"Executives' Compensations According to the Bank of Italy"

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(I)

INTRODUCTION. POLICIES AND PRACTICES OF COMPENSATIONS AND INCENTIVES IN BANKS AND BANKING GROUPS

1) Executives' compensations as a key factor of the Global Financial Crisis.

The Global Financial Crisis has highlighted many deficiencies in terms of Corporate Governance*:* among these, the compensation and incentive systems of executive directors have been the subject of particular attention, not only by doctrine[1] and regulators - national and international - but also a public opinion particularly susceptible to their significant implications on an economic and social level[2].

Before proceeding to stating the reasons why the issue under review has assumed a central role in the economic-political debate at an international level, we should concentrate on the theoretical background in order to clearly understand what repercussions a deficient system of compensation and incentives could have on actual corporate operations.

The central issue of the executive compensation models is the problem that arises from the separation of ownership and control.

This strict separation increases the risk of a divergence of pursued interests than by those of the shareholders[3]. We know that the first is given, almost exclusively, the management of the company, and not only in the systems of public economy.

In the absence of adequate controls, managers may be tempted to put into place strategic plans characterized by a high risk appetite, aimed at maximizing their personal interests in the short-term, while placing themselves at odds to that of their shareholders, generally long-term oriented.

To avoid such a dangerous contrast, there will be a need to develop systems of compensation and incentives of the executives that will be able to determine a convergence in the long term between the objectives pursued by management and the interests of shareholders, so as to reduce the risk appetite of the first and to ensure sound and prudent management.

The link between the compensation of executives and the degree of risk appetite inherent to the operations of the entities they head has been the subject of detailed analysis in the aftermath of the financial turmoil of 2007.

It has been seen how systems of compensation, set up for the most part in corporate reality, were actually designed to encourage short-term corporate management policies through excessive risk-taking functions to a huge increase in fees, but contrary to proper administration.

In particular, these forms of compensation have encouraged the engagement of unscrupulous short-term oriented policies by executives, characterized by higher levels of risk utterly incompatible with the principles of sound and prudent management.

The phenomenon in analysis is better known as short-termism, also defined as *managers myopia* (A. EDMANS, *Blockholder Trading, Market Efficiency, and Managerial Myopia*, *Journal of Finance*, Vol. 64, No. 6, pp. 2481-2513): this expression indicates *"the tendency to focus attention on short-term gains, often at the expense of long-term success or stability"* (COLLINS ENGLISH DICTIONARY, *Short-Termism,* 5th Edition, 2000, http://dictionary.reverso.net/english-definitaion/Short-termism) [4].

We must add that, before the beginning of the Global Financial Crisis, the situation was already particularly delicate: in fact, the financial institutions themselves were seeking short-term profits, regardless of the long-run consequences. This *myopic* behavior was later shared

by several market participants, such as mortgage originators, securitizers, credit-default swap sellers, and investors as well.

From these observations, it is possible to assume that the deficit elaboration of the systems of compensation and incentives has been one of the principal factors[5] that triggered the global financial crisis[6].

In the banking and finance area, it is not possible to merely find the misalignment between the short-term interests of executives and those of long-term of the shareholders.

The reasons which call for observing the phenomenon in a different way are the following: *i)* the significant macroeconomic implications inherent in the role and activities carried out by financial institutions, a corollary of a globalized economy dominated by the presence of intermediaries, not only too big to fail, but also too interconnected to fail, causing serious systemic risks[7]; *ii)* the exasperation of the canons of sound and prudent management that derives from these, *iii)* the existence of other subjects substantially interested than the only shareholders (depositors and taxpayers in the case of public bailouts); *iv)* the contrast between the liquid nature of the liabilities – comprising of the vast majority of deposits - and the long-term maturation of assets, likely to give rise to, during a period of crisis characterized by the massive withdrawals of depositors, severe liquidity problems in the short and medium term; *v)* the tendency of bank shareholders and executives to be "*more prone to moral hazard than are non-bank managers and shareholders"* (G. FERRARINI – M. C. UNGUREANU, *Economics, Politics, and the International Principles for Sound Compensation Practices: An Analysis of Executive Pay at European Banks,* in *Vanderbilt Law Review,* 2011, Vol. 64, 2, p. 439) [8].

From these considerations an appropriate design of the systems of compensation and incentives somewhat emerges - with a view to creating long-term oriented value - not only does it respond to the need of aligning the interests of the executives and shareholders, but it

also appears to be appropriate for the stability of the economic-financial system as a whole and the protection of stakeholders which are more numerous and heterogeneous compared to those that are called upon to relate with non-financial institutions.

2. The legislative response to the problems of post-crisis compensations.

In the aftermath of the explosion of the Global financial crisis, the regulators pointed their attention to these problematic issues, previously neglected due to the general euphoria that they did not want to oppose[9].

Before proceeding with the specific analysis of the discipline elaborated by the Bank of Italy, we should carry out a global survey of the supranational guidelines on compensations and incentives that inspired and guided Italy's supervisory authorities in the implementation process of the monitoring arrangements, beginning with the international standards elaborated on the subject.

