

ABI response to CEBS' draft of high-level principles on Remuneration Policies

I - General comments

The Italian Banking Association (ABI) welcomes the opportunity to comment on the CEBS consultation regarding draft high-level principles of remuneration policies.

Much work has been done in this area at international (Financial Stability Forum/FSF, European Commission, Institute of International Finance/IIF) and national level in various EU Member States. Specific measures were also adopted in the context of banks' assistance programs.

During the last meeting in London the leaders of the Group of Twenty have issued a Declaration, *Strengthening the Financial System* in which they agreed «to endorse and implement the FSF's tough new principles on pay and compensation and to support sustainable compensation schemes and the corporate social responsibility of all firms».

In order to address this issue and limit the risk for organizations and financial markets, the financial industry at national level (banks and banking associations) has already taken many initiatives to improve the sustainability of its incentive policies. The Italian Banking Association believes that national responses in implementing principles in this area are more appropriate especially in the context of **Article 137** of the EU-Treaty and the principle of subsidiarity.

It is also important to acknowledge the **need** for the banking industry to retain **highly talented staff** and the need also not to undermine Europe's competitive position with regard to other international financial centres.

So, any initiative at EU level should preferably take into account progress at the international level. Indeed the Banking Industry operates in a global environment and as such there is a need for a coordinated response from regulators. Any initiatives which only impact banks headquartered in Europe could put those firms at a competitive disadvantage.

We would like to emphasize that it is crucial that any application of those principles would be implemented on a **principles and risk based way**. Not every principle should apply in the same way to every firm. A **proportionality principle** should apply. Regulators should not adopt a 'one size fits all' approach, as substantial differences in business practices have

to be taken into account (such as differences between investment banks and retail banks or large and small banks).

The main objective is assessing whether remuneration practices within financial institutions pose unacceptable risks. Initiatives in this area should therefore not address the level of remuneration, which has to be considered as a matter for companies, their board and shareholders. Regulators should then rather focus on ensuring good governance rather than designing remuneration structures.

More details could be found in the specific details hereunder.

II – Specific comments

GENERAL

- i. The financial institution should adopt an overall remuneration policy that is in line with its business strategy and risk tolerance, objectives, values and long-term interests. It should not encourage excessive risk-taking. The remuneration policy should cover the institution as a whole and contain specific arrangements that take into account the respective roles of senior management, risk takers and control functions. Control functions should also be adequately rewarded to attract skilled individuals.*

ABI believes, in line with the Bank of Italy dispositions (4 March 2008), that appropriate remuneration and incentive mechanisms for banks' directors and managers can enhance the competitiveness and governance of their businesses. Compensation, in particular that of persons with key roles within the corporate structure, should attract and retain persons with skills and experience meeting banks' needs.

At the same time, remuneration schemes must not conflict with a bank's prudent risk management policies or its long-term strategy. In particular, equity-based incentives (e.g. stock options) or performance-linked pay must take account of the risk borne by banks and be structured so as to avoid generating incentives that conflict with their long-term interests.

ABI also believes that principles could be considered at EU and International level to address possible weakness in remuneration practices but considers that those principles should remain high-level and should be restricted to managerial functions, risk takers and control functions. As high-level principles in this area are targeted to adequately mitigate risks for financial institutions, only those functions and categories of **managerial**

personnel which led to potentially expose the financial institutions to financial risks linked to the performances of market instruments, should be taken into account.

ii. The remuneration policy should be transparent internally and adequately disclosed externally.

The Italian Banking Association supports the issue of transparency of the remuneration policy.

It should be clarified however what is the extent of the external disclosure and the relevant stakeholders that might be involved. While a regulator's demand appear legitimate, the current wording leaves the door open to other categories of external stakeholders, which might need to be further detailed.

For banks, external disclosure seems mostly appropriate towards the supervisor. ABI believes that the external disclosure of the special requirements of banks' remuneration policies would fit very well in the framework of Pillar 3 where banks would be able to disclose their remuneration as a general policy.

Therefore, ABI would like to underline that external disclosure should not mean that the remuneration of individuals should be disclosed (except normal disclosure applicable to other listed companies). This is important for the industry when it comes to terms and employment and the **possibility to retain qualified professionals**.

As far as internal disclosure is concerned, flexibility should also be given to companies depending on whom this information is disclosed to. Different levels of disclosure should therefore be permitted, the main reason being to preserve the secret strategy of the company.

