French firms must ensure that a figure of 20% is reached. The legislation will apply to companies in France which are either listed, have more than 500 employees or revenues over 50 million euros. Netherlands are in process of enacting similar quota laws with at least 30% of seats to be held by each gender and Belgium, Sweden and Italy are considering their own versions. Germany is also envisaging measure to promote gender balance on corporate Boards but is for the time being considering voluntary quotas only.

128 Norway Central Bureau of Statistics, Focus On Gender Equality: Key Figures, 2010
129 Commission database: women and men in decision-making.

The table below summarises different measures which exist in different Member States:

Table 4: Quota laws in Member States

Country	Status and applicability	Minimum representation and penalties
Belgium	Federal law proposal prepared but not discussed in parliament yet	Min. 33% women on Boards of listed companies by 2016
France	Quota law passed in 2011 applicable to listed companies and companies with more than 500 employees or turnover/asset of more than € 50 mln; in total 2000 companies.	At least 20% women on Board in 3 years and 40% in 6 years from the first Annual Meeting since implementation of the law Non-compliance brings annulment of nominations and deliberations of the Board
Iceland	Quota law was passed in 2010. Applicable to publicly owned and publicly limited companies with more than 50 employees	40% of each gender per September 2013
Netherlands	Dec 2009 proposal for soft targets accepted in parliament applicable to companies with more than 250 employees. Needs to be passed by senate (unsure)	Target of min. 30% of each gender at both Board levels (executive and supervisory) per 2016.
Norway	Quota incorporated into Companies' Law (in 2003). Applicable to listed companies (approx.400), inter-municipal, state-owned, municipal and cooperative companies.	Min. representation of each gender of 40% per 2008. Penalties: warnings, fines, ultimately delisting
Spain	Quota law. Applicable to public companies with more than 250 employees and IBEX-35	Representation of 40% of each gender by 2015

If the goal is to accelerate the numbers of women on Boards in a short period of time, the figures mentioned above tend to show the effectiveness of legislated quotas in increasing the numbers of women directors.

Regardless of whether the targeted percentage of women directors is reached in a given period of time, the evidence in Member States which have or will impose quotas seem to show that numbers tend to increase, and far more swiftly than in past years. The proposal of a quota will come with a great deal of press attention that will place the whole issue of women on corporate Boards in the public discourse. In addition, companies that worry about appearing discriminatory may accelerate their appointment of women directors as a consequence. In France percentage of women directors, for example, was only 6.4% in 2007 until the lead-up to the passage of its quota law in 2010. In 2010 France had 14.4%

of its Board directors being women, doubling its earlier numbers within three years, even though the legislation was not yet passed in the Senate. Quota legislation seems to be the therefore an effective tool to accelerate Board diversity and reach meaningful levels of women's representation on companies' Boards.

One argument frequently used against a women quota on Boards is the lack of qualified women that would be detrimental to the quality of the Board. The need to achieve a quota would not allow for selection of the best candidate but would privilege the female candidate even if such candidate would not be the most suitable one. However, recent statistics show that more than half of the students (59%)[130] graduating from Europe's higher educational institutes are women. Furthermore, in 2009, the Statistical Bureau of Norway showed that because of the high educational level among female members of the Board, the general level of education rose in the Boardrooms. Consequently, women's talents are currently being underutilized at decision-making levels, in particular at top level. While women have a higher level of tertiary educational attainment than men in the EU, their professional careers do not fully reflect their skill levels, which is a waste of human resources and competencies.

However, introducing a quantitative target for gender balance in Boars of credit institution could have some negative aspects. First, such a quota is not flexible and does not allow taking into account different nature of credit institutions. Second, introducing gender quotas for credit institutions would not be coherent with the more general strategy of the Commission with regard to gender equality which forsees a two step approach, first encouraging self-regulation and then eventually imposing hard quotas if the results of this self-regulation do not prove sufficient.

In addition, gender quotas would not cover other diversity aspects, such as geographical, educational and professional backgrounds. There is no experience in Member States or studies that show what specific percentage should be desired for each diversity category in a Board for it to function properly. Implementation of such a quantitative target by credit institutions seems also to be difficult. Therefore, a more general out-come focused principle with regard to these diversity aspects is more appropriate.

Regarding the cost impact of this option, depending on the way the individual financial institution chooses to ensure the implementation of the principle (whether they choose to replace existing Board members or recruit additional ones), there could be costs for the company but there are no cost estimates available. If, to satisfy the target, the credit institution recruits additional Board members, this will entail additional costs linked to the need to remuneration these new Board members. If one Board member is simply replaced by another, this will not entail additional costs. In any case, additional costs should not be significant as the average annual remuneration of non-executive directors in credit institutions is estimated at €77,000.

130 See Eurostat Labour Force Survey, annual averages.

Other costs could be linked to internal processes or the recruitment or remuneration of HR specialists or head hunters that will search for required diversity.

3. b. Positive discrimination. In might be envisaged to require that in case of equivalent skills, candidates which contribute to improve gender balance should be privileged as compared to other candidates. This option is more flexible that a quantitative target and at the same time would achieve its objective if effectively implemented by credit institutions. However, it is very difficult to monitor the implementation of such principle: whereas it is possible for the supervisor to objectively see whether a proposed candidate for Board membership satisfies required criteria, it much more difficult to monitor why one candidate has been preferred to another. The selection of the candidates is the primary responsibility of the credit institution and the selection process itself is subjective and difficult to monitor. This sub-option should therefore be discarded.

3.c. Increase employee participation on Boards. This sub-option should effectively contribute to increase diversity on Boards of credit institutions, especially with regard gender diversity. According to German experience, where the employee representation on supervisory boards of companies is mandatory, the percentage of women among employee representatives is significantly higher than the percentage among shareholder-elected board members. For instance, in 2010, two-thirds of women on the supervisory boards of banks and savings institutions were appointed to those positions as employee representatives under employee co-determination legislation[131].

However, this sub-option would increase the number of Board members, slowing down the decision-making process. Also, this sub-option would touch on company law of Member States which, for the time being, have very different regimes with regard to employee representation and different roles of trade unions.

4) Combination of different sub-options

It results from the discussions of the sub-options that a combination between measures enhancing transparency, outcome-focused principles and more detailed rules establishing minimum standards is an appropriate combination. Each sub-option will not be sufficient on its own to achieve the underlying objective of improved diversity in Board composition. Different sub-options will be mutually reinforcing.

Disclosure of exiting diversity policies (sub-option 1.a.) will allow the market and supervisors to monitor whether credit institutions have appropriate and ambitious diversity targets and whether they have been implemented. Benchmarking of existing practice during the transitional period for achievement of quantitative targets will encourage credit institutions to rapidly improve diversity on Boards. However, these sub-options will not be sufficient. They should be complemented by principle-based sub-options (sub-options 2a and 2b) on diversity policy and diversity as a criteria of Board

[131] German Institute for Economic Research, Weekly Report : A squandered opportunity: Even after the financial crisis, top positions in large financial firms still largely occupied by men, March 2011

composition, which e are flexible enough help avoid box-ticking and allow supervisors to ensure that credit institutions include diversity of views as one of the criteria of board composition, at the same level as time-commitment and expertise.

As a result, the following sub-options will be retained:

Sub-option 1.a. Disclosure of internal policy on diversity in annual report.

Sub-option 1.b. Benchmarking of different practices

Sub-option 2.a. Diversity must be one of the criteria of Board composition

Sub-option 2.b. Requirement to establish a policy with regard to diversity

Sub-option 3.a. Put in place a quantitative target for gender balance

Table 5: Comparison of sub-options (diversity of Board composition)

	Effectiveness	Impact on supply of candidates	Flexibility	Impact on level playing field	Enforceability	Efficiency
Sub-option 1a	+	=	=	=	+	+
Sub-option 1b	+	=	=	=	+	+
Sub-option 2a	+	=	=	=	=	+
Sub-option 2b	+	=	-	+	+	+
Sub-option 3a	++	=	--	++	++	++
Sub-option 3b	-	=	-	++	=	n.a.
Sub-option 3c	+	=	--	+	+	--

Magnitude of impact as compared with the baseline scenario: ++ strongly positive; + positive; – – strongly negative; – negative; = marginal/neutral; ? uncertain; n.a. not applicable

Section 2: Ownership by Board of risk strategy

A) Measures to improve transparency of corporate governance practices

1. a. Boards must produce a declaration on an annual basis on the adequacy of risk management systems.

The Board could be required to publish a declaration on an annual basis providing assurance to different stakeholders that the risk management systems put in place are

adequate with regard to credit institution's activities and that the Board ensures the effective risk oversight.

Such a declaration could explain to investors how members collectively have reviewed, challenged and approved management's information on company risk and risk management in light of the company's strategy. Boards could disclose in such declaration risk oversight challenges that may have emerged over the reporting period, including action taken or planned to address them and how on an ongoing basis it seeks to improve risk oversight. It could also explain how and how often strategy, level of risk tolerances, and risk oversight are assessed by the Board in connection to each other; how and how often the suitability of the capital structure, the capital allocation process, the risk management framework and the risk management process are assessed with respect to strategy and risk tolerance; how and how often the structure of information flow and levels of decision making regarding actively taken risks are assessed with regard to effective risk oversight.

For the time being, Boards are not required to produce such a declaration under the CRD. Draft EBA guidelines do not provide for it either. Capital Requirement Directive in Article 22 only requires credit institutions as such to have robust governance arrangement, including effective processes to identify, manage, monitor and report risks. However, the division of responsibilities within credit institutions with regard to which body is responsible for putting in place such arrangements is not clearly defined.

Many respondents to the public consultation supported the view that such a declaration on the adequacy of risk management systems would make Boards effectively aware of their role in risk oversight and give a powerful tool to shareholders and supervisors to take Boards accountable for putting in place adequate procedures to oversee risk in credit institutions. In order for the Board to be responsible for the risk oversight and effectively own the risk strategy of the credit institution, the Board should take ownership of improving risk management in the organization.

Therefore, this sub-option seems to have a strongly positive impact on clear division of responsibilities within credit institutions and effectively achieve the objective of improving Board's oversight of risk.

On the other hand, some respondents thought that although such a declaration could be useful, approval by Boards would not have any added value compared to already existing requirements in different national or European legislations or corporate governance codes, or would be too formalistic and disproportionate. In particular, a majority of the respondents were opposed to a Sarbanes - Oxley[132] type declaration as they thought it was too burdensome and also did not prevent the crisis in US.

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[132] The Sarbanes-Oxley Act adopted in 2002 in US makes reporting on internal controls mandatory for SEC registrants and their independent auditors. Section 302 of the Act entitled "Corporate

However, the present sub-option will be different from Sarbanes-Oxley requirements where the declaration should be audited, which makes it very costly to companies. Also, Sarbanes-Oxley declaration has to be approved by executives and not by the Board, which could partly explain why it did not prevent the crisis in US.

This sub-option could also have an indirect impact on the supply of candidates to become Board members due to a possible increase in the accountability of Boards. It could be argued that potential candidates would be discouraged from becoming Board members if they know they will be held accountable if adequate risk management structures are not in place. It could also be argued that to motivate potential candidates and compensate the increase in accountability, the Board members would ask to be paid more and this would entail additional cost for credit institutions.

Nevertheless, the objective to improve risk oversight by Boards underlying this sub-option would be difficult to achieve without increased accountability of the Board which is the governing body of the credit institution finally responsible for the sustainability of the credit institution's activity before shareholders.

Moreover, in most Member States, Board are collectively and not individually (except in certain particular circumstances) accountable before the shareholders. Consequently, the sub-option should not have an impact on the individual accountability of Board members. Thus, the negative impact on the supply of candidates for Board membership should be limited. Therefore, this sub-option seems to be proportionate with regard to the underlying objective.

Like the other measures that foresee a disclosure in the annual report the compliance cost can be estimated to between 600 and 1,000 €p.a. per legal unit. There may be additional costs related to the internal processes, the legal advice or audit review of the declaration. However, these costs are difficult to estimate. For further details, see Annex II.

<u>1. b. Boards must publish on an annual basis a risk statement which would consist of a short and clearly understandable report on the credit institution's approach to risk</u>.

The Board could be required to publish in the annual report or in a separate document a risk statement which would describe the credit institution approach to risk, main risks, strategy for delivering the objectives and how this strategy is consistent with risk appetite, and explain the basis on which credit institution generates or preserves value over longer term. This risk statement to fulfil its objective, should be succinct, highlight

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Responsibility for Financial Reports" establishes management responsibility for internal controls and requires management to evaluate the effectiveness of internal controls. Section 404 of the Act directs the SEC to adopt rules requiring annual reports of public companies to include an assessment, as of the end of the fiscal year, of the effectiveness of internal controls and procedures for financial reporting. Section 404 also requires the company's independent auditors to attest to and report on management's assessment.

major issues, distil key issues in a thematic way and should be updated in case of material changes.

For the time being, credit institutions are already required to publish information on risk according to different provisions in the Capital Requirements Directive. However, as described in Part 3 of the impact assessment, this information is dispersed throughout the annual accounts, is very technical and difficult to find and analyse. It does not provide the shareholders and the market with a clear picture of what is the credit institution's approach to risk, what the risk strategy is and how the current risk exposures are aligned with this risk strategy.

A formal statement of risk appetite could contribute to create a transparent risk mechanism and allow stakeholders to take a more considered view of the Board's pursuit of objectives that are for or against stakeholders' interests. Risk appetite statements can serve as a clear and objective tool for ensuring accountability, ensuring that stakeholders' interests are adequately reflected in Board decision-making.

Half of the respondents to the public consultation, especially institutional investors, that provided an answer to the relevant question expressed very strong views that the disclosure of risk management needs to be enhanced. They think that a short and clearly understandable report informing shareholders on risk exposures, risk strategy and tolerance would help investors to form a comprehensive view of risk appetite of the financial institution, if it would not become a boiler plate declaration. In their opinion, it would also contribute to raise Board's awareness of risk issues. In particular, the dynamic nature of risk management needs to be captured more effectively: where significant risks have changed over the reporting period, this should be disclosed, along with an explanation as to why. There also needs to be more effective disclosure of management and Board actions to manage and mitigate risks on a dynamic basis.

Other respondents (mainly financial services industry) who are against putting in place such risk statement think that existing European legislation on credit institutions and insurance companies already requires financial institutions to disclose sufficient information on risk. Furthermore, French, German and UK respondents indicated that their national legislation or corporate governance codes require extensive risk disclosures. However, this sub-option would not require additional information on risk to that already required under existing legislation, but improves the presentation of this information to the public which could easily for a view of main risk exposures of the credit institutions, which are now dispersed throughout the annual report.

