REMUNERATION POLICIES IN THE ITALIAN BANKING SYSTEM: COMPLIANCE WITH BEST PRACTICE AND FUTURE PERSPECTIVES

Lucia Giovanelli*, Federico Rotondo**

* Department of Economics and Management, University of Sassari, Italy
** Department of Humanities and Social Sciences, University of Sassari, Italy

Abstract

This paper focuses on remuneration policies in banking, an issue that is not particularly studied in relation to its importance to financial institutions' long-term viability and the sustainable growth of the economy as a whole. It aims to assess, through a gap analysis, the level of compliance with best practice in the remuneration policies of Italian banks prior to the implementation of new standards established as a result of CRD IV, as well as the FSB and EBA principles. It also seeks to analyse the evolution of remuneration systems in relation to new international standards in order to identify theoretical and practical implications. The study reveals that the long path through which today's standards have developed has basically fostered a learning process within the banking sector, which has led to a material respect for most of the best practices. In the same time, it also shows the presence of grey areas, which still undermine the full consistency of bank policies with sound remuneration practices.

Keywords: Remuneration, Banks, Best Practices, Compliance

1. INTRODUCTION AND OBJECTIVES

Lessons learnt from the global financial crisis, whose beginning is commonly associated with the collapse of Lehman Brothers in September 2008, have suggested the need to focus on strengthening corporate governance, given that the lack of effective control mechanisms was seen as a cause that led to excessive risk-taking in managing financial institutions (Adams and Mehran, 2012). Thereafter, corporate governance, which can be defined as the structure of rules and relations among stakeholders (owners, directors, managers and employees) that is useful for directing and controlling a company in a fair way in order to improve performance (Cadbury Report, 1992), has become a key point in the debate on the future of the banking industry and a means to rebuild credibility in the financial market (Mulbert, 2010). Today scholars are aware of the importance of developing mechanisms for balancing power and reducing agency costs inside banks, as well as banks' uniqueness at the heart of a more severe agency problem (Levine, 2004). Corporate governance, in this case, cannot simply be framed in terms of the solution of the conflict of interests between shareholders and the management, as banks' peculiarities increase both risk propensity of controlling shareholders in the short term and information asymmetry between majority and minority shareholders (Szego et al., 2008). In addition, especially when considering the public funding of the banking system by governments during the crisis, banks' creditors and taxpayers have become unprotected stakeholders whose interests, which are more oriented towards banking and financial system stability, are potentially divergent from those of shareholders. Furthermore, due to the Bank Recovery and Resolution Directive's introduction of a "bail-in" tool from January 2016 onwards, bank account holders with more than €100,000 must be rationally included within the categories whose interests need more protection. This is why the rules of corporate governance need to be adapted in order to take account of the specific nature of banks, and why supervisory authorities internationally are fostering good corporate governance practices in order to align the strategy, risk profile and appetite for risk of financial institutions with the goal of financial stability and long-term economic growth.

One of the main areas of intervention by regulators is the remuneration policy in the financial sector, as it is viewed as one of the factors that contributed to the crisis. In fact, the traditional lack of attention within compensation practices to long-term risk created a perverse mechanism in which high short-term profits led to excessive bonus payments to employees, that in turn amplified risk-taking and a shortage of bank resources to cope with the crisis. Europe is in transition towards sound compensation practices, with several countries, like Italy, currently implementing the Capital Requirements Directive 2013/36/EU, the so-called "CRD IV", which promotes new standards in the wake of the EBA and FSB principles. Nevertheless, remuneration policy in the banking system seems not to be significantly studied in relation to its importance to financial institutions' long-term viability and the sustainable growth of the whole economy. In particular, in the literature on bank corporate governance, most studies have focused on specific aspects, rather than considering all of the factors that contribute to improving a bank's

remuneration policy. Even if a good number of studies has dealt with the assessment of the effectiveness of new regulations introduced in the aftermath of the financial crisis, it has mainly paid attention to executive remuneration.

This research intends to fill the gap by considering all best practices, established by regulations and guidelines at an international level, which enhance the soundness of remuneration policies. In this regard, the international standards on compensation mix and structure, compensation sensitivity to both risk and performance, the role and remuneration of a bank's boards and bodies, with particular attention to the remuneration committee, and the level of disclosure of the remuneration system are included in this investigation.

