

## **EPFSF Breakfast Discussion**

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### **“Remuneration policy in the financial sector”**

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Distinguished Members of the European Parliament,  
Ladies and Gentlemen,

I am delighted to be here today to comment on the issue of “Remuneration Policies in the Financial Sector”.

As we all know, the subprime mortgage crisis in the United States triggered the financial crisis that involved banks and financial markets around the globe. This crisis exposed pervasive weaknesses in financial industry around the world.

In this context, there is a large consensus on considering Compensation as one of the factors that contributed to the financial crisis. The belief that an aggressive incentive pay scheme could affect managers' propensity to select more risky projects, urged Regulators and Policy-Makers as well as many firms to take initiatives in order to prevent unsound risk management and encourage the long-term growth.

In order to make the best use of our time, I have structured my speech as follows:

1. Firstly I'd like to summarize very briefly the main initiatives that Regulators and Policy Makers are implementing at an International level; I will focus in particular on the FSB Principles, which are the international benchmark;
2. Then I'm going to talk about the main initiatives that have been advanced at industry level;
3. Finally, I'd like to share with you what Italian retail banks are doing in order to align their policies to the sound compensation practices recommended by Regulators and Industry;

Before going to the first point, let me tell you something about the group that I work for.

Intesa Sanpaolo is a banking group, leader in the Italian market, with a significant international presence focused on Central-Eastern Europe and the Mediterranean basin. Our business model is focused on the retail domestic market where we take full advantage of wide-ranging customer franchise and product capability. Our good performance in 2009 is the result of the continued focus on *sustainable profitability* and *low risk profile*, which are and remain *top* priorities for our Group.

## 1. I'd now like to recap the main initiatives of Regulators at an International level:

- After G20 leaders called for “immediate action” in the area of remuneration, last April the FSB has issued its “*Principles on sound compensation practices*”. These Principles are applicable to top executives and more in general to anyone whose decisions may affect the firm’s risk profile. They have been subsequently, integrated by the Basel Committee into its risk management guidance.

The FSB focus on three crucial areas:

- Effective corporate governance processes;
- Alignment of compensation with prudent risk taking;
- Effective disclosure to stakeholders and supervisory review.

Moreover, last September, the FSB has released a set of “Implementation Standards”, that is specific proposals on corporate governance reforms, global standards on pay structure and greater disclosure and transparency.

The main recommendations can be summarized as follows:

- a significant part of variable compensation should be connected to individual, business-unit and firm-wide performance, with payment deferred for at least three years, subject to appropriate claw-back and vested in the form of stock or stock-like instruments, in order to encourage long-term value creation and time horizon of risk;
- Compensation policies and structures must be transparent and open to the public;
- Significant financial institutions should ensure that total variable compensation does not limit their ability to strengthen their capital base. National supervisors should limit variable compensation as a percentage of total net revenues if it is inconsistent with the maintenance of a sound capital base;
- Multi-year guaranteed bonuses are not consistent with sound risk management or the pay for-performance principle and should not be a part of prospective compensation plans;
- Remuneration committees overseeing compensation policies should be able to act independently.

The European Parliament should play a crucial role in ensuring the implementation of these Principles and their consistent application at a global level.

## 2. Moving to my next point, how did the industry react to the Regulators and Members of Government:

Since the beginning of the financial turmoil, a growing number of financial institutions have acknowledged that unfair remunerations were one of the factors affecting the crisis.

Therefore, in July 2008, the IIF (the Institute of International Finance, the global association of financial institutions) published its “*Principles of Conduct and Best Practice Recommendations*”, focusing also on compensation policies and in line with the FSB Principles.

In March the IIF published, as a result of an in-depth survey, the Report “*Compensation in Financial Services: Industry Progress and the Agenda for Change*”. The Report shows that firms are increasingly aligned to both to FSB and IIF principles and we expect an update to be published early next year.

These industry initiatives certainly are not a substitute for regulation, but they are crucial in promoting a “cultural” change towards sounder practices.

### **3. Coming to the last point of my speech, I'd like to put you in the picture on the impact that these principles have had on the Italian banking sector.**

We are now at a crucial stage. The determination shown by international coordinated efforts must lead to a consistent implementation at national level.

In this respect, in March 2008 Bank of Italy introduced a set of principles and implementation guidelines on executive remuneration that apply to all banks, thus in part anticipating the international developments.

At the end of October 2009, Bank of Italy has asked all Italian banks to apply by the end of the current year the FSB implementation standards.

Therefore, the outlook of the compensation practices currently used by the most important Italian banks is almost in line with the principles defined by FSB and Bank of Italy. One of the main strengths of the Italian banking approach, is the existence of a business model focused on a long lasting relationship with clients, not purely “transactional”, but with a strong role of the retail market and based on credit to the productive system and to families. Consequently, Italian banks have not suffered some of the excesses – including those concerning remuneration - that have been highlighted in the wholesale sector.

Still, a number of areas need improvements and under the supervision of the Bank of Italy, banks have implemented a number of changes.

In particular, as far as the payout structure is concerned, many firms have so far implemented deferred compensation schemes, most part of them using stock or stock-connected instruments in an effort to discourage “short-termism”<sup>1</sup>. This practice represents a significant change for banks, because before the crisis, deferred plans was used just with a retention objective, but now the intention is to align the compensation payout with the risk time horizon. Whilst there is common agreement with the definition of long term incentive plans, the implementation of the bonus/malus systems (or claw-back agreements) may be tricky, as banks may find it difficult to retain talents and even face some legal issues.

As to the calculation of the bonus pool, the bonus systems are connected to the bank risk-adjusted and cost-of-capital-adjusted profitability, promoting sustainable performances. This is another crucial point in order to prevent unsound practices: measurement like ROE or TSR are replaced by risk-adjusted and cost-of-capital-adjusted performance indicators.

With the same objectives, banking systems are rebalancing the pay-mix, between fixed and variable pay.

In terms of Governance, a Remuneration Committee is present in most Italian Banks. HR collaborate on designing the new performance system with the cooperation of the risk management function and CFO.

The big challenge for HR managers, from my point of view, will be the capability to lead a deep cultural change, where the principles for a sound compensation system become indeed part of managerial mindset and culture. It is paramount, in order to create stability of

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<sup>1</sup> This is particularly key in businesses where risk-adjusted performance is hard to measure accurately, either because the time horizon of transactions is long or the products are illiquid.

these principles over time, that they could not be recognized by managers as some top-down rules, but as some sound principles, becoming part of their deep convictions and read as a model of best practice in the corporate culture.

#### Concluding remarks

In conclusion, we all know that the tone of debate has grown increasingly hostile, in some cases justifiably: while many executives in the financial sector have declined bonuses in 2008, we still recently have examples of over-compensation, especially in corporate and wholesale banking.

It is crucial that this debate leads to lasting changes in particular in the structure and governance of remuneration. The action of policy-makers and supervisors will be key in ensuring a consistent implementation of prudent principles.

In my opinion in devising the new rules, policy makers should consider some key elements:

- First of all, I believe that all stakeholders should play their role in promoting sound practices, and self-regulation alone cannot work. However, the rules should acknowledge that in the area of corporate governance too much intervention would be counterproductive;
- Second, it is important that we achieve a full convergence on how the principles for sound remuneration are implemented in all major jurisdictions, otherwise we risk to create harmful competitive distortions;
- My last remark is that, in my opinion, there is not a “one-size-fits-all” solution. Any measure should be risk-based, but treating in the same way institutions with a high risk profile and those with a more prudent risk approach, would be ineffective in the attempt to discourage reckless practices.

Thank you for your kind attention.