As a response to the questionnaire on compliance costs an Italian bank states that the information that would need to be included in the statement is already contained in other documents which the Board of Directors is responsible for, and on that basis assumes a cost of 2/3 man-days (between €400 and €600) to collect and organize this information in the Annual Report. Based on general knowledge on measurement of administrative burdens the Danish Commerce and Companies Agency on the other hand estimate the compliance costs to be around 4,300 € per company and explains that compliance with

any requirement on information to be disclosed in the Annual Report would involve a substantial amount of time consumption because the information normally needs to be approved on several levels. The costs can also be higher if the risk statement is subject to external audit.

However, this sub-option leaves to the credit institution the choice of appropriate document to publish the risk statement. If the risk statement in the annual report is subject to statutory audit under the national law, n that case credit institution could decide to publish the risk statement as a separate document, avoiding costs linked to the external audit.

This sub-option seems therefore to be proportionate to the underlying objective.

2) Principles-based, outcome-focused rules with high degree of flexibility

2. a. Board must determine or approve the risk profile and strategy and any changes.

In order to effectively oversee risk in a credit institution, Boards should be able to directly influence its risk profile. This involves making key decisions such as setting boundaries outside which the management is not permitted to operate.

However, Capital Requirements Directive already contains a provision that "management body (Board) shall approve and periodically review the strategies and policies for taking up, managing monitoring and mitigating the risks the credit institution is or might be exposed to". This option should therefore be discarded and superfluous.

3) Strict rules with limited degree of flexibility

3. a. Board must approve new financial products.

Board could be required to put in place the new product approval process and scrutinise product development and new business activity irrespective of the size of the capital commitments entailed, in order to identify risks from a forward looking perspective and ensure that the risks involved are consistent with the risk appetite and strategy of the financial institution.

Such product approval process is not for the time being required by the Capital Requirements Directive nor is it the case in practice. The results of the public consultation show that a systematic approval by the Board of all new products would be disproportionate, as it would entail involvement of Boards in operational issues, which is the responsibility of executive management. On the other hand, Board could approve products that have a significant impact on the strategy and the risk profile of the financial institution, as it would be part of global risk strategy. Therefore, this sub-option seems superfluous with regard to the sub-option 2.a requiring Boards to approve risk profile and strategy of the credit institution and any subsequent changes. It should therefore be discarded.

4) Combination of different sub-options

It results from the discussions of the sub-options that only measures enhancing transparency (sub-options 1and 1b) will effectively achieve the underlying objective. Whilst sub-option 1a could entail additional administrative burden, it seems to be still proportionate and efficient. As a result, the following sub-options will be retained:

Sub-option 1.a. Boards must produce a declaration on an annual basis on the adequacy of risk management systems

Sub-option 1.b. Boards must publish on an annual basis a risk statement which would consist of a short and clearly understandable report on the credit institution's approach to risk

Table 6: Comparison of the sub-options (Board ownership of risk strategy)

	Effectiveness	Impact on supply of candidates	Impact on clear division of responsibilities	Flexibility	Impact on level playing field	Enforceability	Efficiency
Sub-option 1a	++	=	++	-	+	++	+
Sub-option 1b	++	=	++	-	+	++	+
Sub-option 2a	=	=	=	=	=	=	n.a.
Sub-option 3a	++	=	-	--	++	+	n.a.

Magnitude of impact as compared with the baseline scenario: ++ strongly positive; + positive; – – strongly negative; – negative; = marginal/neutral; ? uncertain; n.a. not applicable

Section 3: Time devoted by Boards to risk issues

1) Measures to improve transparency of corporate governance practices

<u>1. a. Credit institution must disclose its policy and practice with regard to discussion and analysis of risk issues during Board meetings.</u> It could be envisaged to require the credit institution to disclose whether it has set up a standalone risk committee to deal with risk issues and/or how much time it devotes to discussing risk in Board meetings. There is no such disclosure requirement for the time being in CRD.

This sub-option could incentivise credit institutions to devote sufficient time to discussion of risk matters as the public disclosure allows for benchmarking of different practices in different credit institutions and to have a public insight on whether a Board of a credit institution devotes enough time discussing risk as compared to its peers.

However, as already mentioned previously, transparency of existing practices relies on market discipline and could be a useful tool to inform the market and the supervisors of the credit institutions practices. But, in the absence of effective monitoring and sanctioning by the market, it would not be sufficient on its own to improve time devoted by Boards to risk. Consequently, it seems appropriate to combine enhanced disclosure with more stringent requirements and improved supervisory review.

Like the other measures that foresee a disclosure in the annual report the compliance cost can be estimated to between 600 and 1,000 €p.a. per legal unit.

2) Principles-based, outcome-focused rules with high degree of flexibility

2. a. Board must devote sufficient time to risk issues.

Currently, there is not requirement in CRD that Board should devote sufficient time to discuss and analyse risk strategy. However, this sub-option could be effective to achieve the underlying objective if correctly implemented by credit institutions and would avoid box-ticking exercise. But such general principle could be subject to different interpretations and practices by credit institutions but also in different Member States by supervisory authorities and thus allow for regulatory arbitrage.

It could entail costs for supervisors which will need to examine practices in each specific financial institution to monitor whether each the Board of each financial institutions devotes sufficient time to examine risk issues. There should be no direct costs for credit institutions.

Consequently, this general principle needs to be accompanied by detailed guidelines coordinated at European level. However, other sub-options setting more detailed requirements in European legislation could also usefully complement this sub-option.

3) Strict rules with limited degree of flexibility

3. a. Mandatory risk committee at Board level, subject to exceptions. It could be envisaged to require credit institutions to set up a mandatory risk committee at Board level.

For the time being, there is no legal requirement in the Capital Requirements Directive requirement to have a risk committee in credit institutions. However, whilst there is no 'one size fits all' approach to risk management, and the methods by which a company may choose to assess, manage, and provide oversight of its risks can differ from company to company, an emerging trend among credit institutions has been the formation of stand-alone risk committees of the Board of directors[133]. Revised Basel Principles recommend the establishment of a risk committee at Board level, in order to increase efficiency and allow deeper focus on risk issues.

[133] This results form the interviews conducted by the Commission with credit institutions.

Also, the majority of respondents to the public consultation (81 out of 141) that provided an answer to this question think that separate risk committees are good practice, especially for large, systemically important financial institutions. It could be therefore required that each credit institution puts in place a self-standing risk committee which will advise the whole Board on risk issues.

Such a requirement seems to effectively meet the objective of improving the time devoted by Boards to discuss risk issues and therefore to the improved understanding of main risk exposures of the credit institution. Risk management will become the primary agenda focus of the committee, not simply another topic on the list. This approach is particularly important for credit institutions with complex risk management issues. Also, it will help maintaining a continuous view of risks. The nature of the credit institution's risk exposures frequently changes over time. Having a continuous risk dialogue can help the Board better understand subtle changes to the risk profile, as well as help the Board better identify emerging risks and risks that may be inherent in new or existing operations

In addition, a stand-alone risk committee could provide other important benefits[134]:

- *Setting the tone on the top for a corporate culture of risk management*. Creation of a stand-alone risk committee can help inform both investors and supervisory authorities that the credit institution is serious about risk management issues.

- *Additional expertise in managing risks*. If there is a body for which the sole focus is risk, that body may be able to come to a more nuanced understanding of the operational and other risks facing the company and develop specific risk management expertise.

- *Improving communication processes regarding risks*. A risk committee can serve as a singular unit to which management can report risk-taking activity and the emergence of new risks on a regular basis. In addition, the members of the committee can serve as an effective liaison between the company's risk management coordinators and the Board as a whole.

However, this sub-option could have some negative impacts. According to some respondents to the pubic consultation which were opposed to mandatory risk committees, some organizations, especially those with smaller Boards, may find that their Board members are already strained for time. Adding one more committee means that the company will need to assign Board members to serve on that committee, which might not be feasible for companies whose Board members are already serving on multiple committees. However, this concern may be mitigated by the proportionality principle which allows smaller credit institutions not to establish a stand-alone risk committee under the control of supervisory authorities.

[134] See, for instance, John C. Partigan and Daniel McAvoy, *The role and construction of risk committees*, August 2010

Also, typically, credit institutions will pay Board members for attendance at Board and committee meetings. An additional committee and committee chair means additional compensation to the Board members serving on that committee. This would entail additional costs for credit institutions.

In addition, even if the Board establishes a stand-alone risk committee, the committee may not be able to effectively provide oversight of enterprise risks if processes are not put in place to ensure that the committee is informed of risky activities and other corporate risks. Lines of communication would need to be established between the risk committee, the Board of directors as a whole, and the other committees of the Board to ensure that those other bodies are able to incorporate the analysis of the company's risks into the performance of their duties. This also could entail additional costs.

It can be assumed that the additional annual costs for those institutions that do not already have a risk committee, all costs would be around the same as for setting up a nomination committee, i.e. between 8,000 and 15,000 € per year, depending on how many times the risk committee will meet. These costs seem to be relatively low and therefore proportionate to the underlying objective. As regards smaller credit institutions, these costs will be mitigated by the application of the proportionality principle, as described above.

Finally, there could be a potential for the risk committee to duplicate duties of the audit committee and compensation committee where these committees exist. However, this can be mitigated by a well defined role and responsibilities of risk committee in the legislation or in terms of reference of the risk committee itself.

Consequently, this sub-option seems to be proportionate with the regard to the underlying objective.

<u>3. b. Minimum time that Board must be spend to discuss risk issues</u>. This sub-option means that the number of days per year that Boards must spend discussing risk issues will be specified.

At first sight, this option seems to effectively contribute to achieving the objective to improve time devoted by Boards to risk issues. However, such measure would be disproportionate and difficult to put in place in practice as the minimum number of days necessary to fully cover all risk matters will vary enormously according to different types of credit institutions. Also, such a minimum requirement could result in a box-ticking approach which at the end will be contrary to the objective of the Board spending sufficient time on risk issues according to the needs of a specific credit institution. This option should therefore be discarded.

4) Combination of different sub-options

It results from the discussions of the sub-options that a combination between measures enhancing transparency, outcome-focused principles and more detailed rules establishing minimum standards is an appropriate combination. Each individual sub-option will not on

itself be sufficient to achieve improved risk oversight by Boards. Different sub-options will be mutually reinforcing.

Disclosure of existing practice with regard to time devoted by Boards to risk (sub-option 1a) will help supervisors to easily evaluate whether the Boards devote sufficient time to risk issues at limited costs for credit institutions. Supervisory review will thus be facilitated. Mandatory risk committee at Board level (sub-option 3a), whilst less flexible than other sub-options, is the most effective to achieve the underlying objective. However, in order to avoid box-ticking, the sub-option 3a will be usefully complemented by the general principle that Board devote sufficient time to risk issues, even when there is a stand-alone risk committee at Board level.

As a result, the following sub-options will be retained:

Sub-option 1.a. Require credit institution to disclose its policy and practice with regard to discussion and analysis of risk issues during Board meetings.

Sub-option 2.a. Set up a general requirement for Boards to devote sufficient time to risk issues, subject to supervisory review.

Sub-option 3.a. Mandatory risk committee at Board level, subject to exceptions under the control of supervisory authorities

Table 7: Comparison of the sub-options (time devoted by Boards to consideration of risk issues)

	Effectiveness	Impact on supply of candidates	Impact on clear division of responsibilities	Flexibility	Impact on level playing field	Enforceability	Efficiency
Sub-option 1a	+	=	=	=	=	++	+
Sub-option 2a	+	=	++	=	=	++	+
Sub-option 3a	++	=	++	-	++	++	++
Sub-option 3b	=	n.a.	n.a.	--	=	=	n.a.

Magnitude of impact as compared with the baseline scenario: ++ strongly positive; + positive; – – strongly negative; – negative; = marginal/neutral; ? uncertain; n.a. not applicable

Section 4. Information on risk

1) Measures to improve transparency of corporate governance practices

1. a. Require credit institution to disclose its policy and practice with regard to the information flow on risk to the Board.

This sub-option could incentivise credit institutions to put in place timely and accurate information flows on risk to the Board as the public disclosure allows for benchmarking of different practices in different credit institutions and for having a public insight on whether a Board of a credit institution is sufficiently informed on risk issues as compared to its peers.

However, as already mentioned previously, transparency of existing practices relies on market discipline and could be a useful tool to inform the market and the supervisors of the credit institutions practices. But, in the absence of effective monitoring and sanctioning by the market, it would not be sufficient on its own to improve time devoted by Boards to risk. Consequently, it seems appropriate to combine enhanced disclosure other sub-options with substantive requirements and improved supervisory review.

It is estimated that this sub-option would entail no or very small additional costs for financial institutions.

2) Principles-based, outcome-focused rules with high degree of flexibility

2. a. Board must determine the content, format and frequency of risk information it should receive from management to perform its risk oversight function.

Accurate and timely information are important features as they allow Board members to incorporate insightful information in making decisions. If the Board has incomplete or inaccurate information, its decisions may magnify risks rather than mitigate them. However, currently there is no general requirement in CRD regarding the type and timeliness of information to be provided to Boards.

As described in Part 3 of the impact assessment, for the time being either Boards do not receive sufficient information on risk or they receive to much information they are not able to analyse for Board meetings.

Serious consideration should therefore be given by the Board to instituting periodic reviews of the amount and quality of information the Board receives or should receive.

All respondents to the public consultation that provided an answer to the relevant questions agree that the Board needs to receive timely and accurate information on risk and that correctly identifying the type of information the Board requires to adequately fulfil its duties and the capacity of the Board to understand the information provided to it are crucial.

Information protocols within a company should allow for and anticipate the continually changing landscape in which credit institutions operate. Therefore, Boards should obtain assurance from management that the risk information provided to the Board is complete and reliable with regard to identified risks and that the management has undertaken all

reasonable endeavours to identify all material risks. To be truly effective, risk reporting to the Board requires careful design in order to ensure all relevant risks are conveyed in a concise and meaningful manner.

This sub-option is flexible enough to allow credit institutions to adapt the information flow to the Board depending on the nature of its activities and its own particular needs. At the same time it makes the Board think about the information it needs and to ask for this information. Consequently, it seems to be affective to achieve the underlying objective be objective to improve information of the Board on risk and at the end risk oversight by Boards.

Whilst it could result in different practices in credit institutions, such flexibility is crucial to allow Boards to adapt the information they receive to their particular needs. What matters in this case, is the final outcome and not the process.