3. International standards on executives' compensations. The crucial issue of the mechanisms of compensations and incentives of executives has contributed to the preparation of numerous International Standards on the subject. Among these, the following are the most important:

- Financial Stability Forum (FSF): *FSF Principles for Sound Compensation Practices*, *Principles for Sound Compensation Practices, Implementation Standards,* 2009. The principles developed by the Financial Stability Forum (then the Financial Stability Board) are driven from the assumption that "*Multiple surveys find that over 80 percent of market participants believe that compensation practices played a role in promoting the accumulation of risks that led to the current crisis. Experts agree. Few if any observers and respondents believe that compensation was the sole cause of the*

crisis, nor do they believe that changes limited to compensation practice will be enough to limit the chance of future systemic crises. However, absent such changes, other reforms are likely to be less effective". They aim at achieving the following objectives: *i)* an effective governance of compensation[10]; *ii)* an effective alignment of compensation with prudent risk taking[11]; *iii)* an effective supervisory oversight and engagement by stakeholders[12];

- Financial Stability Board (FSB), *Thematic Review on Compensation, Peer Review Report*, 2010. The document can be divided into two distinct parts: in the first, the Financial Stability Board carries out an overview of implementation by National Authorities of measures to promote sound compensation practices. From this analysis two distinct regulatory approaches emerge:

  i) "Many jurisdictions have adopted an implementation model that includes a mix of enforceable regulation and supervisory oversight"; ii) "Other jurisdictions follow a primarily supervisory approach to implementation, involving principles and guidance and the associated supervisory reviews". For the purpose of this work, it must be stressed that the Authority emphasizes that "*In some jurisdictions,* ***regulatory initiatives on compensation had pre-dated the crisis, but requirements were seen more from a code of conduct than from a prudential perspective*** *– focused on public disclosure, corporate governance and specific control or review requirements for the remuneration of senior management and executive board members –* ***and were applicable to all listed companies rather than being specific to the financial sector***". From the quoted passage it emerges that the attention towards the problems relative to executives' compensations, despite having been already warned by individual firms before the Global Financial Crisis, only afterward did it become subject to measures in a prudential perspective. In the second part, the FSB

develops further recommendations, addressed however, contrary to the *Principles for Sound Compensation Practices*, not to individual intermediaries, but the Authorities - national and supranational - committed to developing a global convergence regarding executives' pay;

- Basel Committee on Banking Supervision, *Compensation Principles and Standard Assessment Methodology*, 2010; *Range of Methodologies for Risk and Performance Alignment of Remuneration*, 2011. Within the first document, the Basel Committee provides an assessment methodology which "*aims to guide supervisors in reviewing individual firms' compensation practices and assessing their compliance with the FSB Principles for Sound Compensation Practices and their implementation standards"*. This methodology has two main principles: *i)* provides additional supervisory guidance aimed at guiding the individual firms to a successful implementation of the FSB Principles; *ii)* in relation to each principle, presents a series of appropriate operational instruments to achieve this goal, keeping in mind that this "*toolkit* […] *should be adapted to existing supervisory approaches as well as to the institution being reviewed"*. With reference to the second document - which, according to the non-binding nature of standards, "*is not intended to be prescriptive"*, it *"responds to recommendation 7 of the FSB Peer Review Report on compensation",* regarding the methodologies of adjusting compensations to risk and performance. The paper provides an overview of the methodologies currently used by individual firms, followed by some reflections on the most relevant elements to ensure an effective risk alignment. The Basel Committee adopted a risk-based approach to supervising, an assumption confirmed by the relevance attributed to the principle of proportionality, defined within the document as "*a key principle to consider for the implementation and supervision of the FSB Principles and Standards on Sound*

Compensation Practices". Pursuant to this principle, "*from the firms' perspective, the implementation of the rules can be tailored to the institutions' specific characteristics. From the supervisors' perspective, proportionality implies that the intensity of supervision will vary according to the particular risk characteristics of those institutions. This corresponds in practice to risk-based supervision*".

From the analysis just completed, it emerges that the approach of the supranational bodies to the issue of executives' compensations results as being characterized - on one side - by the wide liberty granted to individual intermediaries in the activity of the implementation of elaborated standards, - and on the other - from the arrangement, in favor of them, of a set of methodologies and instruments that, if adapted through the use of the proportionality standard for individual corporate realities, will facilitate the achievement of sound compensation practices.

4. The community legislative approach: in particular, the Directive 2010/76/CE. The Supervisory Provisions issued by the Bank of Italy transpose the already mentioned Directive 2010/76/CE, Credit Requirements Directive III (c.d. CRD III).

In turn, this has been preceded by two interventions of which would be considered appropriate to give a brief account:

a) The European Commission Recommendation 30 April 2009, N. 385, "*complementing Recommendations 2004/913/EC and 2005/162/EC as regards the regime for the remuneration of directors of listed companies*" [13], where we find the set conviction that "*remuneration structures have become increasingly complex, too focused on short-term achievements and in some cases led to excessive remuneration, which was not justified by performance*". Under this assumption, the focus of the Authority shifts from the incentive alignment model

that characterized the previous recommendations to the performance-pay model and long-term sustainability[14]. The recommendation establishes principles on a compensation structure, on the design and implementation of compensation policies, and on the role of supervisory authorities in the review of compensation policies of financial institutions. It also introduces forecasts to strengthen the independent profiles of the Remuneration Committee, whose creation was already required by Recommendation 2005/162/EC[15];

b) The *High Level Principles for Remuneration Policies* (2009) of the Committee of Banking Supervisors (CEBS, now the European Banking Authority, EBA). The document provides "*guidelines addressed both to regulators and regulated institutions"*, to regulate the remuneration policy with respect to the generality of the subjects included within the corporate structure, with particular reference to the senior employees and other risk-takers and risk managers. The document provides important guidelines on transparency, based on the assumption that "The remuneration policy should be transparent internally and adequately disclosed externally."

As we proceed now to the analysis of the Directive 2010/76/EC, it is necessary to premise that it is part of the most extensive supervisory framework established - according to the Basel II rules on capital measurement and standards - by the Capital Requirements Directives[16].

With reference to the adopted prescriptive formality, it must be stressed how the Directive highlights the modified quality – now consolidated at a European level – of the regulatory intervention in relation to the issues of corporate governance, characterized - in line, moreover, with the objectives of harmonization pursued by the community legislature – by implications that are typically principles-based rather than rule-based[17].