This paper aims to assess, through a gap analysis, the level of compliance with best practices in relation to remuneration policies in the Italian banking system prior to the implementation of new standards. Secondly, since the new requirements came into force in November 2014, the analysis of the remuneration systems adopted by Italian banks in 2015 enables the assessment of the possibility of alignment with international standards and the grey areas that still exist, with the final aim of presenting practical implications and identifying new research avenues.

2. LITERATURE REVIEW ON REMUNERATION PRACTICES IN BANKING

As mentioned above, in the literature on bank corporate governance, most studies have focused on specific aspects of remuneration practices, while a special interest has been devoted to executive remuneration policy. Słomka-Gołębiowska and Urbanek (2014), for instance, assessed the incompleteness of the enforcement of new regulations concerning executive pay in Poland and the difficulty in evaluating the progress made. Meanwhile, Chen et al. (2011), through a case study on five troubled UK banks, found that ineffective executive remuneration could contribute significantly to business failure. Many studies, following a quantitative approach, have explored the relationship between directors' pay and performance, such as that of Doucouliagos et al. (2007) on Australian banking, which revealed an absence of a relationship with contemporaneous and prior year performance. In general, no conclusive evidence was found on this issue, since some authors assessed a negative relationship between bank performance and CEO compensation (Joyce, 2001), while others found controversial results. Fahlenbrach and Stulz (2011), for instance, in their investigation, which was carried out during the recent financial crisis, revealed that banks with CEOs whose incentives were better aligned with the interests of shareholders performed worse, while there was no evidence that they performed better. In addition, they found that banks with higher option compensation and a larger fraction of compensation in cash bonuses for their CEOs did not perform worse during the crisis. Conversely, other authors, such as Bosworth et al. (2003) and Sigler and Portfield (2001), found a positive relationship between executive compensation and, respectively, efficiency and financial performance in the US banking system. Magnan and St-Onge (1997) pointed out that executive compensation was more related to bank performance in a context of high managerial discretion, while Shiwakoti (2012) analysed the determinants of executive remuneration in the UK financial services sector, finding that industry norms are more used than performance to attract and retain executives. A number of studies has addressed the relationship between compensation and risk appetite, such as that of Handorf (2015), which evaluated a sample of regional US bank compensation practices before and after the crisis, providing evidence that the more risky banks appeared to have rewarded management more generously. Similarly, Guo et al. (2015) found that bank risk during the crisis increased with both the percentages of short-term and long-term incentive compensation, as well as observing that a greater proportion of incentive pay reduced the likelihood of a bank becoming a problem or a failed institution. The studies of Bebchuk, Cohen and Spamann (2010) and Bhagat and Bolton (2014), which were carried out in the US banking system between 2000 and 2008, supported the finding that incentives generated by executive compensation programmes were correlated with excessive risk-taking by banks, while unforeseen risks were not necessarily correlated to poor performance. In relation to the US situation, as noticed by Becher et al. (2005), Bai and Elyasiani (2013), and DeYoung et al. (2013), the deregulation of the industry around the year 2000 expanded growth opportunities and increased competition, while also having a strong impact on risk-taking and executive compensation. In the period leading to the banking crisis, Fortin et al. (2010), using a sample of large US bank holding companies, revealed that banks paying CEOs high base salaries also take less risk, while those that grant CEOs more in stock options or higher bonuses take more risk. Interestingly, Vallascas and Hagendorff (2013), in relation to both US and European banking, showed that increases in CEO cash bonuses lowered the default risk of a bank, while claiming there was no evidence of cash bonuses exerting a risk-reducing effect when banks were financially distressed or when banks operated under weak bank regulatory regimes.

Today, it is well-recognized that the financial crisis has led to greater concern about bankers' incentive compensation, especially executive compensation (Jansen et al., 2015), among the general public, while little research has documented the impact of recent compensation regulations implemented to encourage a long-term perspective in decision-making and to limit excessive risk-taking (Proctor and Murtagh, 2014). Furthermore, very little is known about the remuneration of non-executive directors or employees below the top executive level. Kampkötter, in his studies of a sample of German and Swiss banks (2015a; 2015b), found that non-executive bonus payments significantly followed bank performance prior to the financial crisis, but this effect vanished in the crisis period. He also showed that the crisis had a deep impact on short-term bonus payments in favour of higher fixed salaries, leading to a lower performance sensitivity towards compensation. Furthermore, Kostyuk et al.