This sub-option will not entail significant costs for credit institutions and is therefore proportionate with regard to the underlying objective.

2. b. Risk management function must be able to report directly to the Board or risk committee if necessary, independent from management.

For the time being, there is no provision in the Capital Requirements Directive explicitly allowing for such a practice. Direct reporting of the CRO to the Board exists in some credit institutions but not in others.

This sub-option would implement at European level the revised Basel Principles recommendation that while the Chief Risk Officer (CRO) may report to the CEO or other senior management, the CRO should also report and have direct access to the Board and its risk committee without impediment.

The majority of respondents to the public consultation consider that the chief risk officer should be able to report directly to the Board or to the risk committee in order to alert boar on any risk issues it thinks appropriate and which were not reported upon by management. This mechanism could not only serve as an important way to inform the Board on some specific issues, it will also incentivise management to provide Board with accurate information. In addition, it would help to achieve another objective of improved status, authority and independence of the risk management function.

However, some respondents from jurisdictions with mandatory two-tier boards indicate that in their system only the management board has the competence to report directly to the supervisory board, not the chief risk officer who can report to the management board only. This concern could be mitigated by the fact that direct reporting to the Board by CRO should not be a common reporting procedure but should only take place in exceptional circumstances. There is sufficient flexibility to Member States to adapt the sub-option to their national Board structures.

There should be no significant costs for credit institutions associated with this sub-option.

This sub-option seems therefore to effectively achieve the underlying objective and be proportionate.

3) Strict rules with limited degree of flexibility

3. a. Specific structures and formats for information flows to the Board and specific escalation procedures

It could be envisaged to require credit institutions to put in place specific procedures for information flows on risk as well as specific templates and formats for such information.

Whilst this sub-option seems form the first sight likely to achieve the underlying objective of improving information flows to the Board, it is too inflexible and disproportionate as compared to the expected benefits. It would entail additional costs to put in place all required minimum procedures and templates whilst not necessarily proving more adequate information to the Board as a result, given the very different natures of risks in different financial institutions. This option should therefore be discarded.

4) Combination of different sub-options

It results from the discussions of the sub-options that a combination between measures enhancing transparency and outcome-focused principles is an appropriate combination. Each sub-option taken alone will not be sufficient to improve information flow to Boards on risk. Different sub-options will be mutually reinforcing.

Disclosure of the exiting policy (sub-option 1a) will help supervisors, at limited costs to credit institutions, to easily check what kind of information Board receives and on the timeliness of that information and asses whether this information flow is adequate. This reduces costs for the supervision. Requiring specific templates and procedures for the information flow seems unduly inflexible and will not necessarily be effective. However, general principles that Board must determine the content of the information (sub-option 2a), and that the risk management function should be ale to report directly to the Board (sub-option 2b) seem to be effective, flexible and efficient in order to achieve the underlying objective.

As a result, the following sub-options will be retained:

Sub-option 1.a. Require credit institution to disclose its policy and practice with regard to the information flow on risk to the Board.

Sub-option 2.a. Board must determine the content, format and frequency of risk information it should receive from management to perform its risk oversight function

Sub-option 2.b. Risk management function must be able to report directly to the Board or risk committee if necessary, independent from management

Table 8: Comparison of the sub-options (information flow to Board on risk)

	Effectiveness	Impact on clear division of responsibilities	Flexibility	Impact on level playing field	Enforceability	Efficiency
Sub-option 1a	+	=	=	=	+	+
Sub-option 2a	++	+	=	+	+	+
Sub-option 2b	++	=	-	+	++	++
Sub-option 3a	=	n.a.	--	++	++	-

Magnitude of impact as compared with the baseline scenario: ++ strongly positive; + positive; – – strongly negative; – negative; = marginal/neutral; ? uncertain; n.a. not applicable

II. OPTIONS TO IMPROVE THE STANDING OF THE RISK MANAGEMENT FUNCTION

To establish a risk culture in credit institutions, in addition to improved oversight of risk by Boards, the following options could be envisaged:

1) Measures to improve transparency of corporate governance practices

1. a. Credit institution must disclose in the annual report its policy with regard to the standing and authority of risk management function.

This option could incentivise credit institutions to give the appropriate status to the risk management function as public disclosure allows for benchmarking of different practices in different credit institutions and for having a public insight on whether a credit institution gives sufficient independence and authority to its risk management function as compared to its peers.

However, as already mentioned previously, transparency of existing practices relies on market discipline and, whilst it could be a useful tool to inform the market and the supervisors of the credit institutions practices, in the absence of effective monitoring and sanctioning by the market, it would not be sufficient on its own to achieve the underlying objective. Consequently, it seems appropriate to combine enhanced disclosure with other sub-options establishing more detailed requirements and an improved supervisory review.

Like the other measures that foresee a disclosure in the annual report the compliance cost can be estimated to between 600 and 1,000 €p.a. per legal unit.

2) Principles-based, outcome-focused rules with high degree of flexibility

2. a. Head of risk management function must have an appropriate status and authority to influence risk strategy and risk-relevant management decisions.

Many credit institutions recognise the benefits of centralizing the risk management function within an organization and giving a Chief Risk Officer (CRO) a prominent role in the company.

All respondents to the public consultation that provided an answer to the relevant question (think that the CRO should be a catalyst for change in risk-related behaviours. They also agree that CRO should have high status and authority, be independent from operational and business units and have close relationship with the Board.

This sub-option will implement the revised Basel Principles recommendation that the CRO should have sufficient stature, authority and seniority within the organisation which will typically be reflected in the ability of the CRO to influence decisions that affect the bank's exposure to risk. Currently, there is no provision in CRD regarding the stature of the head of the risk management function.

This sub-option seems likely to achieve the underlying objective of improving the standing of the risk management function. It could also have other benefits, such as motivating talented staff to join the risk management function and to retain the existing staff once they have earned in experience and expertise. It has been showed that often risk management was not seen as prestigious enough and operational and trading units drained staff form risk management units.

At the same time, this sub-option is flexible enough to allow credit institutions to determine the appropriate position of the CRO according to their size and the nature of their activities. However, it could lead to different practices in different credit institutions and in different Member States. It could also be difficult for supervisors to monitor whether in a specific credit institution CRO has the sufficient standing and authority. It seems appropriate therefore to accompany this sub-option by other sub-options with a more detailed requirements.

It is estimated that this sub-option would entail no or very small additional costs for financial institutions.

3) Strict rules with limited degree of flexibility

3. a. Credit institution should have a risk management function or equivalent, which must have an appropriate status and authority and be independent from the operational and business units.

This sub-option would implement the revised Basel Principles recommendation that the risk management function should have sufficient stature within the bank such that issues raised by risk managers receive the necessary attention from the Board, senior management and business lines and should be sufficiently independent of the business units whose activities and exposures it reviews.

For the time being, the Capital Requirements Directive provides only that arrangement should be defined concerning the segregation of duties in the organisation and the

prevention of conflicts of interest. However, nothing is mentioned regarding the authority and the independence of the risk management function.

This sub-option seems likely to achieve the underlying objective to improve the status of the risk management function within credit institutions. It is also likely to have additional benefits as described in sub-option 2.a above.

However, it is likely to lead to different practices and its implementation could be difficult to monitor by supervisors. It leaves a large amount of discretion to credit institutions to decide what the appropriate status of the risk management function should be. This could also lead to different practices in different Member States and to regulatory arbitrage. It seems appropriate therefore to accompany this sub-option by other sub-options with a more detailed requirements.

It is estimated that this sub-option would entail no or very small additional costs for financial institutions.

3. b. Credit institutions must appoint an independent Chief Risk Officer.

This sub-option would implement the revised Basel Principles recommendation that at least significant credit institutions should have an independent senior executive with distinct responsibility for the risk management function and the institution's comprehensive risk management framework across the entire organisation. For the time being, there is no such requirement in the CRD.

It results from the interviews conducted with credit institutions that appointing an independent chief risk officer without any management or financial responsibility in respect of any operational business lines or revenue-generating functions should be best practice. This sub-option seems likely to achieve the underlying objective of having an independent risk management function and would help to avoid conflict of interest with operation units.

In addition to avoiding conflicts of interest regarding risk management, by appointing a single manager as the CRO, companies can take advantage of the benefits listed below:

- *Consolidated approach to risk management:* Hiring a top-level executive with sole responsibility over the risk function helps to ensure a more comprehensive assessment of company-wide risk.

- *Minimized potential for compliance failures:* CEOs and CFOs, the traditional risk owners, can now rarely devote enough time to the management of operational risk. The growing importance of risk management warrants a dedicated position and enables companies to fully understand risks and their potential outcomes, to make a more informed business decisions.

This sub-option seems therefore to effectively achieve its underlying objective and have a positive impact on clear division of responsibilities within the credit institution.

3. c. Head of risk management function must be member of executive management or Board.

Many respondents to the public consultation (52 out of 96) that provided an answer to the relevant question suggested this option in order to improve the standing and the independence of the CRO. This sub-option seems to be an effective tool to achieve the underlying objective of having a strong and independent CRO. It gives the guarantee that CRO will have sufficient status within the credit institution as compared to the CFO and thus by definition will be able to influence management decisions.

On the other hand, prescribing the exact hierarchical status of the chief risk officer could appear disproportionate. It has been argued by some respondents to the public consultation (44 out of 96) that it should be better left to each financial institution to decide upon. Whilst this issue may be easily solved by the proportionality principle, it still seems that this sub-option is unduly inflexible.

In addition, requiring CRO to be member of the Board would interfere with the power of the shareholders to nominate Board members. It could also entail additional costs as being member of the Board will require remunerating CRO for additional responsibilities as board member. It could also have a negative impact on the clear division of responsibilities and on the independence of the CRO. Therefore, this sub-option seems to be disproportionate proportionate with regard to the underlying objective and should be discarded.

3. d. Removal of the Head of risk management function must be subject to prior approval by Board.

This sub-option would implement the revised Basel Principles recommendation that if the CRO is removed from his or her position for any reason, this should be done with the prior approval of the Board and generally should be disclosed publicly. The bank should also discuss the reasons for such removal with its supervisor. There is currently no such requirement in the CRD.

Some respondents to the public consultation suggested this option to improve the standing of the CRO and ensure its independence from management. This sub-option is seen as a guarantee that CRO cannot be sanctioned by the CEO in case of disagreement and if CRO reports directly to the Board on specific issues on which there is disagreement with management.

This sub-option seems therefore to effectively achieve the objective of improving the standing and the independence of the risk management function.

There would be marginal opportunity costs for the Board, but as the relevant incidents would presumably be very rare those costs are negligible. The costs of having to contact and discuss it with the supervisor would on the other hand be more substantial per incident, but again since the incident presumably would occur very seldom and could potentially be a cause of great concern the costs would not be disproportionate.

4) Combination of different sub-options

It results from the discussions of the sub-options that a combination between measures enhancing transparency, outcome-focused principles and minimum standards is an appropriate combination. Different sub-options taken alone will not suffice to improve the stature and authority of the risk management function. Different sub-options will be mutually reinforcing.

The disclosure of existing practice with regard to the status of the risk management function (sub-option 1.a.) will allow supervisor to easily evaluate whether this standing is appropriate. Requiring credit institutions to appoint a chief risk officer (sub-option 3.a.) which should not be removed without prior approval of the Board (sub-option 2.a.), whilst less flexible that other sub-options, are very effective to achieve the underlying objective of having a strong risk management function. Sub-option requiring CRO to be part of the executive management or Board seem however unduly inflexible. Sub-option 2a, requiring that CRO should have an appropriate status and authority to be able to influence risk strategy, seems, on the contrary flexible enough and effective. Sub-option 3a regarding the risk management function and its status also seems very effective to achieve the underlying objective and flexible enough.

As a result, the following sub-options will be retained:

Sub-option 1.a. Require credit institution to disclose in the annual report its policy with regard to the standing and authority of risk management function.

Sub-option 2.a. Head of risk management function must have an appropriate status and authority to influence risk strategy and risk-relevant management decisions

Sub-option 3.a. Risk management function must have an appropriate status and authority and be independent from the operational and business units

Sub-option 3.b. Credit institutions must appoint an independent Chief Risk Officer

Sub-option 3.d. Removal of the Head of risk management function must be subject to prior approval by Board.

Table 9: Comparison of the sub-options (status of risk management function)

	Effectiveness	Impact on supply of candidates	Impact on clear division of responsibilities	Flexibility	Impact on level playing field	Enforceability	Efficiency

Sub-option 1a	+	=	=	=	=	+	+
Sub-option 2a	++	+	+	=	=	=	+
Sub-option 3a	++	++	+	=	=	=	+
Sub-option 3b	++	++	+	-	++	++	++
Sub-option 3c	++	++	-	--	++	++	-
Sub-option 3d	+	=	++	-	++	++	++

Magnitude of impact as compared with the baseline scenario: ++ strongly positive; + positive; – – strongly negative; – negative; = marginal/neutral; ? uncertain; n.a. not applicable

III. OPTIONS TO IMPROVE SUPERVISORY REVIEW OF CORPORATE GOVERNANCE PRACTICES

1) Measures to improve transparency of corporate governance practices

There are no sub-options under this category.

2) Principles-based, outcome-focused rules with high degree of flexibility

2.a. Corporate Governance issues must be part of a dialogue with supervisors and the adequacy of CG structures should be part of supervisory review.

This sub-option entails that corporate governance arrangements i.e. Board composition, performance, role in risk oversight, status of the risk management functions, should be part of the regular discussions between credit institution and the supervisory authority as part of the prudential supervision. For the time being, some supervisors are changing their practices to include specifically these issues into the supervisory review (ex : Belgium, United Kingdom) but it is not the case in each Member State. For the time being, there is no empowerment in CRD for supervisor to evaluate and monitor internal culture and behaviour within credit institutions.

As explained in the impact assessment, supervisory review and monitoring of corporate governance arrangements is essential for effective implementation of the existing and new principles.

To be effective, supervisors must go beyond box-ticking and formal analysis of compliance and find ways to better evaluate Board performance and corporate culture. Previously, supervisors tended to focus only on the formal compliance by credit institutions with the requirement of Article 22 of the Capital Requirements Directive.

This sub-option would implement the revised Basel Principles recommendation that supervisors should regularly perform a comprehensive evaluation of a bank's overall corporate governance policies and practices and evaluate the bank's implementation of the principles.