The confirmation of this approach is provided by the same analysis of the literal data: in fact, Whereas n. 4 states that "*The principles should recognize that credit institutions and investment firms may apply the provisions in different ways according to their size, internal organization and the nature, scope and complexity of their activities and, in particular, that it may not be proportionate for investment firms referred to in Article 20(2) and (3) of Directive 2006/49/EC to comply with all of the principles*".

Under this assumption, through the application of the principle of proportionality, the Directive therefore emphasizes how the provisions regarding compensations should not be *totally* complied with by any intermediary, regardless of their operational characteristics and size, but should be applied in a qualitative and quantitative manner consistent with the types of individual subjects, for some of which the full implementation of the principles under review would become unsustainable and destructive.

This approach should be shared because it can be well adapted - for its application flexibility - not only for the distinctive features of its various recipients, but also for the continuous and inevitable changes that characterize the current financial and banking world. In contrast, excessive rigidity and an almost obsessive attention to detail are likely to lead to the rapid obsolescence of the regulatory systems whose origin - by virtue of the high complexity of the reality of which they will insist - is in most cases very long and troubled[18].

Another argument in favor of the *principles-based* approach is that, in a field with many important implications on *corporate governance* such as the present, the *regulators* suffer from an information *deficit* in relation to individual companies and are not able to determine what requirements would ensure proper and efficient corporate governance. For this reason it is preferable to entrust this role to recipients of the discipline[19], within a context in which the fundamental principles and guidelines to be followed will be imposed, however.

Lastly, with reference to the relationship between technical standards and implementation costs, whether principles-based systems impose greater ex-post costs on the participants, called to a more challenging task for purposes of compliance, is an empirical unknown (C. L. Ford, *New Governance, Compliance, and Principles-Based Securities Regulation, American Business Law Journal*, 2008, V. 45, 1 p. 34).

With specific reference to the discipline relating to compensations and incentives, "*regulators should not replace boards in setting pay structures and* […] *regulatory intervention concerning executive compensation at banks should be limited in scope, so as to maintain the flexibility of executive pay arrangements"* (G. FERRARINI – M. C. UNGUREANU, *op. cit.,* p.435), since only a "*principles-based regulation* […] *is flexible enough to allow for innovation and diversity in executive pay structures, while preventing excessive risk taking"* (G. FERRARINI – M. C. UNGUREANU, *op. cit.,* p. 438).

The intervention of the community legislature, which has a global reach with regards to remuneration (in fact, Whereas n. 4 states that "*because excessive and imprudent risk-taking may undermine the financial soundness of credit institutions or investment firms and destabilize the banking system,* ***it is important that the new obligation concerning remuneration policies and practices*** *should be implemented in a consistent manner and* ***should cover all aspects of remuneration including salaries, discretionary pension benefits and any similar benefits***"), is substantiated, as well as the principles regarding corporate governance, in strict quantitative limits related to the remuneration structure and the arrangements for ensuring adequate publicity of the decisions taken.

With reference to the requirements of transparency, the Directive, at Whereas n. 21, states that "*in order to ensure adequate transparency to the market of their remuneration structures and the associated risk, credit institutions and investments firms should disclose detailed information on their remuneration policies, practices and, for reasons of*

confidentiality, aggregated amounts for those members of staff whose professional activities have a material impact on the risk profile of the credit institution or investment firm. That information should be made available to all stakeholders (share-holders, employees and the general public)".

From the brief analysis conducted, it emerges that the European Community legislature, through the flanking of precise quantitative limits and previsions of principle in corporate governance, aims to encourage, at a European level, a convergence towards sound compensation practices which are to be achieved through the empowerment of individual financial institutions called upon to implement the principles under review - while respecting the quantitative predictions provided - in a flexible way, based on the operational and dimensional characteristics of the individual intermediaries, and to give adequate information to the market.

The Directive was then implemented through the issuing of the *Guidelines on Remuneration Policies and Practices (2010)* by the Committee of European Banking Supervisors to ensure the credit institutes a more smooth and effective implementation of community provisions.

(II)

EXECUTIVES' REMUNERATION UNDER ITALIAN LAW

In this chapter we will analyze the measure with which the Bank of Italy had regulated the subject of executives' compensations in the financial sector. Before proceeding to the detailed exposition of the most relevant previsions, preceded by several reflections on the legislative approach utilized by the Supervising Authority, it is however necessary to conduct a preliminary systematic framework - on a national level – of the regulation under review.

1) Precedents of the Bank of Italy Instrument.

The provisions of monitoring of the Bank of Italy of March 30th, 2011 represent the first national regulatory measure specifically aimed at essentially regulating the systems of incentives and compensations in the financial sector. Despite this, they were preceded by similar actions, involving only the listed companies which would be considered opportune to evaluate in order to point out the common *ratio*[20].

This analysis must be conducted from Article 114-*bis* Legislative Decree n. 58/1998 (Consolidated Law regarding financial matters, so-called T.U.F.): this article - which should be kept in mind, applies to the listed issuers and issuers of financial instruments significantly widespread among the public -, introduced by the Law n. 262/2005 (so-called Law on Savings), expects, in the first place, that the compensation plans based on financial instruments in favor of determinant corporate officers - specifically, members of the Board of Directors or the Management Board, employees or collaborators not directly linked to the company's employment activities, or the same professionals belonging to other companies or subsidiaries – are approved at the annual general meeting.

This provision is addressed to ensure a more conscious and direct participation in the approval process of remuneration policies by the shareholders, whose interests are likely to be affected by short-term and risk-oriented compensation plans.

The second paragraph of the provision under review requires instead that individual companies take the responsibility of making appropriate information available to the market regarding the relevant profiles of the adopted remuneration systems.