(2012) showed that independent directors' remuneration practices in banks were strongly related to the governance system in place. Surprisingly, little attention has been paid to the role of bank remuneration committees, in spite of the important reforms concerning these bodies that followed the financial crisis. Dell'Atti et al. (2013), through a qualitative analysis on 30 top European banks during 2008-2010, showed a high diffusion of these bodies within banks and a gradual disclosure of the information about their tasks and decision-making.

3. SOUND REMUNERATION POLICIES IN BANKING: EVOLUTION OF LEGISLATION AND GUIDELINES

The recent financial crisis has prompted the introduction of a number of legislative initiatives and guidelines by international and national institutions in order to strengthen corporate governance mechanisms in the field of remuneration of financial institutions. The inefficiencies of bank remuneration policies, such as their short-term orientation, excessive risk-taking and low sensitivity towards performance, were in fact pointed out as the possible causes of the crisis. Actually, the creation and evolution of international standards in relation to sound remuneration systems in banking have followed a long and turbulent path, which started around 10 years ago with the guidance issued by the Basel Committee on Banking Supervision (BCBS). The BCBS' guidance promoted principles for enhancing corporate governance and was inspired by the principles published in 2004 by the Organisation for Economic Co-operation and Development (OECD). Among the other key issues, it pointed out that compensation policies should be consistent with a bank's long-term objectives. Nevertheless, as with the first appearance of the crisis in 2007, official action by national authorities has been called upon in order to fix deficiencies in compensation practices within the financial industry, such as the perverse relationship between high short-term profits and bonus payments without any attention to longer-term risk and bank stability. In its meeting in Washington on 15 November 2008, for instance, the G20 set out the objective to improve, amongst other things, risk management and compensation practices within financial institutions. In this context, the Financial Stability Forum (then known as the Financial Stability Board [FSB]) published, in 2009, the "Principles for Sound Compensation Practices", targeted at significant financial institutions, and with the aim to "*ensure effective governance of compensation, alignment of compensation with prudent risk taking and effective supervisory oversight and stakeholder engagement in compensation*". The principles, in particular, were oriented to increase effectiveness of the governance of the compensation, the alignment of compensation with prudent risk-taking and the supervisory oversight and engagement by stakeholders. The European Commission, drawing lessons from the crisis, adopted several recommendations (Recommendation 2009/384/EC and Recommendation 2009/385/EC) to tie remuneration policy, especially executive remuneration, to risk appetite and to include the cost of capital and liquidity ratios in the criteria used for measuring a bank's performance and individuals' goals. Nevertheless, the implementation of such recommendations by Member States was found to be neither uniform nor satisfactory, and the Commission, in its Green Paper of 2010 on corporate governance and remuneration policies in financial institutions, gave consideration to the need for new legislative measures. For this reason, the Commission decided to introduce explicit remuneration requirements in financial institutions in the revised Capital Requirements Directive (CRD III), the Directive 2010/76/EU of the European Parliament and of the Council of 24 November 2010, which amended Directives 2006/48/EC and 2006/49/EC. The main provisions regarded the identification of the "material risk takers" (MRTs), the group of people whose activity may have a material effect on a bank's risk exposure, as well as the definition of specific ratios and references about pay structure and pay mix (cash shares or equivalent, deferral thresholds and period, retention period), the obligation to establish a remuneration committee and the increase in the disclosure level on compensation practices. Actually, many of these standards were borrowed from the report issued by the FSB in September 2009, which proposed global standards on pay structure and promoted greater disclosure and transparency, as asked for by the G20 Finance Ministers and Governors in order to enhance the implementation of the FSB principles in significant financial institutions throughout the world. Furthermore, the Committee of European Banking Supervisors (CEBS), which is the predecessor of the European Banking Authority (EBA), was required, in 2010, to elaborate guidelines on sound remuneration policies in the financial sector in order to facilitate the compliance of the remuneration principles included in the CRD III. In the guidelines, the approach of proportionality among institutions and among categories of staff, which is strongly recommended in the implementation of the standards, is explained. In Italy, the Bank of Italy, which is the national supervisory authority, acknowledged the CRD III and the CEBS guidelines in March 2011.