Almost all respondents to the public consultation that provided an answer to the relevant question agree that supervisory authorities, in course of the periodic supervisory review, should be able to challenge the efficiency of internal governance structures and monitor whether these structures could have a negative impact on financial stability. A number of respondents (61 out of 136) think that supervisory authorities should have more powers to control the performance of the Boards and to sanction any shortcomings in internal governance of financial institutions. In particular, many respondents (58) were of the view that supervisors should give closer attention to the balance in the Board in relation to risk strategy and satisfy themselves that the Board is able to exercise efficiently its oversight function.

Supervisors could in particular, on a regular basis, review the governance arrangements of risk management, risk profile and overall business strategy of the FI. They could engage proactively with Board members, report on supervisory findings and seek the responses of the Boards to these findings. However, some respondents to the public consultation (7) doubted that even the most sophisticated regulators have either the staff level expertise or the resources to engage in such comprehensive governance assessments.

The costs of this sub-option seem to range from 50,000 € p.a. in DK (one day per institute or 3,000 hours in total), 103,700 € p.a. in AT (on average 2 hours) and approximately 1,500,000 € in DE (assuming that it will correspond to 3% for both on-site inspections and off-site reviews).[135] For the majority of supervisors, this sub-option does not seem to entail material additional costs. For a limited number of financial supervisors with a big number of credit institutions to supervise and which will have to put in place the necessary procedures and dedicate staff for the corresponding tasks these costs could be significant. However, these costs are inherent to improved supervision of risk governance in credit institutions which is essential for the correct implementation of substantive principles and cannot be avoided if the underlying objective is to be achieved. Nevertheless, these costs may be mitigated by the risk-based supervision where supervisors check the available information which is directly disclosed by credit institutions on regular basis and, if this information or the regular supervisory review gives indication of possible infringements to sound risk governance, perform a deep review of risk governance practices in this specific credit institution.

<u>2. b. Extensive supervisory review which must examine the ability of Board members to exercise their oversight function</u>. This sub-option entails the examination by supervisors when giving their authorisation to the credit intuition, at the time of recruitment of new

[135] See Annex II for details on the compliance costs for supervisors.

Board members and afterwards, the ability of Board members to exercise their function. This review should include the following criteria:

- time commitment;

- individual and collective understanding of all material risks of financial institutions;

- independence of mind;

- honesty, integrity;

- effective and constructive challenge of management decisions.

Supervisors might also as part of this supervisory review ensure that Board members continue to possess all necessary qualifications taking into account the risk profile of the credit institution.

For the time being, Capital Requirements Directive provides that supervisory authorities shall not grant authorisation to the credit institution if the persons who effectively direct the business of the credit institution are not of sufficiently good repute or lack sufficient experience. However, what is meant by sufficient experience and what should supervisors exactly look upon, is not specified.

Prior to the crisis, in the majority of Member States the "fit and proper test" of Board members performed by supervisors takes the form essentially of probity requirements. It does not include a review of technical and professional competence of candidates, such as general governance and risk management skills and behavioural and other qualities, and does not clarify their strategy and personal objectives as Board members. However, the financial crisis has revealed the need for Board members in credit institutions to possess sufficient expertise to understand all material risks in order to be able to effectively control them.

This sub-option seems to effectively achieve the underlying objective of having Board members capable of effectively performing their oversight function. At the same time it remains flexible enough to allow supervisors to put in place relevant procedures in order to satisfy themselves that Board members satisfy the necessary requirements. This sub-option also takes account of the risk-based approach of the financial supervision.

This sub-option will entail additional costs for supervisors. According to the questionnaire on costs sent to national supervisory authorities, 17 out of the 18 responding supervisors indicate that this sub-option would lead to adaptations of the existing practice and thus involve additional costs for the supervisors, notably being the recurring costs of having to conduct a review more detailed than the current one and doing it more frequently than at present, and in some cases that the potential new measure targets non-executive Board members, whereas the current review is focused on

executive Board members (/management Board members). Those responses that quantitatively estimate the additional recurrent costs contain estimates ranging from 15,500 € (in Greece) to around 12 million € per year (in Germany). Other estimates include 1,250 € per examination (in the UK), 500 hours every 3 years per bank (in Spain) and four to five full time equivalents per year (in Belgium).

Some respondents also give a quantitative estimate of the one-off costs ranging from 30,000 € in Latvia (costs of modifying the official regulations and internal assessment criteria, etc.), 95,000 € in Slovenia (costs of updating the internal supervisory methodology and the thematic supervisory review) to 1,070,000 € in Denmark (the cost of interviewing all existing Board members). In Spain the one-time cost of adapting the supervisory guidelines is estimated to 500 hours. The FSA in the UK estimate that the additional costs per interview for the individual banks would be £1850 (€2,200). See Annex II for details on the costs for supervisors.

These costs will be significant for financial supervisors with a big number of credit institutions to supervise and the number of Board members to authorise and which will have to put in place the necessary procedures and dedicate staff for the corresponding tasks. However, these costs are inherent to the improved authorisation procedure of executive and non-executive Board members which is essential to ensure that Board members of a credit institution are able to challenge management decisions and thus effectively control risk strategy and risk profile. These costs cannot be avoided if the underlying objective is to be achieved. The UK experience (which has put in place a procedure for authorisation of key persons, including interviews) shows that the importance to have in place this authorisation procedure and the ability of a Member State to put it in place even in a time of public deficit. It should be kept in mind that in many Member States financial supervisors have their own budget which is in partly or entirely financed by supervised financial institutions.

3) Strict rules with limited degree of flexibility

3. a. Supervisors must attend Board meetings. In order to ensure that Board members actually constructively challenge management decisions, supervisors could regularly attend Board meetings.

Some supervisors already attend Board meetings, to assess if non-executive directors are sufficiently challenging vis-à-vis management. Feedback from supervisors of their assessments after participation in Board meetings is often seen as helpful with a view to improving the functioning of the Board. However, supervisors do not always have access to these meetings. Moreover, some supervisors do not make use of the right to attend Board meetings.

Whilst this sub-option seems likely to achieve the underlying objective of improving supervisory review of corporate governance arrangements and the effectiveness of the implementation of existing and new principles, the sub-option could appear as disproportionate. According to some supervisors, attending Board meetings would not be feasible given the large number of credit institutions in their jurisdiction and would not

have any added value. Furthermore, the presence of supervisors could influence the discussion during the Board meetings and Board members would be reluctant to speak freely. Moreover, the costs related to this sub-option would be too high with regard to the expected benefits.

Consequently, this sub-option should be discarded.

<u>3.b. Supervisors must review agendas and supporting documents for meetings of the Board and Board committees</u>. Supervisors could look for agendas that address key areas and offer sufficient time for discussion, questions and critics; for supporting material that is adequate to provide Board or committee members with good understanding of the issues. Supervisors could satisfy themselves that supporting documents are sent in timely manner before the Board or committee meetings. Where these conditions do not exist, it will be difficult for Board members to perform effectively.

This sub-option is seen by many supervisors as a useful tool to monitor the correct functioning of the Board of the credit institution. It is also seen as having an added value and being proportionate with regard to the additional administrative burden and the relating costs.

Therefore, this sub-option seems likely to achieve the underlying objective and be proportionate.

<u>3.c. Supervisors should review the evaluation of the Board performance.</u> Supervisors could review the results of Board self-evaluation as part of their prudential supervision to ensure that Boards perform effectively and challenge management decisions.

This sub-option was supported by a number of respondents to the public consultation. It seems as effectively achieving the underlying objective to improve the supervisory oversight of the Board's ability to effectively oversee management. It also seems that the related costs are proportionate to the expected benefits.

4) Combination of different sub-options

It results from the discussions of the sub-options that a combination between outcome-focused principles and minimum standards is an appropriate combination. Different sub-options will be mutually reinforcing.

All the sub-options, except sub-option 3a, are effective to achieve the underlying objective of improved supervisory review of risk governance. Sub-options 2a and 2b are complementary to all other sub-option in option C examined in Chapters I and II of this Annex. Without supervisory review of risk governance and Board member's ability to exercise their function, the implementation of other sub-option may not be effective.

As regards sub-option 3b and 3c, although less flexible, they give clear guidance and powers to superiors which seem necessary for them to be able to exercise their supervisory review. The relating costs, though significant, are inherent to the improved

supervisory review of risk governance and seem proportionate with regard to the overall benefits.

As a result, the following sub-options will be retained:

Sub-option 2.a. Corporate Governance issues must be part of a dialogue with supervisors and the adequacy of CG structures should be part of supervisory review.

Sub-option 2.b. Extensive supervisory review which must examine the ability of Board members to exercise their oversight function

Sub-option 3.b. Supervisors must review agendas and supporting documents for meetings of the Board and Board committees

Sub-option 3.c. Supervisors should review the evaluation of the Board performance

Table 10: Comparison of the sub-options (supervisory review of risk governance)

	Effectiveness	Flexibility	Impact on level playing field	Enforceability	Efficiency
Sub-option 2a	++	=	=	=	+
Sub-option 2b	++	=	+	+	+
Sub-option 3a	+	--	+	++	-
Sub-option 3.b	+	-	++	++	+
Sub-option 3c	+	-	++	++	+

Magnitude of impact as compared with the baseline scenario: ++ strongly positive; + positive; – – strongly negative; – negative; = marginal/neutral; ? uncertain; n.a. not applicable

ANNEX II: ADMINISTRATIVE BURDEN FOR CREDIT INSTITUTIONS AND SUPERVISORS

The cost estimates described in the table below are based on the available public data and on the responses to a questionnaire sent by DG Internal Market and Services to credit institutions and to national supervisory authorities in the Member States. In a few instances, where possible, it was necessary to recalculate the figures provided by the respondents to the questionnaire in order to adjust the estimate to the intended scope of the potential measure, which was not always clear to the respondents. Several respondents have been unsure what would be the exact scope and detail of some of the potential measures described in the questionnaire, which has made it difficult for the respondents to assess exactly the need to adapt their current practices and thus assess the compliance costs precisely. Therefore, and due to the qualitative nature of the measures potentially to be implemented, a fair amount of uncertainty needs to be included in the numbers provided.

Table 1: Additional costs for credit institutions of implementing necessary modifications of current policies resulting from the potential new requirements

Costs in relation to	One-off costs	Recurrent costs per annum	Remarks
Board time commitment			
Disclosure of the number of mandates of board members	0	€600 - €1,000	Actual costs would depend on whether the publication is on group or subsidiary level. Costs will be less for publication at group level and higher if publication at subsidiary level for groups with a significant number of subsidiaries.
Board members must spend sufficient time to exercise their duties	Not available	Not available	Depending on the way the individual financial institution chooses to ensure the implementation of the principle, there could be costs for the company but there are no cost estimates available. These costs could be linked to internal processes or the recruitment or remuneration of HR specialists or head hunters that will search for board members with adequate time-commitment. The increase in time spent by board members as a result of this principle could result in increase in remuneration of these board members.
Limit the number of mandates that a board member may hold at the same time	Not available	Not available	There are no cost estimates available. Limited costs could be linked to internal processes or the recruitment or remuneration of HR specialists or head hunters that will search globally for more board members with adequate time-commitment. Additional costs could result from an increase in remuneration of the board members which will cumulate less mandates.

Expertise of board members			
Disclosure of recruitment policy and of expertise and skills of board members in the annual report	0	€600 - €1,000	Actual costs would depend on whether the publication is on group or subsidiary level. Costs will be less for publication at group level and higher if publication at subsidiary level for groups with a significant number of subsidiaries.
Minimum expertise requirements for board members	Not available	Not available	Depending on the way the individual financial institution chooses to ensure the implementation of the principle, there could be costs for the company but there are no cost estimates available. These costs could be linked to internal processes or the recruitment or remuneration of HR specialists or head hunters that will search for board members with adequate expertise. Additional costs could result from an increase in remuneration of the board members with specific expertise.
Continuous induction and training		€20,000 - 30,000	However the actual costs are difficult to estimate and will depend on the size of the board and the expertise needs
Nomination Committee	0	€8,000 - 15,000	These costs are linked to the internal organisational costs and to the additional remuneration of board members that are members of Nomination Committee.
Counterbalancing management dominance			
Disclosure of the existing practice	0	€600 - €1,000	Actual costs would depend on whether the publication is on group or subsidiary level. Costs will be less for publication at group level and higher if publication at subsidiary level for groups with a significant number of subsidiaries.
Mandatory prohibition to cumulate the mandates of Chairman /CEO	0	0	There should be no additional costs or the costs should be limited as the two compensations (for the Chairman and for the CEO) already exist but would be then dissociated.
Diversity			
Disclosure	0	€600 - €1,000	Actual costs would depend on whether the publication is on group or subsidiary level. Costs will be less for publication at group level and higher if publication at subsidiary level for groups with a significant number of subsidiaries.
Diversity as a criteria of board composition	0	0	There should be no direct additional costs for credit institutions.
Establishment of a policy on diversity	Not available	Not available	There are no cost estimates available. These costs could be linked to internal processes and the recruitment and remuneration of HR specialists or head hunters that will search for required diversity.
Quantitative targets	Not available	Not available	Depending on the way the individual financial institution chooses to ensure the implementation of the principle, there could be costs for the company but there are no cost estimates available. If, to satisfy the target, the credit institution recruits additional board members, this will entail additional costs. If one board member is simply replaced by another, this will not entail additional costs. Other costs could be linked to internal processes or the recruitment or remuneration of HR specialists or head hunters that will search for required diversity.