With the previously mentioned article it is possible to approach, for uniformity of purpose and content, Article 123-*ter* T.U.F., entitled *"Report on Remuneration"*. This provision, introduced by Legislative Decree 259/2010, bearing the "*Implementation of the*

Recommendations of the European Commission 2004/913/CE and 2009/385/CE regarding the directors of listed companies", requires companies to make available to the public - at least twenty one days before the convocation date of the general shareholder's meeting - a report on the remuneration - approved by the Board of Directors or by the Supervisory Board for companies that use the two-tier system - at the registered office, on their website and through other formalities established by Consob regulation.

Consob, in accordance of the wording of paragraph 7 of Article 123-*ter* - which contemplates that *"with regulation,* [...] *indicates the information to be included in the section of the report on remuneration provided in paragraph 3, including the information aimed at pointing out the consistency of the remuneration policy with the pursuit of long term interests of the company and the policy of risk management"* – had adopted Resolution No. 18049/2011, by which the new Article 84-*quater*, also titled *"Report on Remuneration"*, was inserted in the Consob Regulation of May 14th, 1999, N. 11971 (so-called Issuer Regulations), by which the Authority of Supervision, consistent with the delegation under the legislation, has itemized in extreme detail the contents that the report must present.

The provisions of supervision do not overlap the two measures analyzed for they insist on a contiguous and supplementary level. They, in fact, contrary to Articles 114-*bis* and 123-*ter* of T.U.F., do not focus exclusively on the needs of transparency but merely regulates the manner of the involvement of corporate bodies (thus touching the profiles of corporate governance) and the structure of remuneration. Profiles, which if not properly managed, threaten to undermine the achievement of the objectives of sound and prudent management underlying the interventions of regulation mentioned, even in the face of an effective system of corporate disclosure.

The matter under discussion was also the subject of an intervention of self-regulatory rank: the Code of Conduct for Listed Companies – in the new version in vigor as of 2011[21] -

requires, as stated in Article 7, - on the basis of a comply or explain approach typical of a self-regulatory source – that listed companies adopt long-term oriented remuneration systems, establishing a set of application principles consistent with those contained in Recommendation 2009/385/EC, and a Remuneration Committee[22] - whose establishment was also expected as early as 1999, the year of the realization of the code's first version -, prohibiting any director from participating in the meetings of this body where proposals are expressed to the Board of Directors relating to his remuneration.

On the other hand, the authors of the Code, aware of the crucial role that adequate remuneration could play in the involvement of capable and prepared corporate managers in the project, emphasizes that *"the remuneration of the administrators is set at a sufficient level to attract, retain and motivate directors with the professional skills necessary for the successful management of the issuer"*.

2) The rapport between the Bank of Italy measure and the Directive 2010/76/EC.

On March 30th, 2011, in the implementation of the provisions on executives' remuneration contained in the above-mentioned Directive 2010/76/EC, the Bank of Italy issued the "Provisions of Supervision concerning the policies and practices of remuneration and incentives in banks and bank groups", aimed at regulating the profiles of transparency, risk management and corporate governance inherent in the establishment of appropriate systems of remuneration.

Precisely because of this direct European Community derivation and before beginning the detailed analysis of the regulatory measure, it would be considered appropriate to provide several reflections on the approach adopted by the Authority of Supervision, and its relation with the legislative technique adopted at a supranational level.

Within the previous chapter, in the analysis of the Directive CRD III, it was emphasized how this was characterized by a principles-based approach which aims to acknowledge a considerable freedom to the individual intermediaries in the activity of concretization of the principles of established corporate governance, in such a way as to allow them to be more adherent and functional to the actual corporate reality in which they will be called to operate.

At the same time, it restricts these operational spaces through the provision of strict quantitative limits - percentages and time – in regards to incentive plans aimed at securing the variable component of the remuneration to long-term growth objectives.

In this regard, it should be noted that the approach adopted by the Bank of Italy appears almost identical: the quantitative limits established by the European Community legislature - despite the possibility of previsions of higher thresholds - were re proposed without variations. As for the principles of corporate governance, the Authority of Supervision acknowledges similar freedom to Italian intermediaries through the expectations that, subject to the necessary adaptations to the peculiarities of national financial and corporate regulations, follow in substance the provisions contained in the Directive.

The flexibility acknowledged to the individual institutions in the implementation is guaranteed through the use of the principle of proportionality (paragraph 3.3.), according to which only the larger banks will be held to the full application of the regulatory supervisions: on the contrary, with main reference to the expectations concerning the structure of incentive systems, smaller banks can implement the regulatory provisions, even partially, to the extent that such activity is consistent with their characteristics.

This option, in a legal framework so delicate and subject to ongoing public opinion, must be shared: as necessary good corporate governance rules may be for assuring a proper structuring of the executives' remuneration, these, considered in isolation, do not appear able

to avoid excessive risk-taking by managers. Therefore, the appropriate choice would be to support their rigid limits intended for realigning the interests of ownership and control.

3) The contents of the measure of March 30, 2011 of the Bank of Italy.

The Provisions of Supervision regarding the remuneration and incentive plans are applicable to banks and banking groups, including the foreign components and the Italian branches of non-EU banks (with reference to the latter, if the provisions under review are applicable). For a better understanding of the measure, we now proceed to the analysis of the more relevant provisions.

3.1. Dependants whose remuneration is governed by the measure. The Provisions of Supervision apply, according to the letter of paragraph 3.2, to the entire personnel, to the notions which include: the members of the boards with the function of strategic supervision, management and control, employees and associates, and workers of the external distribution networks.

Despite the fact the affirmation is general in nature, the Bank of Italy then distinguishes the personnel as "relevant" or not: only subjects belonging to the first subset - whose activities may result in significant repercussions on the risk profile of the bank - will have applied the more stringent provisions provided in paragraphs 5.2.3, 5.2.4 and 5.3 (to be discussed below).