The most recent European intervention is the CRD IV package (Regulation EU No. 575/2013 and Directive 2013/36/EU), which has introduced the global standards of the Basel III agreement into the EU law. The recent reform, even if in line with the previous legislation, sets new standards in a number of key issues relating to financial institutions' remuneration systems, such as the determination of the pay mix and cap (see the 1:1 ratio between fixed and variable pay), new governance mechanisms (see the power of a shareholders' meeting to approve a higher cap of the pay mix) and the reinforcement of ex-post risk adjustment (malus and clawback provisions). Meanwhile the EBA, which has supervised the European banking system since January 2011, has been given the power to elaborate *regulatory technical standards* (RTS), which are mandatory and directly enforceable. One of the most awkward aspects disciplined by RTS is the identification process of the MRTs, adopted by EU Delegated Regulation No. 604 in March 2014, on a proposal from the EBA. In general, the approach to the principle of proportionality in the application of the CRD IV package has changed, when compared to

the 2010 CEBS guidelines. While the consideration of institutions' size, internal organization and the nature, scope and complexity of their activities is still recommended, it is argued that flexibility should not lead to "neutralization", as the principle of proportionality cannot lead to the non-application of these rules. In December 2015, the EBA also released, after a three-month consultation period, the final report with guidelines to facilitate the implementation of sound remuneration practices, to be applied from 1 January 2017. The Bank of Italy, after a consultation period as well, issued a new regulation on 18 November 2014 called *"Politiche e prassi di remunerazione e incentivazione"*, in order to comply with CRD IV and new international standards (EBA and FSB). Table 1 shows the main standards and best practices, classified for significant categories (structure, relation with risk and performance, role of bank bodies, remuneration of bank bodies, remuneration committee, disclosure), as well as the indication of the source, drawn from the evolution of legislation and guidelines. In line with the rationale of recent reforms, they all account for a remuneration system that is consistent with a bank's values, strategies and long-term objectives; related to bank performance; conveniently risk adjusted in order to reflect capital and liquidity levels that are adequate to sustain a bank's activity while discouraging excessive risk-taking and any risk to global financial stability.

Table 1. International standards on remuneration

Structure
• Only two categories: fixed or variable. Golden parachutes (not recommended) included under the variable part. [Sources: CEBS 2010; CRD IV] • Variable remuneration ≤ 100% fixed remuneration (exception: shareholders's meetings can increase the ratio to 200% with a special quorum). [Sources: CEBS 2010; CRD IV] • Variable remuneration is aligned with long-term performance and risk. [Sources: BCBS 2006; FSB 2009a, 2009b] • Minimum 50% of any variable remuneration in bank shares or equivalent instruments. [Sources: CRD III; FSB 2009b; EBA 2015] • Minimum 40% or 60% of the variable remuneration is deferred by at least three to five years for particularly high amounts or particular staff categories. Significant institutions: for members of the management body in its management function and senior management deferral periods of at least five years. [Sources: CRD III; FSB 2009b; EBA 2015] • The first deferred portion (also *pro rata*) should not vest sooner than 12 months after the start of the deferral period. [Sources: CRD III; EBA 2015] • For awarded instruments, a retention period of at least one year should be set. [Sources: CRD III; EBA 2015] • Proportionality: remuneration policies and practices should be consistent with the individual risk profile, risk appetite and strategy of an institution by considering the size, the internal organization and the nature, scope and complexity of the institution's activities. [Sources: CEBS 2010; CRD IV]
Relation to risk and performance
• The award, pay-out and vesting of variable remuneration should not be detrimental to maintaining a sound capital base. [Sources: Recc. 384-385 EC; FSB 2009b; CRD IV] • When assessing whether the capital basis is sound, the institution should take into account the Common Equity Tier 1 capital and the combined capital buffer requirement. [Sources: Recc. 384-385 EC; FSB 2009b; CRD IV] • The remuneration policy should not lead to shortcomings in an institution's liquidity. [Sources: Recc. 384-385 EC; FSB 2009b] • The objectives of the institution, business units and staff should be considered. [Sources: CRD IV; EBA 2015] • Individual performance: financial and non-financial indicators. [Source: CRD IV] • Quantitative and qualitative, absolute and relative objectives. [Sources: CEBS 2010; CRD IV] • Guaranteed variable remuneration is not permitted, except when hiring new staff, and only for the first year of employment. [Sources: FSB 2009b; CEBS 2010; CRD IV] • Institutions must be able to apply malus or clawback arrangements up to 100% of the total variable remuneration. [Sources: CRD IV; EBA 2015] • Malus and clawback arrangements can be applied within both deferral and retention periods. [Sources: CRD IV; EBA 2015] • Variable remuneration should not be assigned in the case of financial institutions in a loss position. [Source: FSB 2009a] • The variable remuneration should be consistent with and adjusted for all current and future risks taken. [Sources: FSB 2009b; EBA 2015] • Risk adjustment parameters: capital (amount and cost), liquidity (amount and cost), time and future earnings. [Source: CRD IV]