Responsibility of the board for risk strategy			
Board is responsible for publication in the Annual Report of a risk statement	0	€600 - €1,000	Actual costs would depend on whether the publication is on group or subsidiary level. Costs will be less for publication at group level and higher if publication at subsidiary level for groups with a significant number of subsidiaries. Costs would mainly consist in publication costs. There should not be additional significant costs as the information to be disclosed should be already produced by the institution and part of its information system.
Boards to disclose in the Annual Report a declaration on the adequacy of internal control systems	Not available	€600 - €1,000	There are no cost estimates available. Direct costs will be linked to publication. Indirect costs will be linked to the underlying process to ensure that internal control systems are adequate. These costs should not be significant as they are already part of the assurance process which is built by the Internal Auditors and External Auditors while developing their missions on a risk based approach.
Time devoted by boards to risk issues			
Disclosure of existing practice	0	€600 - €1,000	Actual costs would depend on whether the publication is on group or subsidiary level. Costs will be less for publication at group level and higher if publication at subsidiary level for groups with a significant number of subsidiaries
Boards must devote sufficient time to risk issues	Not available	Not available	Depending on the way the individual financial institution chooses to ensure the implementation of the principle, there could be costs for the company linked to internal processes but there are no cost estimates available. Costs should not be significant.
Risk Committee	Not available	Not available	There are no cost estimates available, however they should not be significant. These costs are linked to the internal organisational costs and to the additional remuneration of board members that are members of Risk Committee. Actual costs will be linked to the number of days per year a Risk Committee will have to meet. On average, based on existing practice of credit institutions with separate Risk Committees, it is expected that Risk Committee will be composed of at least three persons and will meet at least 4 times a year On the other side there is a moderate gain to expect on the Audit Committee side which will not have to cover in depth risk issues..
Communication of information on risk			
Disclosure of existing policy	0	€600 - €1,000	Actual costs would depend on whether the publication is on group or subsidiary level. Costs will be less for publication at group level and higher if publication at subsidiary level for groups with a significant number of subsidiaries

Board to determine the content, format and frequency of risk information	0	0	To be integrated in the already existing internal processes
Risk Management Function must be able to report directly to the Board or Risk Committee	0	0	To be integrated in the already existing internal processes
Standing and independence of Risk Management Function			
Disclosure of existing practice	0	€600 - €1,000	
CRO must have an appropriate status to influence risk strategy	0	0	To be integrated in the already existing internal processes
Risk Management Function must have appropriate status and be independent from the operational and business units	0	0	However, limited costs may be linked to put in place the necessary processes
CRO must be appointed	0	€ 200,000 - € 500,000	There are no cost estimates available. If credit institution recruits a new person as a CRO there will be a additional cost. If an existing staff member is promoted as CRO, there should be no significant additional costs.
Removal of the CRO must be appproved by the board	0	0	Some marginal costs may be linked to the set up of the necessary internal process.

Table 2: Additional costs for supervisors of implementing necessary modifications of current policies resulting from the potential new requirements

Costs in relation to	One-off costs	Recurrent costs per annum	Remarks
Extensive supervisory review of board's fitness and propriety	100,000€- 1,000,000 €	40,000 €- 12,000,000 €	The lowest numbers were reported were supervisors with small number of supervised credit institutions and the highest numbers for supervisors with a big number of supervised credit institutions
Benchmarking of practices on diversity of board composition	20,000 €- 100,000 €	20,000 €- 130,000 €	The lowest numbers were reported were supervisors with small number of supervised credit institutions and the highest numbers for supervisors with a big number of supervised credit institutions
Risk governance issues to be part of the dialogue with supervisors + adequacy of risk governance structures to be part of the supervisory review	0	0,000 €- 1,500,000 €	No cost for supervisors that already review corporate governance systems and significant additional cost for supervisors with a big number of supervised credit institutions.
Supervisors must review agendas and supporting documents for meetings of the board and board committees	?	?	No precise estimation, costs are part of the general cost of corporate governance review
Supervisors must review the evaluation of the board performance	?	?	No precise estimation, costs are part of the general cost of corporate governance review

Detailed analysis of responses in Table 2:

Compliance costs related to extensive supervisory review of board's fitness and propriety:

17 out of the 18 responding supervisors indicate that the measure would lead to adaptations of the existing practice and thus involve additional costs for the supervisors, notably being the recurring costs of having to conduct a review more detailed than the current one and doing it more frequently than at present[136], and in some cases that the potential new measure targets non-executive board members, whereas the current review is focused on executive board members (/management board members). Those responses that quantitatively estimate the additional recurrent costs contain estimates ranging from

[136] From the response of the only respondent that did not indicate any additional costs (LT) it could however seem that there would in fact also be recurring new costs of conducting a review more often than presently required.

15,500 € (in EL) to around 12 million € per year (in DE). Other estimates include 1,250 € per examination (UK), 500 hours every 3 years per bank (ES) and four to five full time equivalents per year (BE).

Some respondents also give a quantitative estimate of the one-off costs ranging from 30,000 € in LV (costs of modifying the official regulations and internal assessment criteria, etc.), 95,000 € in SI (costs of updating the internal supervisory methodology and the thematic supervisory review) to 1,070,000 € in DK (the cost of interviewing all existing board members). In ES the one-time cost of adapting the supervisory guidelines is estimated to 500 hours.

The reasons given by the respondents explaining why the potential new measure would requirement amendments in the existing review procedures are:

- the listed aspects of the qualifications' review are more detailed than the existing approach, which is often a more global examination of the qualifications (e.g. mainly focused on expertise and experience) [BE, DK[137], LV[138], PT[139], SE[140]]

- the new measure targets non-executive board members, whereas the current review is focused on executive board members (/management board members) [BE, DE, FR[141]].

Compliance costs related to benchmarking of practices on diversity of board composition:

16 out of the 17 supervisors that responded to this question indicate that the measure would involve additional costs for the supervisors, since no such measure currently exists.[142] The sources of the additional costs are related to the setting up of a data base (investments in IT and data collection from all banks) and updating it (data consolidation). One supervisor (FI) envisages extensive manual work to collect the necessary data, including time for contacts with the supervised entities and possible requests for resubmitting data in a more detailed way. Another supervisor assumes an effort of approx. 1 hour per bank (DE). The cost estimates for the one-off costs range from at least 1,600 € in LV, 1000 hours in ES to approximately 75,000 € in IE. The cost

[137] In DK the additional requirements would be reviewing the understanding all material risks, the independence of mind and checking honesty and integrity. Would require interviews of new members and a report every three years.

[138] In LV "the criteria differ".

[139] PT: measure 1 would deserve particular attention to comply, especially to cover all criteria and do it periodically.

[140] SE: The laws and regulations are not that detailed and should perhaps be modified in order to enhance clarity.

[141] In FR a fit and proper process is already in place for certain senior managers (i.e. executives) of credit institutions. However, there is currently no requirement in the French regulatory framework for a fit and proper process concerning board members.

[142] Only LT inform that there will be no additional costs, but from the description of the legislation it seems there is no current requirement covering the potential new measure.

estimates for the recurrent costs range from at least 600 €in LV to 191,000 €in DK (and perhaps more in AT).

Compliance costs related to the requirement that risk governance issues to be part of the dialogue with supervisors and the adequacy of risk governance structures to be part of the supervisory review:

11 of the 17 supervisors that responded to this question indicate that this measure would lead to no additional costs or no material additional costs. The reason is that the requirement of the measure is already in place (or largely so). In addition AT, DE, DK and LV mention that they also already carry out reviews of the CG structures, but that there might be room for improvement (AT), be some additional effort for the review of corporate governance issues that go beyond risk management (DE), or be an annual review on top of the current setup (DK). The costs of these possible additional efforts would range from 50,000 € p.a. in DK (one day per institute or 3,000 hours in total), 103,700 € p.a. in AT (on average 2 hours) and approximately 1,500,000 € in DE (assuming that there will be some additional effort for the review of corporate governance issues that go beyond risk management, the additional effort amounting to 3% for both on-site inspections and off-site review). LV also already carry out extensive review of the corporate governance structures but expect anyway a need to modify the official regulations amounting to one-off costs of approximately 1,200 € SI expects recurrent annual costs of between 60,000 and 90,000 €

ANNEX III: CORPORATE GOVERNANCE IN CREDIT INSTITUTUIONS: MECHANIMS AND CASE STUDY

This Annex describes who corporate governance mechanisms work in credit institutions and provides the example of UBS to explain a case of bad governance.

1. Corporate governance mechanism in credit institutions

Corporate governance is the set of processes, customs, policies, laws and institutions affecting the way a credit institution is directed, administered or controlled. Corporate governance also includes the relationships among the many stakeholders involved and the goals for which the credit institution is governed. The principal stakeholders are the shareholders, management and the board of directors. Other stakeholders include depositors, employees, customers, regulators, the environment and the community at large.

It is a system of structuring, operating and controlling a company with a view to achieve long term strategic goals to satisfy shareholders, creditors, employees, customers and depositors, and complying with the legal and regulatory requirements.

The perceived quality of a company's corporate governance can influence its share price as well as the cost of raising capital. The positive effect of good corporate governance on different stakeholders ultimately is a strengthened economy, and hence good corporate governance is a tool for socio-economic development.

Parties to corporate governance in credit institutions

Parties involved in corporate governance include the governing bodies (e.g. the Chief Executive Officer, the board of directors, management and shareholders general assembly). Other stakeholders include financial regulators, depositors, employees, creditors, customers and the community at large.

In companies, shareholders (the principal) delegate management decisions to the board and senior management (the agent) who should act in the principal's best interests. This separation of ownership from control implies a loss of effective control by shareholders over managerial decisions. Partly as a result of this separation between the two parties, a system of corporate governance controls is implemented to assist in aligning the incentives of managers with those of shareholders.

A board of directors plays a key role in corporate governance. It is their responsibility to endorse the strategy, appoint, supervise and remunerate senior executives and to ensure accountability of the credit institution to its owners and supervisory authorities.

Senior executives, under the direction of the Chief Executive Officer, implement the strategy and perform the day-to-day management of the credit institution.

Credit institutions also generally have in place (i) a risk management function which identifies, measures, monitors, mitigates and reports on risks, (ii) an internal audit function which evaluates the effectiveness of internal controls and governance processes, and (iii) a compliance function which identifies, measures and reports on compliance risks. To be effective, these functions should be organisationally independent from the units they control.

Internal governance mechanisms within credit institutions

Internal controls monitor activities and then take corrective action to accomplish organisational goals of a credit institution.

The board of directors is finally accountable for the efficiency of internal controls and plays a crucial role in monitoring management.

Regular board meetings allow potential problems to be identified, discussed and avoided. However, the ability of the board to monitor the firm's executives is function of its understanding of the management decisions and of its access to adequate and timely information.

The board cannot monitor management on day-to-day basis. Therefore, credit institutions should have an appropriate internal control framework to develop and maintain systems that ensure effective and efficient operations; adequate control of risks; prudent conduct of business; reliability of financial and non-financial information reported or disclosed (both internally and externally); and compliance with laws, regulations, supervisory requirements and the institution's internal policies and procedures.

In assessing the efficiency of internal control within an institution, the board may rely on the work of control functions, including the risk management function, the compliance function and the internal audit function.

2. The case of UBS[143]

In March 2006, the UBS decided, to close revenue gap compared to its competitors, to expand its securitised products and develop trading strategies for these products. However, these activities were linked to a significant risk which afterwards resulted in huge write downs.

Notwithstanding the fact that the senior management and the board identified the subprime issue as a major risk in September 2006, the management did not adjust until July 2007. The Board did not feel strongly enough about the risk. Growth and revenue were in the interests of the shareholders and the Board would not have been able to act forcefully.

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[143] Based on The Current Financial Crisis: Causes and Policy Issues Adrian Blundell-Wignall, Paul Atkinson and Se Hoon Lee , OECD 2008.

The Shareholder Report (April 2008) states that senior management took comfort from the main exposures being AAA rated, and that they were prepared to rely on investment bank assurances that the risk was well managed. Revenue growth and catching up to competitors was the dominant culture. All management focus within the investment banking on 'processes' for new business initiatives and prior approval of transactions were: "…on speeding up approvals as opposed to ensuring that the process achieved the goal of delivering substantive and holistic risk assessment of the proposals presented". Departing top risk managers were replaced by people from a sales background (consistent with growth), not a risk management background.

The Shareholder Report also stated that internal reporting of risk positions was complex, even across the 'silos' within a business line. A holistic picture of the risk situation within investment banking business lines was not presented to management or the board, and there was no serious internal challenge to the overall strategy.

The UBS example illustrates clearly that corporate governance, too, played a role in the crisis. The culture of investment banking is much harder to control from the board room and needs strong internal control systems with an independent risk management which failed in the case of UBS. The business is more complex, and the products are inherently more difficult to understand than simple banking products so that risk control practices are much more difficult. Therefore, board members need to have minimum expertise to understand the underlying risks and effectively challenge management decision, not relying on management assurance or external ratings, which was the case at UBS.

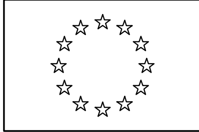
ANNEX IV : NATIONAL FINANCIAL CRISIS MEASURES

Financial crisis measures approved until 31 March 2010 (approved amounts in €billion)

Member State	Guarantee schemes	Recapitalisation schemes	Liquidity intervention schemes	Asset relief intervention schemes	Individual cases
Belgium					274.5
Denmark	580*	13.4			6.3
Germany	400	80		x	107.6
Ireland	376			54	25.6
Greece	15	5	8		
Spain	200	99	30		
France	265	23.95			62.2
Italy	n.a	20			
Cyprus	3				
Latvia	4.27				3.3
Luxembourg					7.32
Hungary	5.35	1.07	3.87	0.04	
Netherlands	200				56.2
Austria	75	15		x	0.5
Poland	4.62	4.62			
Portugal	16	4			0.5
Slovakia	2.8	0.66			
Slovenia	12		x		
Finland	50	4			n.a
Sweden	156	4.71			0.5
United Kingdom	381.87	62.79			405.6
Total EU27**	**2746.9**	**338.2**	**41.9**	**54.0**	**950.1**

Source: State Aid Scoreboard: Commission Report on recent developments on crisis aid to the financial sector- Spring 2010 Update

ANNEX V : FEEDBACK STATEMENT



EUROPEAN COMMISSION
Directorate General Internal Market and Services

FREE MOVEMENT OF CAPITAL, COMPANY LAW AND CORPORATE GOVERNANCE
Company law, corporate governance and financial crime

FEEDBACK STATEMENT

SUMMARY OF RESPONSES TO COMMISSION GREEN PAPER

ON

CORPORATE GOVERNANCE IN FINANCIAL INSTITUTIONS

1. GENERAL REMARKS ON CONSULTATION PROCEDURE AND FEEDBACK

On 2nd June 2010, the European Commission launched a wide-ranging public consultation on corporate governance in financial institutions[144].

The scale of the recent financial crisis 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 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.

Although corporate governance did not directly cause the crisis, the lack of effective control mechanisms contributed to excessive risk-taking on the part of financial institutions. The crisis revealed 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. Consequently, the Commission decided to address the fundamental question of whether the existing corporate governance regime is deficient as far as financial institutions are concerned and to seek views on possible ways to address the deficiencies.

The issues on which the Commission invited views and evidence included:

- **Functioning of boards and their role in risk oversight:** The consultation invited views on how to improve time commitment, experience and diversity of board members and their challenge of management decisions, risk oversight and accountability of boards for risk issues, boards' cooperation with supervisors and how to encourage boards to take into account interests of depositors and other stakeholders of financial institutions.