Regarding the identification of "relevant" personnel, the Authority of Supervision provides certain presumptions of relevance: namely, former paragraph 3.2, *"It is presumed, unless proven otherwise by the bank, in the category of "most relevant personnel" the following subjects: i) managers with executive tasks; ii) general manager and executives of the principal business lines, corporate functions or areas, as well as those who report*

directly to the bodies with the function of strategic supervision, management and control; iii) managers and personnel of a higher level with internal control functions; iv) other subjects who, individually or collectively (ex. committees for credit grants, operating tables for portfolio management), assume significant risks ("other risk takers"). To locate these individuals, the banks establish suitable criteria of relevance, such as, for example, the amount of total remuneration in absolute terms, the ability to take positions of risk, generate profits or impacts on other balance sheet items for significant amounts. In any case, the personnel whose total gross remuneration, including discretionary pension benefits, does not exceed 200,000 euro per year and, together, the variable part which does not exceed 20%, may not be considered relevant. If the activity has or may have a significant impact on the risk profile of the bank, then it must also be included in the category of "most relevant personnel", v) any employee whose total remuneration, including discretionary pension benefits, falls within the same pay zone of categories ii) and iv) previously mentioned."

With reference to categories of certain subjects, the Authority of Supervision expects that: i) with reference to non-executive directors - in order to preserve their supervisory role within the corporate structure – who will not be subject to incentive mechanisms and, if they have already been determined, however, will only involve a non-significant portion of the total compensation; *ii)* with reference to the controlling body – in the tense situation of assuring a strict separation between the administration and controlling body - has precluded any form of variable remuneration; *iii)* with reference to the responsible and the personnel with higher level internal control functions, and the manager responsible for the preparation of corporate accounting documents, the fixed compensation must be at the appropriate level of the significant responsibilities and commitment associated with the role, while the incentive mechanisms, if any, must be consistent with the assigned tasks and independent of

the results obtained from the areas under their control. For these reasons, unless they are valid and proven, bonuses linked to economic performance should be avoided.

As for the identification of additional subjects, although eligible to be subject to the most stringent rules expected for the "relevant" personnel, the Bank of Italy replaced the incumbent for the individual intermediaries, called to perform an accurate self-assessment process which, together with its outcome, had to be properly formalized. This general prevision of closure is undoubtedly appropriate, avoiding risk - inevitable in the preparation of rigid closed lists - of not mentioning subjects that could instead have significant effects on the risk management of the credit institute.

3.2. The concept of remuneration. According to paragraph 3.1, the term *"remuneration"* refers to any kind of salary or benefit paid – it does not matter if the remuneration is in terms of cash money, financial instruments (securities) or benefits (fringe benefits) –, directly or indirectly, for each task or professional service that the bank receives, as well as any other member of the group.

On the contrary, the category does not include payments and fringe benefits granted to personnel on a non-discretionary basis, whether they are paid according to a general policy of the bank and, moreover, if they have no effects on the recruitment incentives or risk control.
The total remuneration must then be rigidly distinguished in its fixed and variable component – understood as any payment or benefit that is relevant to bank performance – the method of measurement is not relevant – or other similar standards, with the exception of severance pay set by the general legislature in regards to labor relations.

The relation between these two components must be balanced, precisely determined and carefully assessed in relation to the characteristics of the intermediary and the different

categories of personnel, in kind to those who would be considered part of the "most relevant personnel".

With specific reference to the variable component - key intervention area for assuring an alignment of the executives' compensation with the objectives of creating long-term oriented value – the Bank of Italy, along with technical previsions to constrain the development of the remuneration variable to criteria of the awareness of the different risk levels, expects that: *i) "a substantial share of at least 50% must be appropriately balanced between: a) shares, instruments associated with them or, for unlisted banks, cash equivalents, and b) where appropriate, non-innovative instruments of computable equity up to 50% of the core capital to properly reflect the credit quality of the bank on an ongoing basis".* This prevision is clearly oriented to stimulate the achievement of the correlation between the objectives of the personnel and the creation of value and sustainability of the bank. In the interests of proper risk management, it is then expected that *ii) "a substantial share of at least 40% should be subject to a deferred payment system for a period of not less than 3-5 years, so that the remuneration takes account of the time passed of the risks taken by the bank (so-called malus mechanisms)".* In the event of compensation awarded to executives, the percentage to differ rises to at least 60%. Both provisions just analyzed should be applied, however, with exclusive reference to the "relevant" personnel.

The Bank of Italy eventually establishes several general principles to which individual institutes - taking into account the specific features that individually characterize them – must give practical effect: it expects, in particular, that the total amount of the variable remunerations must be sustainable for the intermediary, without hindering the maintenance or the achievement of an adequate level of capitalization to the risks assumed.

With regard to severance pay and the pension policy, the Authority of Supervision – to assure its alignment with the values and long-term objectives of the bank – rules that

discretional pension benefits should be attributed to the "relevant" personnel in the form of shares, instruments associated with them, equivalent instruments - in the case of non-listed banks - and non-innovative capital instruments that reflect the credit quality of a bank on an ongoing basis. It then expects that the fees agreed upon in the event of the early termination of employment (so-called golden parachutes) be linked to the performance achieved and the risks assumed.

In conclusion, we should be reminded that all of the provisions on the structure of the systems of remuneration and incentives do not apply to the personnel departures that respond exclusively to a need for cost containment, which favors the adhesion to measures of support for the employees in general and the expectation of claw-back clauses that cover at least the cases of fraudulent behavior without producing distorting *ex ante* effects on the behavior of the personnel.