Table 1. Continued

Role of bank bodies
• The supervisory function or, where established, the remuneration committee should ensure that the remuneration policy and practices of the institution are subject to a central and independent internal review at least annually. [Sources: FSB 2009a; CEBS 2010] • The shareholders' meeting decides on the remuneration of the bodies that it nominates, the assignment of shares or equivalent instruments, and the increase of the pay-mix. [Source: CRD IV] • The supervisory function oversees the whole remuneration system. [Sources: FSB 2009a; 2009b; CEBS 2010] • All institutions should conduct a self-assessment annually in order to identify all staff whose professional activities have or may have a material impact on an institution's risk profile. The management body has the ultimate responsibility for the identification process. [Sources: CRD III; CEBS 2010; EBA 2015] • Group contexts: the consolidating institution and competent authorities should ensure that a group-wide remuneration policy is implemented. [Sources: CRD IV; EBA 2015]
Remuneration of bank bodies
• The remuneration of non-executive directors should only be fixed (exceptional cases: non-significant amount). [Source: CRD IV] • No variable remuneration for the President of the management body. His/her remuneration should be determined *ex-ante* and should not exceed the fixed remuneration of the top executives (CEO and senior officers). [Source: CRD IV] • Members of the supervisory board: only fixed remuneration. Incentive-based mechanisms based on the performance of the institution should be excluded, unless exceptionally awarded variable remuneration is strictly tailored to the assigned oversight, monitoring and control tasks. [Sources: FSB 2009b; EBA 2015] • Top levels of control function: remuneration related to their responsibilities and not to performance. Limit: variable remuneration no more than 33% of fixed remuneration. [Sources: FSB 2009a; CEBS 2010] • The remuneration of independent control functions should be predominantly fixed in order to reflect the nature of their responsibilities. If allowed, variable remuneration should be a little proportionate and related to their tasks. [Sources: FSB 2009a; CEBS 2010]
Remuneration committee
• All institutions, which are themselves significant, as well as listed institutions, must establish a remuneration committee. [Sources: CRD III; FSB 2009b; CEBS 2010] • Members should collectively have appropriate knowledge, expertise and professional experience. [Sources: CEBS 2010; EBA 2015] • Composed of members of the supervisory function who do not perform executive functions. The chair and the majority of members should qualify as independent. [Sources: CEBS 2010; EBA 2015] • Knowledge (internal or through external support) concerning remuneration policies and practices, risk management and control activities. [Source: CRD IV] • It should collaborate with the risk committee: a member of the risk committee should participate in the meetings of the remuneration committee, and vice versa. [Source: FSB 2009b] • It directly oversees the remuneration of the senior officers of independent control functions, including risk management and compliance functions. [Source: EBA 2015] • Meetings: number and duration. [Sources: CEBS 2010; EBA 2015]
Disclosure
• Official websites displaying the remuneration policy. [Source: CRD IV] • An annual report explaining decision-making, the role of remuneration committee, performance alignment and risk adjustment criteria, awarding and deferral mechanisms, and pay structure. [Sources:FSB 2009b; EBA 2015] • Remuneration policy: rationale, amount, implementation and results. [Sources: FSB 2009a; CRD III; EBA 2015] • Explanation of pay mix. [Sources: CRD III; EBA 2015] • Identification process: number, position and criteria. [Sources: CRD IV; EBA 2015]
Legend *CEBS: Committee of European Banking Supervisors* *CRD: Capital Requirements Directive* *EC: European Commission* *EBA: European Banking Authority* *FSB: Financial Stability Board*

4. METHODOLOGY

From a methodological point of view, a gap analysis, following a qualitative approach, has been carried out in order to assess the level of compliance with best practice in remuneration policies in Italian banking. The sample comprises all the larger and more complex banks in Italy, which are considered as significant according to Article 6(4) of the EU Regulation No. 1024/2013, which introduces the Single Supervisory Mechanism (SSM) of the European Central Bank (ECB) within Europe. In addition, the sample includes Italian-listed banks, even if they are not identified as significant by the ECB, given that they must be automatically considered among the larger and more complex ones (Bank of Italy, bank supervisory regulation No. 285/2013). The rationale that drove the sample selection is that the larger and more complex banks must fully apply the new regulation on remuneration policy in order to comply with CRD IV.