- **Governance of risk management function:** The consultation invited views on how to improve the standing and authority of the risk management functions and establish a risk culture at all levels of financial institutions and how to improve information flow on risk from risk management to the board.

- **Supervisory authorities:** The consultation invited views on the enhancement of the supervisory role with regard to corporate governance mechanisms, including the eligibility criteria of board members and boards' performance.

- **External auditors:** The consultation asked whether the cooperation between external auditors and supervisory authorities should be enhanced and what should be the role of external auditors as regards information on risk.

[144] Green Paper on corporate governance in financial institutions and remuneration policies, COM(2010) 284 final

- **Shareholders:** The consultation invited views on shareholder behaviour as regards risk-taking by financial institutions and on the possible ways to improve shareholder engagement.

- **Enforcement:** The consultation asked whether accountability and civil and criminal liability of board members should be strengthened.

- **Remuneration:** The consultation invited views on the need for possible further regulation of remuneration in financial institutions and in listed companies.

- **Conflicts of interest:** The consultation invited views on whether there is a need to address at European level the question of different rules on conflicts of interest and on possible content of these rules.

The deadline for responses to this consultation paper was 1st September 2010. The following contributions have been received: 178 from organisations, 8 from citizens, and 28 from public authorities.

Responses to the consultation highlighted the following messages:

- The **respondents agree** with the analysis in the Green Paper of the weaknesses in corporate governance in financial institutions. They support the Commission's goal of promoting effective corporate governance as well as the policy intent underlying the principles articulated in the Green Paper. The respondents also support **a more effective supervision** of the implementation by financial institutions of principles on good corporate governance.

- Financial institutions recognise that effective governance makes a meaningful difference in corporate performance and are currently **reviewing their practices**. Although many respondents highlight that certain failures in corporate governance in financial institutions were to a large extent due to a lack of effective implementation of existing rules**,** a number of respondents think that **regulatory framework could be improved** further.

- **Clear definition and division of responsibilities is fundamental**. For a number of respondents, more clarity is needed as regards respective duties of different bodies within the financial institution. Multiplication of controls and procedures should not lead to a confusion of which body is finally responsible for the decision-making and the overall governance of the financial institution

- A number of respondents think that any future proposals of the Commission should **be principle-based and proportionate** in order to take account the differences in business models of financial institutions, the nature of their activity, their size, complexity, legal form and different corporate governance systems and arrangements.

- Many respondents are of the opinion that future action at European level should focus on **desired outcomes** and the detailed implementation of the principles could be dealt

with at national level through legislation, supervisory review, increased transparency or codes of best practice with "comply or explain" approach.

- **Insurance companies and UCITS[145] managers** in particular mentioned the recent reform of internal governance in insurance and in asset management sectors and called on the Commission to take this into account in its reform of corporate governance in financial institutions.

2. OVERVIEW OF RESPONSES TO THE CONSULTATION

The consultation was launched on 2nd June 2010 and closed on 1st September 2010. Responses were invited from all interested parties including public authorities, financial services industry, investor community, law firms, audit and accounting firms, academics, trade unions, citizens and civil society in general. 214 answers were received from a wide range of professional representatives, citizens and public authorities.

Figure 1 provides a general presentation of the spread of the responses received, from organisations, public authorities and citizens.

Figure 2 provides a more detailed presentation of the status of organisational respondents, broken down into 7 categories: financial services industry, investor community (including asset managers), audit and accounting firms, non-financial and cross-sector professional organisations, law firms, employee representatives and civil society (including bodies promoting good corporate governance).

Figure 4 lists the 214 answers received according to their nationality: 202 responses were received from EU-domiciled organisations or European associations representing members from different Member States, 6 answers were received from non-EU domiciled organisations (US, Norway and Ukraine) and 6 answers from international associations.

A list of all the organisations, citizens and public authorities, who have accepted that their answers to the consultation be published, is attached in annex 1.

Figure 1:

Organisations	**178**	**83%**
Public Authorities	**28**	**13%**
Citizens	**8**	**4%**
Total Contributions	**214**	**100%**

[145] Undertakings for Collective Investment in Tradable Securities

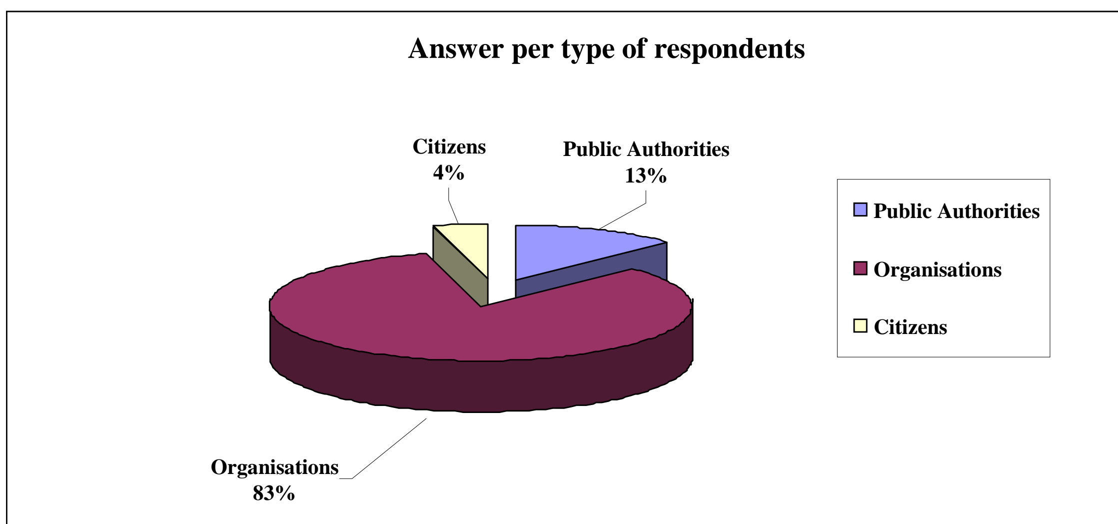


Figure 2:

For the purposes of this feedback statement, answers from respondents have been classified into 8 categories: financial services industry (including banks, insurance companies and financial markets), investor community (including investors, proxy voting agencies, asset managers), non-financial and cross-sector organisations (including professional chambers and associations and one pharmaceutical company), audit and accounting firms, law firms, employee representatives and civil society (including organisations promoting good corporate governance).

FINANCIAL SERVICES INDUSTRY	**55**	**31%**
INVESTOR COMMUNITY	**45**	**25%**
NON-FINANCIAL AND CROSS-SECTOR ORGANISATIONS	**24**	**14%**
AUDIT AND ACCOUNTING FIRMS	**22**	**12%**
CIVIL SOCIETY	**19**	**10%**
LAW FIRMS	**7**	**4%**
EMPLOYEE REPRESENTATIVES	**7**	**4%**
TOTAL	**178**	**100%**

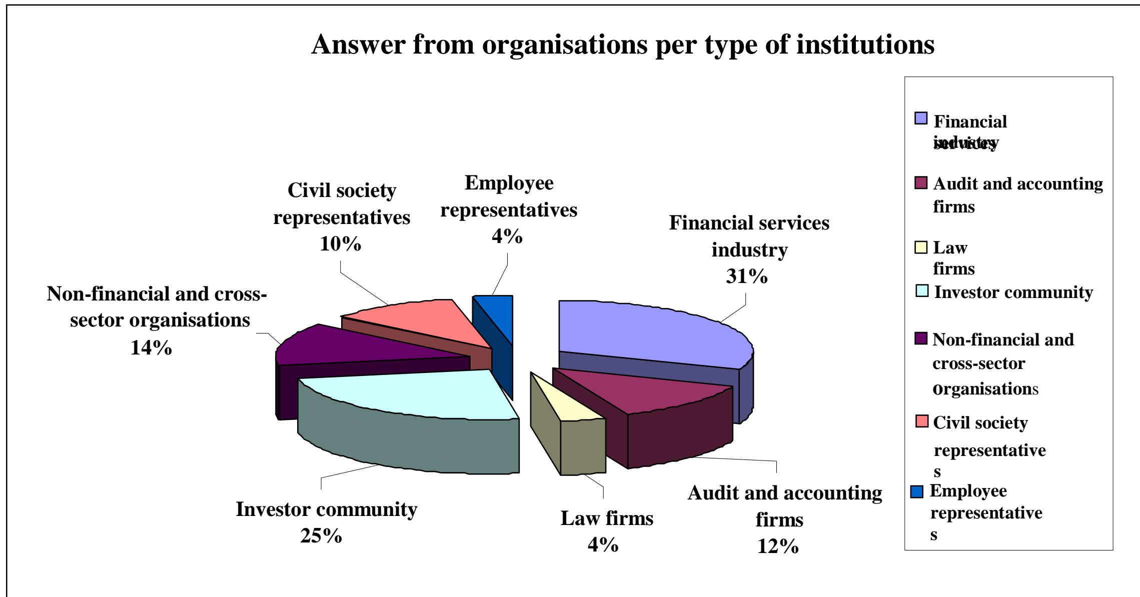


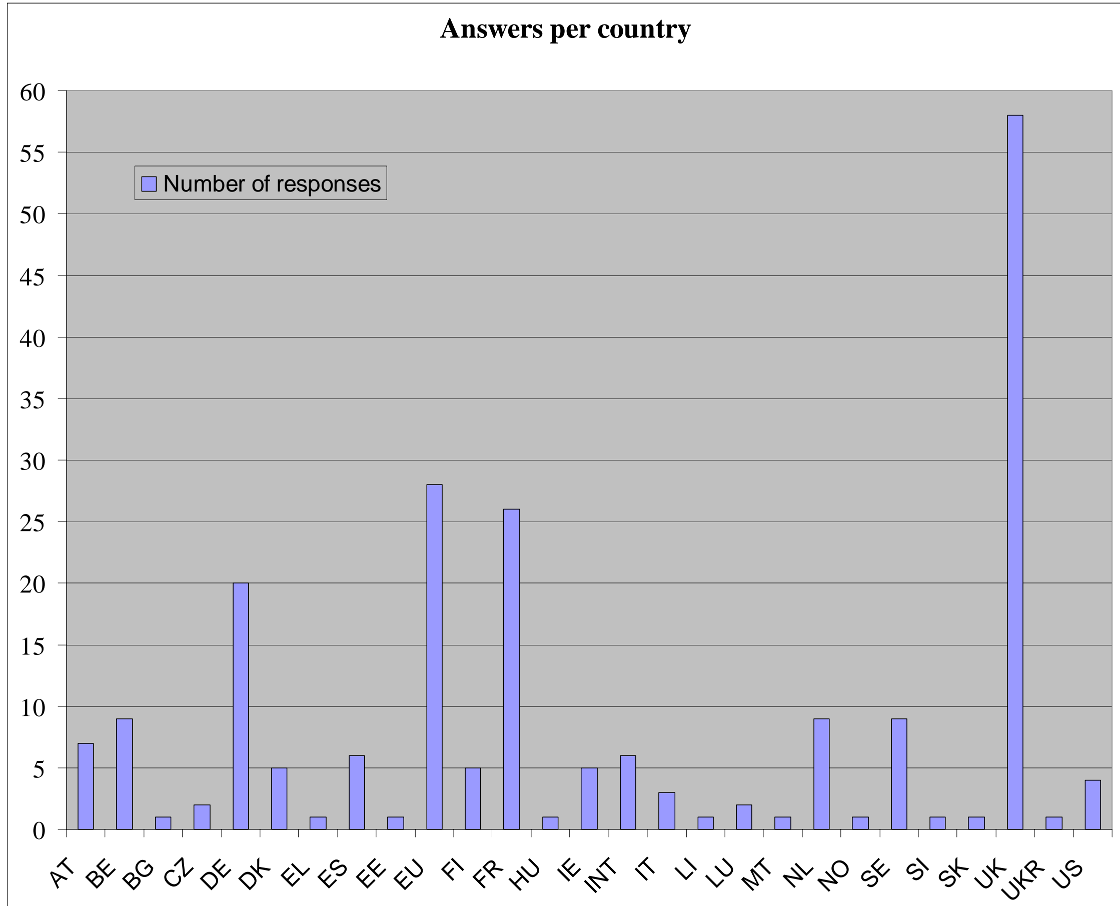
Figure 3:

List of the answers received according to their nationality.

Country		Country		Country	
AT	7	FI	5	SI	1
BE	9	FR	26	SK	1
BG	1	HU	1	UK	58
CZ	2	IE	5	**Sub-total**	**202**
DE	20	IT	3	UKR	1
DK	5	LI	1	US	4
EL	1	LU	2	NO	1
ES	6	MT	1	INT[146]	6
ET	1	NL	9		
EU[147]	28	SE	9	**Total**	**214**

[146] Responses submitted by international associations

[147] Responses submitted by European associations



3. DETAILED ANALYSIS OF RESPONSES

The feedback statement presents a broad summary of responses to each of the 38 specific questions raised in the consultation paper. It is a factual document which presents the results of the consultation and does not announce any policy options.

During the analysis of the responses, opinions have been categorized into 'yes/no' categories of answers where possible. The majority of the respondents have also provided qualitative commentaries to supplement or nuance their 'yes/no' answers. The explanations have been grouped under a number of sub-headings to enable a more detailed analysis of the respondents' views.

Some answers were unclear as to the allocation of a "yes" or "no" and required interpretation. This interpretation may not reflect fully or effectively the opinion of the respondent.

It also should be noted that during the analysis, all responses were given equal weight. Consequently, any individual respondent has the same impact on the result of the consultation as a public authority or an organisation. In addition, some respondents that

provided individual contributions indicated that they also contributed to a submission by a professional association in which they are members.

Please note that some respondents have answered only a limited number of questions which they considered to be of particular relevance and did not provide a response to other questions.

QUESTION 1.1

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

Whilst almost all respondents that provided an answer to this question agree that directors should commit sufficient time to their duties, a large majority consider a general rule on limitation of the number of boards on which a director may sit as inappropriate. The main reason for this being that such a limitation would be too arbitrary and inflexible, and would not allow to take account of the situation of each particular financial institution and individual circumstances of each director. Moreover, such a limitation would not in fact guarantee that director will dedicate enough time for his position.

The majority of respondents suggested the following alternatives:

Instead of a strict limitation of the number of mandates, there should be a general principle that directors devote sufficient time to their duties in a financial institution. The implementation of this general principle by financial institutions should be subject to monitoring by shareholders and supervisory authorities. A limitation of mandates may be envisaged as best practice with a "comply or explain" approach.