3.3. The involvement of the corporate structure in the preparation of the system of remuneration and incentives. The Provisions of Supervisions include an active involvement of all the corporate structure. Following the order of exposition adopted by the Bank of Italy, the general shareholder's meeting - in order to assure a tighter control by the shareholders of the compliance of the systems of remuneration and incentives with the bank's long-term objectives - is first given the task establishing the compensations of the bodies it has appointed, the remuneration policies and the plans based on financial instruments. In order for the general shareholder's meeting to fulfill this function properly, it must be assured an adequate amount of information on the remuneration and incentive policies, and, on an annual basis, the implementation of such policies.

Continuing with the analysis, the body with the responsibility of strategic supervision adopts and reviews on an annual basis - with the involvement of all relevant corporate

functions - the remuneration policy and is responsible for its proper implementation, assuring an accurate documentation that will be accessible within the company. It is also called to define the systems of remuneration and incentives for executive directors, the general director and the managers of the principal lines of business, as well as those who report directly to the bodies of strategic supervision, management and control, and the highest level managers and personnel responsible for the functions of internal control.

Lastly, with regard to the main functions of the system of internal controls: *i)* the Compliance Function - on one hand - provides an opinion on the compliance of the systems developed with the corporate objectives and values, - and on the other - verifies that these systems are respectful towards the internal and external regulations concerned, *ii)* the Internal Audit verifies, at least annually, the compliance of the adopted remuneration practices with the approved policies and the same Provisions of Supervision.

3.4. The Remuneration Committee. The Bank of Italy requires that only the leader of the largest banking groups (*id est,* groups with total assets equal to or greater than 40 billion euro) and listed banks, within the body with the function of strategic supervision, the creation of a *Remuneration Committee* – whose adoption, although voluntary, had already been solicited as noted in the Code of Conduct – composed of non-executive directors, the majority of whom are independent[23]. The main tasks assigned to it are the following: *i)* advisory and proposals functions on the remuneration policy of corporate representatives and the head of the functions of internal control, advisory functions regarding the definition of the criteria for establishing a remuneration policy for the general director, managers of the principal lines of business, corporate functions or geographic areas - and those who report directly to the bodies with the functions of strategic supervision, management and control -, the highest level managers and personnel of internal control functions, other risk takers and

any employee whose total compensation, including discretionary pension benefits, is placed within the same pay zone of the previous categories; *ii)* supervision of the proper implementation of the remuneration policy regarding the top management of the functions of internal control, collaborating in close proximity with the internal control body; *iii)* preparation of the documentation for submission to the strategic supervision body; *iv)* cooperation with other established committees within the strategic supervision body; *v)* assuring the involvement of the corporate functions responsible for the process of the development and supervision of the remuneration policy and practice; *vi)* expressing the results of the performance targets achieved by the bank and on the realization of any other condition for which the remuneration policy was subject to; *vii)* providing appropriate feedback on the activity that was brought about in order to keep other corporate bodies informed, including the shareholders' meeting.

In corporate reality, in which the creation of this body is not mandatory, its functions are carried on by the body of strategic supervision, mainly through the contribution of its non-executive and independent members.

3.5. Transparency of remuneration and incentive systems. With reference to the obligation to give appropriate publicity to the information on remuneration and incentive systems, the Bank of Italy refers to the provisions contained in Title IV of the Circular N. 263/2006, so-called New Dispositions for the Prudential Supervision of Banks. This obligation, which seeks to assure a greater transparency to the market in order to reduce information asymmetries among investors and issuers, and to improve the circulation of the knowledge of corporate governance practices to the market (G. FURLAN – M. CREMASCOLI – C. PAGLIONICO, *Banche: Politiche di Remunerazione e Incentivazione, Diritto e Pratica del Lavoro,* 2011, N. 11, p. 651), has imposed, moreover, a corrective intervention to Title IV of

the New Provisions of Supervision, which aims to make it consistent with the provisions contained in Directive 2010/76/EC.

(III)

CONCLUSION

From the analysis of the previous Chapters it emerges that compensation practices based on short-term profits – which led to bonus payments to employees without adequate regard to the longer-term risks they imposed on the firms – significantly increased the risk-taking that severely threatened the global financial system.

In order to avoid these dangerous repercussions, the European Community and national regulators issued instruments, through the flanking of quantitative – in regards to incentive plans – and qualitative – concerning corporate governance aspects – in which the provisions aim to achieve a convergence towards sound compensation practices by pushing banks to implement remuneration systems adherent to their operational and dimensional characteristics through the use of the principle of proportionality.

Even if this option, particularly in an area of interest subject to the great attention of public opinion, must be considered preferable to a pervasive rule-based approach, the goal of sound compensation practices can only be achieved by embracing a view of remuneration systems strictly related to risk management and risk governance.

The combination of sound compensation systems with other management tools in the search of prudent risk taking will only assure the convergence between the objectives pursued by executives and the interests of the stakeholders towards a sound and prudent management on a long-term basis.

[1] For a comparative overview, see. *e. g.,* A. IDI CHEFFOU, *Agency Costs of Equity and Debt, and Corporate Incentive Compensation Policy: The French Case,* 2011, www.ssrn.com; L. RENNEBOOG – G. TROJANOWSKI, *Managerial remuneration and disciplining in UK: A tale of two governance regimes, ECGI Working Paper Series in Finance,* n. 301, 2010, www.ecgi.org; P. GREGG – S. JEWELL – I. TONKS, *Executive Pay and Performance: Did Bankers' Bonuses Cause the Crisis?,* 2011, www.ssrn.com; G. B. PORTALE, *Un Nuovo Capitolo del Governo Societario Tedesco: l'Adeguatezza del Compenso dei Vorstandsmitglieder, Riv. Soc.,* 2010, n. 1, p. 1 ss; H. P. BURGHOF – C. HOFMANN, *Executives' Compensation of European Banks: Disclosure, Sensitivity, and their Impact on Bank Performance*, Munich Business Research, 2000, www.ssrn.com.