The final sample is made up of 18 banks, including the 13 Italian banking holding companies that the ECB recognized as significant credit institutions due to their having assets greater than €30 billion (excluding the Italian branch of Barclays Bank PLC), as well as 5 other banks currently listed on Italy's stock exchange known as

"Borsa Italiana S.p.A." (excluding Banca Sistema whose shares were listed for the first time in June 2015). Table 2 shows the banks included in the sample and their main characteristics, such as their asset class and number of employees, as well as whether they are significant institutions, holding or listed companies.

Table 2. Characteristics of the sample

No.	Banking company	Asset class (billion)	Number of employees	Significant	Holding	Listed
1	Unicredit	500<assets<1,000	144,972	·	·	·
2	Intesa San Paolo	500<assets<1,000	89,486	·	·	·
3	Monte dei Paschi di Siena	150<assets<200	25,961	·	·	·
4	Banco Popolare	100<assets<125	17,575	·	·	·
5	UBI Banca	100<assets<125	17,462	·	·	·
6	Mediobanca	50<assets<75	3,570	·	·	·
7	Banca Popolare dell'Emilia Romagna	50<assets<75	11,593	·	·	·
8	ICCREA Holding	30<assets<50	2,213	·	·	
9	Banca Popolare di Milano	30<assets<50	7,759	·	·	·
10	Banca Popolare di Vicenza	30<assets<50	5,295	·	·	
11	Banca Carige	30<assets<50	5,737	·	·	·
12	Veneto Banca	30<assets<50	5,590	·	·	
13	Banca Popolare di Sondrio	30<assets<50	2,596	·	·	·
14	Fineco	assets<30	1,008		[1]	·
15	Banco di Desio e della Brianza	assets<30	2,474		·	·
16	Banco di Sardegna	assets<30	2,033		[2]	·
17	Banca Profilo	assets<30	211			·
18	Finnat	assets<30	169			·
[1] *It is part of the Unicredit group*						
[2] *It is part of the Banca Popolare dell'Emilia Romagna group*						

A gap analysis has subsequently been carried out on the official documents which give information on the remuneration systems of the banks included in the sample, mainly the Compensation report, the Corporate governance report and the Annual report. In order to deal with the problem of lack of disclosure, online research was also used in order to gather information from banks' official websites. All reports used in the investigation date back to 2015 in order to assess the evolution of bank remuneration systems over the accounting years 2014-2015. It is important to note that the chapter on the remuneration policy has been added to the Bank of Italy's Regulation No. 285/2013, which acknowledged CRV IV, on November 2014, while the EBA's guidelines were released on December 2015 and will be enforced from January 2017. Therefore, the 2015 Compensation report, accounting for the results of remuneration policies in 2014 and the remuneration strategies for 2015, completely covers the period of change. This is why it has been useful to shed light on the level of compliance before the implementation of new international standards, the adjustments to bank remuneration policies in order to fill the gaps, and the grey areas that still remain and impact upon the full development of sound compensation practices in the future.

5. RESULTS

This section shows, category by category, the main results of the investigation on sound remuneration practices.

Structure

From 2015, there is a remarkably clearer separation between fixed and variable remuneration, even if some cases show the presence of third categories. In two cases "benefits" are not correctly included in the fixed part of remuneration, while one bank reports the presence of a "recurrent integrative remuneration". Golden parachutes are still used in six cases, while in two of them are beyond the parameters set for variable remuneration.

The introduction of the 1:1 ratio between variable and fixed remuneration is new in thirteen banks, but the majority already respected this cap unformally before 2015. In five cases, a lower cap already existed, while a lower cap was introduced in 2015 in another five cases. In six cases, which were mainly larger banks or banks focused on asset management services, the ratio was increased to 2:1 (in two cases, for top-managers only; in three cases, for top managers and executive directors; and, in one case, for all staff categories).

In 2015, the long-term orientation of remuneration incentives was strengthened in four banks. Meanwhile, in two banks, this propensity still seems to be patchy. A strong majority of banks already assigned shares or equivalent instruments, mainly to MRTs, before 2015. Nevertheless, in four cases, the 2015 policies set an amount of shares lower than 50% of the total variable remuneration. Before 2015, only one bank failed to defer variable remuneration. In ten cases, the new policies established salary thresholds to trigger deferral, while eight banks still failed to respect standard parameters of percentage or length.

In the entire sample the first deferred portion is vested after at least twelve months, except for two banks, which allow for the assignment after six months, and one bank, which allows for a possible anticipation of incentives. The bulk of banks established salary thresholds, under which each variable remuneration is in cash and up front. As regards retention for awarded instruments, two banks set a period shorter than one year, while nothing is said in another four cases. In general, the principle of proportionality has largely been applied since before 2015. In two cases, it has been strengthened by the new requirements, while it remains to be adopted in three cases.