GOVERNANCE

iii. The management body, in its supervisory function, should determine the remuneration of the management body, in its management function¹. In addition it should have oversight of the overall remuneration policy of the firm. The implementation of the

¹ For a definition of the management board in either its supervisory or management capacity, please refer to the definition provided on page 6 of CP03. The definition is designed to address both single and dual tier structures within the EU.

remuneration policy should be subject to central and independent review.

ABI supports this principle.

MEASUREMENT OF PERFORMANCE AS A BASIS FOR REMUNERATION

iv. Where the pay award is performance related, remuneration should be based on a combination of the individual performance's assessment, the performance of the business unit and the overall results of the company or group. When defining the individual performance other factors apart from financial performance should be considered. The measurement of performance, as a basis for bonus awards, should include an adjustment for risks and cost of capital.

ABI agrees with this principle.

ABI recognizes the **importance of non-financial factors** in the context of remuneration policies (in this sense, see the IIF report published on the last 30 March).

The Italian banking industry is willing to assume an active role in the creation of a solid framework which identifies and enhances the role of non-financial factors in the context of remuneration policies, for example by means of practices that illustrate how extra financial performances impact on individual performance. The goal is to improve and organize current practices so that they can be used in future.

In this context, the Corporate Social Responsibility office of ABI considers that:

- Non-financial factors are recognized as important elements in devising policies and practices of remuneration/incentives aimed at promoting the integration of company performance with a medium to long-term vision; these comprise solid financial parameters together with planning indicators, as well as those linked to value, legislation, behaviour and knowledge of resources, so as to sustain a long-term vision and the creation of value for the company and for staff;
- Certain banks have already developed practices that contemplate the introduction of non-financial factors in assessing individual staff performance. We refer, for example, to factors associated with: technical/professional skills; to organized behaviour such as: leadership, teamwork, goal-oriented approach, self-development, coaching, conflict management, communication and promoting company values (professional integrity); to qualitative elements concerning, amongst others, customer relationships (cultivating customer loyalty, enhancing

value and customer satisfaction) and/or the execution of strategic plans envisaged by the bank's business planning;

- These non-financial factors are “weighed” in assessing individual performance. The overall assessment is made by the manager and concerns personal improvement and development, including the frequency these factors are put to use. The monitoring and assessment of these non-financial indicators is based on the progress of the project's master plan, in line with multi-year planning. In this way, the use of systems and techniques of project management applied at all levels and monitored by dedicated resources within the various departments supporting project teams, allow the introduction of qualitative parameters tied to implementing solutions, technical and business innovation and consistent improvement;
- Long-term objectives are pursued by also awarding behaviour that is professional and distinguishing company values, so as to direct efforts not only to company performance, but also to “how” these results are achieved. Qualitative indicators, based on, for example, parameters of the bank's code of ethics, have been introduced to verify compliance so that any non-compliance of the rules and regulations, internal as well as external, will cause a “haywire“ of the incentive mechanism system, able to annul any financial performance achieved and any payments made thereto;
- Other practices concern directors, for whom there is no variable remuneration tied to the financial performance of a bank or reaching certain objectives. Compensation is not provided in cases of resignation or removal without just cause;
- Incentives for top management, although they are tied to improvement of fundamental indicators of short-term annual incentives, require a continuous improvement of performance over time, in order to guarantee: on the one hand, company stability, in line with the recent provisions of the Bank of Italy on governance; on the other hand, to more effectively motivate and guarantee the retention of managers in key positions.

FORM OF REMUNERATION

- v. There should be a proportionate ratio between base pay and bonus. Where a significant bonus is paid, the bonus should not be a pure upfront cash payment but contain a flexible, deferred component; it should consider the risk horizon of the underlying performance*

ABI supports the general idea that payment is linked to specific parameters that take the final profitability of the activity and/or of the company into account. However ABI believes that equity compensation schemes already met the criteria for performance adjusted deferred compensation. It is important therefore to underline that sufficient flexibility should also be given to companies as the form of remuneration has to be considered primarily as a matter for each of them.

As a general principle, ABI suggests the introduction of an **appropriateness approach** to this principle. In addition, the impact of this article on existing employment contracts would be important as previously explained. A **transition period** should therefore be specified with appropriate time.