[2] J. WINTER, *The Financial Crisis: Does Good Corporate Governance Matter and How to Achieve it?, DSF Policy Paper Series*, n. 14, 2011, www.ssrn.com, p. 5: "*remuneration is not just a technical issue but has everything to do with perceived fariness, which leads people to make moral judgements"*.

[3] For a behavioural analysis of the so called alignment problem, see J. WINTER, *op. cit.,* p. 5: "*modern behavioural, psychological and neurological research indicates that human beings cannot handle performance based pay, for a number of reasons.16 Our intrinsic motivation is crowded out by financial incentives, affecting both what we seek to achieve and our ability to make judgements and assessments when we need to. The more substantial the variable pay becomes the more we believe that the only reason we should perform well is the remuneration we receive as a result*".

[4] For an overview of the practices related to this tendency, see L. DALLAS, *Short-termism, the Financial Crisis and Corporate Governance,* University of San Diego, School of Law, Legal Studies Research Paper Series, Research Paper no. 11-052, March 2011, p. 6. Short-termism includes: "*decreasing discretionary expenses, under-investing in long-term*

assets, or taking on excessive risk to maximize short-term earnings, investing in assets with hidden risks and taking on excessive debt to bolster short-term firm profits or portfolio returns".

[5] For a more detailed overview of the failures that led to the collapse of world economy, see M. BRUNNERMEIER, *Deciphering the Liquidity and Credit Crunch 2007–2008,* Journal of Economic Perspectives Vol.1, no. 23, 2009, K. DAVIES, *Regulatory Responses To The Financial Sector Crisis,* Griffith Law Review, Vol. 19, no. 1, 2010. For the analysis of the endogenous and exogenous factors of the financial turmoil, see M. DE POLI, *Crisi Finanziaria Globale e Fattori Comportamentali, AGE,* 2012, p. 1 ss.

[6] The opinion is widely shared. *Contra,* although, G. FERRARINI – M. C. UNNGUREANU, *Economics, Politics, and the International Principles for Sound Compensation Practices: An Analysis of Executive Pay at European Banks, Vanderbilt Law Review,* 2011, Vol. 64, 2, p. 431 ss. According to the Authors, "*recent empirical studies found no proof that short-term incentives led to excessive risks. In United States, pay generally was aligned with the long term interest of shareholders.* Ancora, "*Beltratti and Stulz* [A. BELTRATTI – R. STULTZ, *Why did some banks perform better during the credit crisis? A cross-country study of the impact of governance and regulation 2,* in *Eur. Corp. Governance Inst., Fin. Working Paper,* 2009, n. 254, www.ssrn.com] *find no evidence for the thesis advanced in a report by the Organization for Economic Co-operation and Development (OECD)* [G. KIRKPATRICK, *The Corporate Governance Lessons from the Financial Crisis,* in *Fin. Market Trends (OECD),* Paris, 2009, www.oecd.org] *that the <<financial crisis can be, to an important extent, attributed to failures and weakness in corporate governance arrangements>>. In particular, they find no evidence that banks with better governance performed better during the crisis. On the contrary, banks with more pro-shareholder boards performed worse".*

[7] See V. V. ACHARYA, *A Theory of Systemic Risk and Design of Prudential Bank Regulation*, 2001, www.ssrn.com, I. C. MONTEANU, *Systemic Risk in Banking: New Approaches Under the Current Financial Crisis,* 2009, www.ssrn.com. "*At the heart of systemic risk are contagion effects, various forms of external effects. The concept also includes simultaneous financial instabilities following aggregate shocks*" (O. DE BANDT – P. HARTMANN, *Systemic Risk: A Survey, ECB Working Paper n. 35,* 2000, www.ssrn.com).

[8] For a close examination of the argument, see a L. A. BEBCHUCK – H. SPAMANN, *Regulating Bankers' Pay, Georgetown Law Journal, Vol. 98, No. 2, pp. 247-287, Harvard Law and Economics Discussion Paper No. 641,* 2010, L. A. BEBCHUCK - A. COEHN – H. SPAMANN, *The Wages of Faliures: Executive Compensation at Bear Sterns and Lehmann 2000-2008, Yale Journal on Regulation, Vol. 27, pp. 257-282, Harvard Law and Economics Discussion Paper No. 657,* 2010, A. BERNDT – A. GUPTA, *Moral Hazard and Adverse Selection in the Originate-to-Distribute Model of Bank Credit, Carnegie Mellon University - Tepper School of Business and Case Western Reserve University - Department of Banking & Finance,* 2008, www.ssrn.com, A. MILNE – A. E. WHALLEY, *Bank Capital Regulation and Incentives for Risk Taking, Loughborough School of Business and Economics and University of Warwick - Finance Group*, 2002, www.ssrn.com.

[9] M. DE POLI, *Crisi Finanziaria Globale e Fattori Comportamentali, AGE*, 2012, n. 1, p. 7.

[10] This target must be fulfilled through the following recommendations: "*1. The firm's board of directors must actively oversee the compensation system's design and operation; 2. The firm's board of directors must monitor and review the compensation system to ensure the system operates as intended; 3. Staff engaged in financial and risk control must be independent, have appropriate authority, and be compensated in a manner that is*

independent of the business areas they oversee and commensurate with their key role in the firm.

[11] To achieve this goal: "*1. Compensation must be adjusted for all types of risk; 2. Compensation outcomes must be symmetric with risk outcomes; 3. Compensation payout schedules must be sensitive to the time horizon of risks; 4. The mix of cash, equity and other forms of compensation must be consistent with risk alignment.*

[12] To reach this goal: "*1. Supervisory review of compensation practices must be rigorous and sustained, and deficiencies must be addressed promptly with supervisory action; 2. Firms must disclose clear, comprehensive and timely information about their compensation practices to facilitate constructive engagement by all stakeholders.*

[13] The Recommendations concern, respectively, the adoption of an appropriate regime for the remuneration of directors of listed companies and the role of non-executive or supervisory directors of listed companies and on the committees of the supervisory board.