Relation to risk and performance

The principle that variable remuneration should not be detrimental to maintaining a sound capital base is widely respected. In 2015, the connection with capital buffers was strengthened. In particular, the Common Equity Tier (CET) 1 (twelve cases) is usually used as a gate to variable remuneration, while only two banks have taken into account the combined capital buffer requirement. The connection with the liquidity level has been strengthened as well (in 2015, only one bank has not considered it), with the Liquidity Coverage Ratio (LCR) being the main gate to awarding variable remuneration (eight cases). As regards the nature of performance objectives, all financial institutions opportunely included firm, business unit and individual objectives. Financial and non-financial measures have also been widely used (even if the last ones could be better explained), while there has been a remarkable gap in the use of relative parameters, which are taken into account in just three cases. Except for seven cases, in which a welcome bonus has been used according to the law, two banks seem to have ignored the prohibition of assigning a guaranteed variable remuneration, while another five have involved or retained the possibility to use stability and non-competition agreements. One of the main innovations of 2015 concerned the malus and clawback mechanisms, introduced for the first time in six remuneration systems, even if two of them did not clearly define the validity time.

A grey area in the new systems has been the fair consideration of risk outcomes, since banks' loss position did not clearly turn into the prohibition of assigning variable remuneration in seven cases. This was due to the presence of waivers, ambiguous parameters or a simple bonus curtailment. Furthermore, in four cases, bonuses were not adequately aligned to the time horizon of risks.

Similar to what happens for performance objectives, risk adjustment reveals shortages in the definition of time and liquidity parameters (five cases), as well as in the use of relative parameters (six cases).

Role of bank bodies

This is the area where Italian financial institutions show the highest level of compliance. Role and functions of shareholders' meeting, supervisory functions and holding companies are clearly defined and consistent with law requirements. However, it is important to point out that, even if only two banks failed to conduct a self-assessment annually in order to identify MRTs before 2015, a deep revision and, in particular, a remarkable increase on MRTs' perimeter was made in eight cases following the new regulation (RTS adopted by EU, on a proposal from the EBA, in March 2014). There is a variety of bodies responsible for the identification process in the sample: in six cases, human resources play a key role, while a central role is played by the compliance function, the risk management or the remuneration committee in two cases.

Remuneration of bank bodies

There is wide agreement about the dispensation of non-executive directors from variable remuneration, which is theoretically possible but not applied in just one case. Actually, the principle is extended to all directors, except for managing directors (twelve cases), who are basically paid through a fixed remuneration, which is increased for particular offices or tasks, and attendance fees. Best practices for the remuneration of the President of the management body (whose cap in Italy is 100% of the fixed remuneration of the top executives, instead of 30% less than that as set by CRD IV) and the members of the supervisory board are basically respected. Things are quite different for control functions, as the principle of relating remuneration to responsibilities, rather than performance, is ignored in three cases, while a cap of 33% of fixed remuneration for top levels (it is lower than the 25% proposed by CRD IV) is already set in five cases, even if it will only be enforceable from 2016. With reference to all staff involved in control functions, currently no cap is present in two institutions, while another two expressly violate it.

Remuneration committee

The committee is present in the entire sample, even if three banks have introduced or significantly reviewed it from 2014. It is composed of 3.87 people on average, with 5.09% holding a school-leaving certificate and 94.91% holding a degree, mainly in the fields of economics (55.36%), law (23.21%) or engineering (7.14%). The bulk of members show adequate levels of competence (73.71%) and experience (85.71%). Most members are non-executive (96.78%, due to two members taking part in executive committees) and, in most cases, independent (72.58%). The sample reveals a variety in the way competences are integrated in the committee: three banks require just one member to be highly-qualified, three banks do not explicitly require any expertise and four banks turn to external support. In just one case, the absence of adequate professionalism is evident. In general, the remuneration committee collaborates with the risk committee, while four banks do not explicitly task it with overseeing the remuneration of senior officers involved in independent control functions. Remuneration committees meet, on average, 9.5 times annually (a minimum of three, a maximum of nineteen), while their meetings last one hour and 22 minutes each on average (a minimum of 30 minutes, a maximum of three hours).