The expected time commitment should be defined in a letter of appointment for each director. All mandates held by each individual director should be publicly disclosed.

QUESTION 1.2

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

A majority of respondents that provided an answer to this question favour a mandatory prohibition on cumulating the functions of Chairman and of chief executive officer. In their view, combining both functions disregards the divergence of duties and capacities and concentrates an unwarranted amount of power and dominance in the hands of one person. A number of respondents indicated that in their jurisdiction it was already not possible to cumulate both functions. Some respondents considered, however, that certain exceptions would be necessary to accommodate specific situations, especially for small financial institutions and temporary cumulation of functions in particular circumstances.

Those respondents that opposed any prohibition considered that there was no conclusive evidence that financial institutions where the functions of Chairman and CEO were performed by different individuals performed better or have better withstood the crisis than those financial institutions where the two functions were performed by the same person.

QUESTION 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?

The majority of the respondents that provided an answer to this question consider that recruitment policies should specify the duties and the profile of the directors and ensure that directors have adequate skills. A large number of respondents in favour of this requirement consider however that the specific content of such recruitment policies should not be laid down in legislation but be left to financial institutions to decide upon according to their needs. It is also suggested by a number of respondents that a general profile for all board members should be defined in the recruitment policy and a specific profile should be drawn for each particular vacancy.

Among those respondents who were not in favour of recruitment policies specifying the duties and the profile of directors, some thought that it was not possible to define in advance the detailed profile required for each specific candidate. Others considered that shareholders' freedom to nominate board members should not be restricted. Cooperative banks and insurance companies in particular stressed that where directors were democratically elected by the general assembly of members, it was difficult to require in advance that candidates possess specific skills or profile.

Almost all respondents agreed that induction and continuous training of board members are essential.

QUESTION 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?

The vast majority of respondents that provided an answer to this question agree that increased diversity in boards avoids "group think" and strengthens challenge within boards. Some respondents are in favour of imposing quotas on the presence of women on boards. Many respondents consider, however, that diversity should not be pursued at the expense of knowledge and expertise. A board member should be selected taking account of a broad set of criteria, including merit, professional qualifications, experience, personal qualities of the candidate and diversity.

Some respondents also mentioned that diversity should not be limited to gender but it should also include age and cultural background and reflect geographical presence of the financial institution.

Certain respondents consider that diversity can be promoted through different means: codes of best practice with "comply or explain" approach, disclosure of board composition with regard to diversity criteria, benchmarking of existing practices.

Respondents who disagreed that including more women and individuals with different backgrounds in the board of directors could improve the functioning and efficiency of boards of directors considered that there was insufficient evidence that more diverse boards behaved better or that the different nationalities have different behaviours.

QUESTION 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?

The majority of the respondents that provided an answer to this question consider that evaluation of the board performance carried out by an independent expert could be a useful tool to assess the board's performance. There is a general agreement that it should at least be best practice. However, a number of respondents mentioned that there are for the time being too few external evaluators of sufficiently good quality to make the external evaluation mandatory for each financial institution. Some respondents suggested encouraging the professionalisation of external evaluation and the development of tools and methodologies for independent board evaluation.

On the second part of the question, a slight majority of the respondents were in favour of disclosing the main conclusions of the evaluation to the supervisor, but not the full report. There is also a strong preference not to disclose the results to the shareholders. The main argument for this is that if the results of the evaluation were publicly disclosed, it would inhibit directors' openness to the evaluation process and significantly undermine its value.

QUESTIONS 1.6, 1.7 & 1.8

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? Should it be compulsory for one or more members of the audit committee to be part of the risk committee and vice versa? Should the chairman of the risk committee report to the general meeting?

A number of respondents think that separate risk committees are good practice, especially for large, systemically important financial institutions. However, they consider that such requirement should be proportionate and care should be taken to avoid diluting the responsibilities of the whole board for risk oversight.

On the membership of audit and risk committees, many respondents consider cross-participation as best practice where two different committees exist. Some respondents, however, consider this unnecessary, as both committees advise and report to the board as a whole. Others see the cross-participation as one of different tools in ensuring communication between the two committees and think that it should be left to board to decide on specific means to ensure such communication. .

There is a strong opposition to the suggestion that chairman of the risk committee should report directly to the annual general meeting of shareholders. The majority of respondents consider that the board as a whole is accountable to shareholders and should report to the annual general meeting and not an individual director. However, respondents expressed general agreement that the chairman of risk committee should be available to answer questions. Some respondents also suggested that a report from the chairman of risk committee could be part of the annual report.

QUESTIONS 1.9, 1.10 & 1.11

What should be the role of the board of directors in a financial institution's risk profile and strategy? Should a risk control declaration be put in place and published? Should an approval procedure be established for the board of directors to approve new financial products?

All respondents that provided an answer to these questions agree that the board should approve the strategy of the financial institution and the nature and the extent of risks the company is willing to take with regard to its strategic objectives. The board should also be responsible for the oversight of the implementation of risk strategy by executive management.

Regarding risk statement, the views of the respondents are split. Almost half of respondents (mainly investors) that provided an answer think that a short and clearly understandable report informing shareholders on risk exposures, risk strategy and tolerance would help investors to form a comprehensive view of risk appetite of the financial institution, if it would not become a boiler plate declaration. In their opinion it would also contribute to raise board's awareness of risk issues.

The respondents (mainly financial services industry) who are against putting in place such risk statement think that existing European legislation on credit institutions and insurance companies already requires financial institutions to disclose sufficient information on risk. Furthermore, French, German and UK respondents indicated that their national legislation or corporate governance codes require extensive risk disclosures.

On the board's approval of new financial products, some respondents that provided an answer consider a systematic approval by board of new products as inappropriate, as it would entail involvement of boards in operational issues, which is the responsibility of executive management. However, other respondents consider that board could approve products that have a significant impact on the strategy and the risk profile of the financial

institution, as it would be part of global risk strategy. There is also a consensus that there should be a procedure with financial institutions to approve new products and that boards should be responsible for ensuring that this procedure is adequate and correctly implemented.

QUESTION 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?

The majority of the respondents (almost all financial services industry and the majority of investors) that provided an answer to this question consider such additional obligation as unnecessary. In their view, existing European and national legislation already require a high degree of communication between supervisory authorities and the boards or the executive management, which would cover information about material risks. However, some investors, audit and law firms, as well as certain public authorities, citizens and civil society representatives are in favour of introducing a more specific obligation.

QUESTION 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')?

Large majority of respondents that provided an answer to this question are not in favour of creating a specific duty of care with regard to specific stakeholders. They consider that the primary fiduciary duty of boards is to their shareholders. However, there seems to be a general agreement among all respondents that the boards should act in the best interest of the financial institution, which includes interests of different stakeholders. A number of respondents indicated that such duty to act in best interests of the company already exits in their jurisdictions.

QUESTION 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?

All respondents that provided an answer to this question agree that chief risk officer should have high status and authority, be independent from operational and business units and have close relationship with the board. But, according to the majority of opinions, the exact hierarchical status of the chief risk officer should not be prescribed and should be left to each financial institution to decide, taking into account the principle of proportionality.

The main suggestions as to different ways to enhance the status and the authority of the chief risk officer include the following: chief risk officer should be a member of the board or of the management board; chief risk officer should be able to report directly to

the board or to the risk committee; remuneration and removal from office of the chief risk officer should be subject to the board's approval; chief risk officer should be approved by the supervisor.

Some respondents, in particular cooperative banks, mentioned that the position of chief risk officer does not exist in all financial institutions. They stressed the importance of a proportionate approach that would allow small financial institutions not to have a separate and independent position of the chief risk officer.

Respondents from the insurance industry indicated that there was no need to strengthen further the status of the risk management for insurance companies as this issue is already dealt with in Solvency II[148].

QUESTION 2.2 & 2.3

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

Whilst all respondents that provided an answer to these questions agree that the board needs to receive timely and accurate information on risk, the predominant view is that setting up a formal escalation procedure for conflicts resolution is not necessary. But the majority consider that the chief risk officer should either have a duty to report directly to the board or to the risk committee on a regular basis or should be able to do so if needed. Some of the respondents also think that the position of the chief risk officer might be strengthened by periodically attending board meetings or meetings of the risk committee.

However, some respondents from jurisdictions with mandatory two-tier boards indicate that in their system only the management board has the competence to report directly to the supervisory board, not the chief risk officer who can report to the management board only.

Certain institutional investors indicated that shareholders were not sufficiently informed about risk issues and suggested that communication on risk matters should also be improved towards shareholders.

Respondents from the insurance industry indicated that the communication on risk matters from risk management function to the board will be sufficiently dealt with under Solvency II, where the board has to have effective insight into risk management.

[148] 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)

QUESTION 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?

Whilst all respondents that provided an answer to this question agree that information technologies should enable boards and executive management to receive timely and accurate information on risk, the majority consider that the decision to upgrade or not these technologies should be left to each financial institution to decide upon. For many respondents, correctly identifying the type of information the board requires to adequately fulfil its duties and the capacity of the board to understand the information provided to it are crucial.

Some respondents also indicated that systematic upgrading of information tools would entail huge costs and would be disproportionate for small financial institutions.

A number of respondents suggest that it could be a task for supervisors to oversee that information tools to transmit information on risk are appropriate for each specific financial institution.

QUESTION 2.5

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

Some respondents did not give a specific opinion on the subject because the content of the report on the adequacy of internal control system was not clear to them.

But the majority of the respondents that provided an answer to this question are opposed to the requirement for executives to approve such a report. A number of respondents consider that the board as a whole should approve a report on the adequacy of internal control systems as opposed to the executive management.

Others think that such approval would not have any added value compared to already existing requirements in different national or European legislations or corporate governance codes, or would be too formalistic and disproportionate. In particular, a majority of the respondents were opposed to a Sarbanes - Oxley[149] type declaration as they thought it was too burdensome and also did not prevent the crisis in US.

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[149] The Sarbanes-Oxley Act adopted in 2002 in US makes reporting on internal controls mandatory for SEC registrants and their independent auditors. Section 302 of the Act entitled "Corporate Responsibility for Financial Reports" establishes management responsibility for internal controls and requires management to evaluate the effectiveness of internal controls. Section 404 of the Act directs the SEC to adopt rules requiring annual reports of public companies to include an assessment, as of the end of the fiscal year, of the effectiveness of internal controls and procedures

Among the respondents who were in favour of the executives approving a report on the adequacy of internal control systems, certain French, German and Spanish respondents indicated that such an obligation already existed in their national legislation or in a corporate governance code and should become a standard at European level. Respondents from UK were particularly in favour of a Turnbull[150] type declaration.

QUESTION 3.1

Should cooperation between external auditors and supervisory authorities be deepened? If so, how?

The majority of respondents that provided an answer to this question, in particular nearly all public authorities, think that there is a need to deepen the cooperation between auditors and supervisors. In their view, this could be achieved through a more frequent communication and a two-way dialogue, for example on macro-economic issues; trilateral meetings between supervisors, auditors and financial institutions; regular meetings at national or at European level of professional bodies of auditors with supervisory authorities; additional reporting requirements on some specific issues.

Those respondents which are opposed to enhanced cooperation between external auditors and supervisory authorities consider that existing national and European requirements sufficiently regulate the duty of auditors to report to supervisors. In their view, any the primary duty of auditors is to report to shareholders. Any additional cooperation could damage the relationship of trust between auditors and the financial institution. Those respondents also warn against mixing the roles of supervisors and auditors as they have different missions.

QUESTION 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?

A number of respondents (including financial services industry, investors, audit and accounting firms and certain public authorities) that provided an answer to this question are not in favour of increasing the duty of information of external auditors. They consider that the existing rules at national or European level on reporting by external auditors of serious matters to boards and supervisors are sufficient. However, other respondents think that there is a need to analyse how these rules were applied in practice, although

for financial reporting. Section 404 also requires the company's independent auditors to attest to and report on management's assessment.

150 The Turnbull guidance sets out best practice on internal control for UK listed companies. It was initially published in 1999 and subsequently reviewed in 2005. Under this guidance, the board should in particular provide a statement on internal control which should, *inter alia*, include an acknowledgement by the board that it is responsible for the company's system of internal control and for reviewing its effectiveness.

there is not evidence showing that they have been applied. Several respondents nevertheless think that further guidance is needed as to the circumstances that external auditor should report to supervisors, on the nature of information that should be provided and on the procedures.

Those respondents in favour of the increased duty of information (mainly public authorities, certain financial institutions, investors and audit firms, civil society representatives and citizens), think that the duty to report could be widened, for example to encompass weaknesses in internal control.

QUESTION 3.3

Should external auditors' control be extended to risk-related financial information?

A majority of respondents that provided an answer to this question were strongly opposed to extending the duty of external auditors to control risk-related financial information. In their view, current audit requirements contained in their national legislation and in IFRS already encompass information related to risk where auditors need to be satisfied that this information is consistent with financial and accounting information. They consider that auditors' control should not be further extended. Certain respondents also think that auditors do not have appropriate tools to audit non-financial information on risk and that the control of such information should be left to the board and to the supervisors.

Other respondents (mainly public authorities, certain investors, audit and accounting firms and civil society representatives) consider that it is desirable for auditors to validate a greater range of information which is relevant for shareholders.

Some respondents were not opposed to extend auditors' control to risk-related information but considered that the scope of such audit should be defined first and further thought should be given to the ability of auditors to express a professional opinion on the internal control systems of banks and other risk-related issues.

QUESTIONS 4.1 & 4.2

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

Almost all respondents that provided an answer to this question agree that supervisory authorities, in course of the periodic supervisory review, should be able to challenge the efficiency of internal governance structures and monitor whether these structures could have a negative impact on financial stability. Only few respondents are opposed to any role of supervisors in the internal governance.

However, views are split as to the need to enhance the existing powers of the supervisors. A slight majority of the respondents that provided an answer consider that the existing

national and European rules are sufficient and that there is no need to strengthen further the role of supervisors in corporate governance.

A number of respondents think, however, that supervisory authorities should have more powers to control the performance of the boards and risk management and to sanction any shortcomings in internal governance of financial institutions. In particular, many respondents are of the view that supervisors should give closer attention to the balance in the board in relation to risk strategy and satisfy themselves that the board is able to exercise efficiently its oversight function. Some respondents, especially from UK, indicated that in their jurisdictions supervisors have recently been given increased powers to monitor internal governance of financial institutions.