[14] To fulfill this target, "*Variable components of remuneration should therefore be linked to predetermined and measurable performance criteria, including criteria of a non-financial nature. Limits should be set on the variable components of remuneration. Significant variable components of remuneration should be deferred for a certain period, for example, three to five years, subject to performance conditions. Further, companies should be able to reclaim variable components of remuneration that were paid on the basis of data, which proved to be manifestly misstated*".

[15] This obligation is imposed "*Where, under national law, the (supervisory) board is playing a role, either by making decisions itself or by making proposals for consideration by another corporate body, in the process for setting remuneration of directors*". The members of the Remuneration Committee must be chosen among non-executive or supervisory directors, whose majority must be at least independent. According to the 2005

Recommendation, the Committee should at least: *i)* make proposals to the supervisory board on the remuneration policy, individual remunerations and suitable forms of contracts for the executives; *ii)* assist the supervisory board in overseeing the process whereby the company complies with existing provisions regarding disclosure of remuneration-related items (in particular the remuneration policy applied and the individual remuneration attributed to directors); *iii)* make general recommendations to the executive or managing directors on the level and structure of remuneration for senior management; *iv)* monitor the level and structure of remuneration for senior management, on the basis of adequate information provided by executive or managing directors; *v)* debate the general policy regarding the granting of such schemes, in particular stock options, and make any related proposals to the supervisory board; *vi)* review the information provided on this topic in the annual report and to the shareholders meeting where relevant; *vii)* make proposals to the supervisory board concerning the choice between granting options to subscribe shares or granting options to purchase shares, specifying the reasons for its choice as well as the consequences that this choice has.

[16] In particular, the supervisory frame work is composed by 3 legislative interventions: *i)* Directives 2006/48/EC and 2006/49/EC (CRD I), through which European Community has approved Basel II Guidelines; *ii)* Directives 2009/111/EC, 2009/27/EC and 2009/83/EC (CRD II), which have determined amendments aimed to improve the management of large exposures, the quality of banks' capital, the liquidity risk management and the risk management for securitised products; Directive 2010/76/EC (CRD III), that provide, in addition to the remuneration regulations, for the extension of some pre-existing minimum capital requirements. In 2011, the Commission adopted a legislative package (CRD IV) to strengthen the regulation of the banking sector. The proposal replaces the current Capital Requirements Directives (2006/48 and 2006/49) with a Directive and a Regulation and

constitutes another major step towards creating a sounder and safer financial system. The directive governs the access to deposit-taking activities while the regulation establishes the prudential requirements institutions need to respect.

[17] For a close examination, see E. HERSONSKY, *The use of principles is a far more effective way to ensure fair levels of executive directors' remuneration than is the use of detailed legal rules. Discuss",* 2011, www.ssrn.com. According to the Author, even if there is "*theoretical evidence that regulations, which are constructed in this way, are able to create closely relations to regulatory objectives even though there is a large amount of conceivable variations of cases", "many people argue that principles have always the opportunity to be manipulated in favour of senior directors and a principle itself does not import incentive compatibility. Remuneration for senior executives, CEOs to be exact, , has climbed to amounts that have anything else to do but with principles"*. On the other hand, "*detailed legal rules for remuneration seem to guarantee precision",* even though *"the enforcement of such rules is very expensive and effects of enforcement are also uncertain".*

[18] C. L. FORD, *New Governance, Compliance, and Principles-Based Securities Regulation, American Business Law Journal*, 2008, V. 45, 1 p. 34: "*The advantage of regulatory principles, as opposed to detailed rules, is not that they will remain forever vague, but rather that their content can be filled in more dynamically and insightfully by those with the greatest understanding of the relevant situations. Even in principles-based regimes, the content of the principle will be filled in and will accrete with time. The difference is that their content is meant to remain flexible and up to date – that rather than ossifying, the principles' content will continue to evolve, discarding older formulations as newer, more comprehensive or effective ones emerge".*

[19] C.f.r. C. L. FORD, *op. cit.,* p. 37: "*It does not have to be the business of a regulator to know the precise means for achieving good corporate governance in any given corporation*

or firm. It is the business of the regulator to try to ensure good compliance with law, but the corporations or firms themselves are in a better position, in terms of access to information, to determine appropriate means for reaching the end".

[20] For a detailed analysis of these regulations, see M. C. UNGUREANU, *Politica di Remunerazione degli Amministratori delle Società quotate, Le Società,* 2011, n. 5, p. 549 ss.; M. CAMPOBASSO, *I Compensi degli Amministratori di Società Quotate: L'esperienza Italiana, Riv. Soc.,* 2011, n. 4, p. 702 ss.

[21] For an overview of the most important amendments, see P. MARCHETTI, *Il nuovo codice di autodisciplina delle società quotate, Riv. Soc.,* 2012, n. 1, p. 37 ss.

[22] Concerning the implementation of the regulation, see ASSONIME, *Analisi dello stato di attuazione del Codice di Autodisciplina delle società quotate,* 2010, www.assonime.it. According to this study the Remuneration Committee has been established by over 80% of the adherent companies .

[23] Concerning the non-executive directors' role, see N. FERNANDES, *Board Compensation and Firm Performance: The Role of "Independent" Board Members, ECGI Working Paper Series in Finance,* n. 104, 2005, www.ecgi.org. According to this study, relating to a panel of firms from the Portuguese Stock Market, emerges that while "*firms with more non-executive board members pay higher wages to their executives", "firms with zero non-executive board members actually have less agency problems, and have a better alignment of shareholders' and managers' interests".*