Nevertheless, there is a consensus that boards and shareholders of the financial institution should be primary responsible for internal governance arrangements. Cooperative banks in particular stressed that the general assembly of members should remain at the heart of governance and internal control mechanism. Nearly all respondents agree that any enhancement of supervisory powers should not result in supervisory authorities taking management decisions.

QUESTION 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?

The majority of respondents that provided an answer to this question think that the fit and proper test should be extended to include technical and professional skills as well as individual qualities of future members of the board.

Many respondents think that boards should have expertise and knowledge collectively and should be able to challenge management as a team, instead of each candidate possessing all set of specific skills and qualities. Some respondents mention the difficulty to find an appropriate test for individual qualities, the appreciation of which would always be subjective. A number of respondents emphasise that increased competence should not be detrimental to independence and diversity of board members.

Regarding the ways to apply the enhanced fit and proper test, a number of respondents suggest that supervisors should conduct periodic interviews with board members, attend as observers board and sub-committee meetings. They site as example the UK approved persons regime[151].

[151] In 2009 Financial Services Authority in UK tightened its approved persons regime for Significant Influence controlled functions. FSA increased the number of controlled function categories for which approval is required. To approve a particular person, the FSA needs to be satisfied that he is a fit and proper person to perform the function to which the application relates. To this end the

Those respondents that are opposed to extend the fit and proper test to professional skills and individual qualities of candidates think that supervisors already have sufficient powers to check the composition of the board, are not better suited than shareholders to set the board members and thus should not be excessively intrusive in the nomination process. One respondent considered that excessive intervention of supervisors could result in an undue transfer of liability to the supervisor.

QUESTION 5.1

Should disclosure of institutional investors[152] *voting practices and policies be compulsory? How often?*

The vast majority of respondents that provided an answer to this question are in favour of mandatory disclosure of voting policies and records by institutional investors

They consider that such disclosure would have a positive impact on the awareness of investors, optimise investment decision of ultimate investors, facilitate issuers' dialogue with investors and encourage shareholder engagement. However, certain respondents are relatively cautious with regard to public disclosure of voting records for confidentiality reasons.

A number of respondents think that the disclosure should be done at least on an annual basis, with voting records being disclosed after each general meeting of the invested company. There are also some voices in favour of half-yearly or even quarterly disclosure.

Those respondents which are opposed to disclosure by institutional investors of their voting policies and records either feared that such disclosure obligation for a specific category of shareholders would be contrary to the principle of equal treatment or thought that it should be left for each institutional investor to decide on whether to disclose or not its voting policy.

QUESTION 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.

FSA has the power to conduct interviews in order to assess competence and capability of the candidate for the role.

[152] Institutional investors are considered to be professional investors which invest on behalf of or for the benefit of beneficiaries, including but not limited to pension funds, hedge funds, insurance companies and banks

The majority of respondents that provided an answer to this question think that institutional investors should adhere to a code of best practice, whether to national, European or international code, at least on a "comply or explain" basis. A number of respondents consider the UK Stewardship Code as being a model for investor codes of best practice. Some respondents are of the opinion that there is a need either for a European code of best practice or for a common standard at European level with mutual recognition of national stewardship codes.

One respondent thinks that self-regulatory codices are not a viable means to assure the quality of corporate governance. In his view, responsibility of external control should lie with the supervisory authorities and external auditors.

QUESTION 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'?

The majority of respondents that provided an answer to this question support mechanisms that would enable investee companies to identify efficiently their shareholders. Many respondents would be in favour of greater transparency of the shareholders' register and of a uniform binding rule at European level on disclosure of nominees and beneficial owners of shares. French and UK respondents cite their national legislation as an example. Those respondents that are not in favour of enhanced identification of shareholders think that identification of shareholders is already ensured in other instruments, such as the Transparency Directive[153].

With regard to empty voting, some respondents would be in favour of greater disclosure of stock lending practices. However, the majority of respondents do not think that empty voting would be countered by better identification of shareholders, as, in their view, empty voting is linked to the record date issue.

QUESTION 5.4

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

There is a consensus among the respondents that provided an answer to this question that communication and dialogue between the shareholders and the invitee companies is essential. For that purpose, there is a need to reduce costs, remove legal obstacles and regulatory barriers that preclude shareholders to actively engage in companies. Many respondents underline the necessity to facilitate cross-border voting and would be in

[153] Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC.

favour of regulating proxy voting agencies. Effective implementation of the Shareholder Right Directive is also seen as a step towards better involvement of shareholders, as well as improved disclosure of information on risk, strategy and other non-financial information. As regards sustainability and long-terms focus of investments, some respondents suggest greater disclosure of remuneration structures of asset managers, increased taxation of financial transactions to limit the portfolio turnover, actions to promote the awareness of shareholders as to the long-term engagement, incentives for shareholders to vote and hold their participation at long term.

QUESTIONS 6.1 & 6.2

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

The vast majority of respondents that provided an answer to these questions are opposed to any increase in civil and criminal liability of directors. The general view is that current rules impose sufficient liability on directors and their effective implementation should be studied first before any harmonisation is decided at European level. Many respondents underline that increased liability would not automatically result in better decisions by directors, could be detrimental to sound initiative and directors would discourage talented individual to apply for boards' membership. A number of respondents think that supervisors need to apply effectively the range of sanctions they already dispose of to make directors more accountable. Certain respondents are also in favour of annual re-election of board members, which in their view would contribute to enhance the directors' accountability to shareholders.

QUESTION 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?

Nearly all respondents that provided an answer to this question agree that incentives for directors must be properly structured in order to encourage long-term and sustainable performance of companies. However, the vast majority is opposed to any additional legislative measures in this field as regards the structure of remuneration. They think that recently adopted European legislation, such as the amendment to the Capital Requirements Directive[154] and the Commission Recommendation on remuneration of directors in listed companies[155], sufficiently deal with such issues. Certain respondents

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154 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.

155 Commission Recommendation of 30 April 2009 complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies.

would nevertheless welcome more transparency of remuneration policies of directors in listed companies as well as an advisory shareholder vote.

QUESTION 7.2 & 7.3

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? 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 vast majority of respondents who provided an answer to these questions think that stock options are a useful tool to align interest of directors with those of shareholders and should not be prohibited if properly structured in accordance with existing legislation. The only possible field for action at European level for some respondents could be the better disclosure of stock option payments and the shareholder advisory vote.

As regards taxation regime, the predominant view is that favourable taxation of stock options, where it exists, does not have any major impact on risk-taking behaviour of directors and thus should not be dealt with at European level.

QUESTION 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?

The majority of respondents who provided an answer to this question do not see a need to further strengthen the role of shareholders or employees in establishing remuneration policies. In their view, the existing European or national rules give already sufficient weight to shareholders and employees on remuneration issues.

Some respondents, predominantly investors and audit and accounting firms, favour however, an advisory or a binding vote of shareholders on remuneration of directors, which they think should be set up at European level.

Certain respondents, essentially employee representatives, would be in favour of a clear role of employees in remuneration committees and improved information of employees about remuneration of directors.

QUESTION 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?

Whilst the majority of respondents that provided an answer to this question agree that pay, including severance packages, should award effective performance and not the failure, the majority of respondents that provided an answer to this question do not consider appropriate to prohibit severance packages or to further regulate them at European level. In their view, the award of severance packages should be the responsibility of boards and shareholders and should be decided on case by case basis.

QUESTIONS 7a & 7.6

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?

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

The vast majority of respondents that provided an answer to this question think that, in view of new rules on remuneration in credit institutions and investment firms introduced by CRD III, no additional measures are required at European level before the effects of the implementation of these new rules is carefully evaluated. As regards financial institutions having received public funding, the general view is that it should be left to each national competent authority to decide on case y case basis whether there is a need to reduce or suspend the variable remuneration for each specific financial institution. Many respondents indicate that in some cases it could be justified to pay some bonuses to attract new staff to rebuild the financial institution.

QUESTIONS 8.1 & 8.2

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? 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?

Whilst some of the respondents think that no additional measure are needed at European level on prevention of conflicts of interest, the prevailing opinion is that there is a need for greater alignment of existing rules at European level. But the majority of the respondents agree that the specificities of different types of financial institutions and their business models should be taken into account.

The main suggestions as to the content of the possible measures are the following:

- formal written conflicts policy which should be disclosed in the annual report;

- public disclosure of existing conflicts of interest;

- harmonisation of the definition of "conflicts of interest";

- adherence to codes of ethics;

- reduce complexity of financial institutions;

- proper and documented division of responsibilities and segregation of duties;

A number of respondents also indicated that in their view conflicts of interest could arise in all type of companies and therefore should be regulated in general.

Annex 1.

- List of the public authorities that have participated in the consultation.

Austrian Financial Market Authority

Austrian Ministry of Finance

Autorité des marches financiers

Banco de España

CEIOPS

Central Bank of Ireland

Committee of European Banking Supervisors

Czech National Bank

Danish government

Dutch Ministry Finance

Financial Reporting Council

Finnish Financial Supervisory Authority

Finnish Ministry of Finance

French Ministry of Finance

German Bundesrat

German Bundestag

German Federal Government

Malta Financial Services Authority

Ministry of Finance of Estonia

Ministry of Finance of the Czech Republic

Secrétariat général de l'Autorité de contrôle prudentiel

Slovak Republic Government

Slovenian Ministry of Finance

Spanish Government

Swedish Ministry of Finance

Swedish Riksdag

UK Financial Supervisory Authority

UK Government

- List of the citizens which have participated in the consultation.

Centre for Inclusive Leadership

Nicolas Cuzacq, Katrin Deckert, Université Paris Est Créteil Val de Marne

Daniel Ferreira, Tom Kirchmaier, Daniel Metzger

Jim Stewart

Lieve Lowet

Miroslav Nedelchev

Peter Schellinck

Sabine de Bethune

- List of the organisations which have participated in the consultation.

AFG

Allianz

AMICE

APG

Association for Financial Markets in Europe

Association française des entreprises privées

Association française des marchés financiers

Association of British Insurers

Association of Chartered Certified Accountants

Associaton of Swedish Institutional Owners

Assogestioni

Austrian Bundesarbeiterkammer

Austrian Raiffeisenverband

Aviva

AXA Investment Managers

Banco Santander

Barclays

BDO

Belgian Financial Sector Federation

BlackRock

BNP Paribas

BPCE

British Bankers' Association

Building Societies Association

Bundessparte Bank und Versicherung

Bundesverband Investment und Asset Management

Bundesvereinigung der Deutschen Arbeitgeberverbände & Bundesverband der

Deutschen Industrie

Businesseurope

Bvlaco

California Public Employees' Retirement Systems

CBI

CD&V

CEA

Central Chamber of Commerce of Finland

Centre for Corporate Governance, University College Dublin

CFA Institute

CFDT Banques

Chambre de Commerce et de l'Industrie

Chartered Accountants Ireland

Chartered Accountants of Scotland

CIPD

Compagnie nationale des commissaires aux comptes

Confederation of Finnish Industries

Confederation of Swedish Enterprise

Confederation of the Nordic Bank, Finance and Insurance Unions

Conseil des barreaux européens

Consejo General de Colegios de Economistas

Consiglio Nazionale dei Dottori Commercialisti e degli Esperti Contabili

Council of Institutional Investors

Creative Investment Research, Inc.

Crédit Agricole

Crédit Mutuel

Danish Bankers' Association

Danish Financial Sector Associations

Danish Shareholders Association

Deloitte

Deutsche Gewerkschaftsbund

Deutsche Industrie- und Handelskammertag

Deutsches Aktieninstitut

Die Fürungskräfte

DSW

Dutch Investors’ Association

EcoDa

EFAMA

Ernst and Young

Ethical Investment Research Services

Eumedion

Euroclear

EuroInvestors

European Assocation of Co-operative Banks

European Association of Public Banks

European Banking Federation

European Confederation of Institutes of Internal Auditing

European Federation for Retirement Provision

European Financial Services Round Table

European Issuers

European Network of Credit Unions

European Private Equity and Venture Capital Association

European Savings Bank Group

European Trade Union Confederation

European Union of Women

European Women Lawyers’ Assocation

European Womens' Lobby

Eurosif

F&C Investments

Fair Pensions

Fédération Bancaire Française

Fédération Française des Sociétés d'Assurance Mutuelles

Fédération Française des Sociétés d'Assurances

Federation of European Accountants

Federation of Finnish Financial Services

Financial Services Consumer Panel

Forsikring & Pension

Forum of European Asset Managers

GC100

Genworth Financial

German Insurance Association

Glass Lewis

GlaxoSmithKlein

GOODCORP

Governance for Owners

Grant Thornton International

Groupement des Entreprises Mutuelles d'Assurances

Groupement National de la Coopération

GUBERNA

Hedge Fund Standards Board

Hermes

HQB partners

HSBC

Hungarian Banking Association

ICAEW

ICMA Asset Management and Investors Council

ILAG

ING

Institut des Actuaires

Institut Luxembourgeois des Administrateurs

Institute for the Accountancy Profession in Sweden

Institute of Chartered Secretaries and Administrators

Institute of Directors

Institute of International Finance

Institute of Public Auditors in Germany

Institute of Risk Management

Institutional Shareholder Services

Instituto de Censores Jurados de Cuentas de España

International Bar Association

International Research Center of Banking & Corporate Governance (Ukraine)

International Underwriting Association

Inverco

Investment Management Association

KEPKA

KPMG Europe

KPMG France

Law Society of England and Wales and the City of London Law Society

Legal and General

Legal and General Investment Management

Linklaters

Lithuanian Investors

Local Authority Pension Fund Forum UK

London Stock Exchange Group

Mazars

Medef

NASDAQ OMX

National Association of Pension Funds UK

Nationwide Building Society

Nederlandse Vereniging van Banken

Nestor Advisors

Nordea

Norges Banks Investment Management

OPF&VB

Österreichischer Arbeitskreis für Corporate Governance

Pan European Insurance Forum

PIRC

PricewaterhouseCoopers

Proxinvest

Railpen Investments and Universities Superannuation Scheme

Regierungskommission Deutscher Corporate Governance Kodex

Royal Dutch Institute of Registered Accountants

RSA Insurance

Share Plan Lawyers group

SIFA

Societé Générale

Standard Chartered Bank

Standard Life

Swedish Bankers´ Association

Swedish Corporate Governance Board

The Association of Investment Companies

The Co-operative Asset Management

The Director´s Office

Tomorrow's Company

Towers Watson

Transparency International

Uni Europa Finance

Unicredit

Vereinigung der Bayerischen Wirtshaft

Wirtschaftskammer Österreich

Wirtschaftsprüferkammer

Wp net

Zentraler Kreditausschuss