Disclosure

All banks in the sample drew up a Remuneration report. Although, in six cases, this is not displayed in a dedicated space on the website, but is instead included among the deliberations of the

shareholders' meeting. In one case, the report is attached to the Annual report; in another case, however, it is not present on the official website at all.

As regards the content, the main disclosure gap revealed by the analysis is the general lack of a comprehensive report. Except for one case, the sample shows insufficient transparency regarding essential aspects of remuneration systems. In particular, in seventeen cases, the report is not useful in order to assess the composition and qualification of the remuneration committee. For this purpose, supplementary information has to be gathered from the Corporate governance report (in nine cases, although two banks do not draw one up at all), or from the official website (one case). Incomplete information also involves pay-performance relations (four cases), the cash-instruments mix and deferral periods (four cases), and performance management and risk adjustment (two cases each). Finally, transparency regarding the identification process was significantly improved in 2015, but it is still a halfway process, since the same percentage of banks (50%) either disclose detailed information on the process or superficially refer to RTS.

6. CONCLUSION

This paper focuses on a key issue concerning the long-term viability of banks and the stability of the economy at an international level: namely, the remuneration policy within the banking system, which is certainly a topic that is not fully studied in the literature concerning bank corporate governance. In particular, this paper aims to advance the understanding of all factors enhancing the soundness of remuneration policies by analysing the remuneration practices in Italian banks before the implementation of new standards set by CRD IV, as well as the EBA and FSB principles. It seeks to shed light on the distance separating bank remuneration systems from best practices, together with their evolution, in order to facilitate alignment with recent international standards. Through this gap analysis, the way in which new regulations have been acknowledged within Italian banking is assessed, as well as the grey areas that still undermine the full consistency of bank policies with sound remuneration practices. This has permitted the identification of future research avenues and practical implications.

Indeed, the study reveals that the long and turbulent path through which today's remuneration standards have been developed has basically fostered a learning process within the banking system, leading to a material respect towards most of the best practices. The real innovations of bank remuneration policies promoted by the CRD IV package lie in setting a cap in the pay mix, in that the cap can be increased only through the decision of a qualified majority of shareholders, the reinforcement of long-term risk adjustment through malus and clawback provisions, and the significant increase of the number of MRTs, due to the new regulatory technical standards driving the identification process.

Nevertheless, a series of doubts remains about the real propensity of the new framework to overcome some critical factors, which have usually affected remuneration systems and caused excessive risk-taking. As regards the structure of remuneration, the pay-mix cap has been raised to 200% in a significant number of institutions, but mainly the larger ones or those focused towards asset management services. In addition, golden parachutes continue to be a widespread practice among financial institutions. In relation to risk and performance sensitivity of remunerations, a remarkable number of institutions does not clearly state the prohibition of assigning variable remuneration in the case of banks' loss position. Furthermore, both performance measurement systems and risk adjustment processes diffusely suffer from the lack of relative parameters, which could permit the assessment of bank results following a benchmarking approach. Bonus alignment to long-term risks is also often disregarded, while welcome bonuses or anticipated bonuses, assimilated to those assigned in relation to the probability of being fired, are commonly used in the sample. From a theoretical point of view, this implies that, in spite of a stricter regulation on specific aspects, which could promote excessive risk-taking, industry norms are hard to remove and compensation basically remains a strategic tool in order to attract and retain talented staff and management to increase bank competitiveness and performance, while the issue of balancing strategic goals and risks stays in the background of remuneration policy. From a policy perspective, this highlights the importance of regulatory and supervisory authorities' monitoring in the first stage of the implementation of new standards in order to prevent the use of waivers and dissuade bad practices.

The governance of remuneration systems is the area where Italian financial institutions show the highest level of compliance with international standards. However, a grey area affects the remuneration of control functions, for which a gap with best practices still needs to be filled. In fact, a significant percentage of banks does not correctly associate variable remuneration with control responsibilities, nor does it respect the cap between fixed and variable remuneration. This is even more surprising considering that the Bank of Italy, in relation to control functions, as well as the remuneration of the President of the management body, chose to establish a lower cap than that proposed by CRD IV. The unsatisfactory attention paid to control functions is also highlighted by the fact that a notable number of banks does not explicitly task, as recommended, remuneration committees with the oversight of the remuneration of senior officers involved in the independent control functions. Remuneration committees are present, well-qualified and committed in the entire sample, although the study reveals strong differences in their composition and functioning among institutions. This kind of "legal compliance", adopted by banks, has a key implication for future research. Much more investigation, in fact, is required into the real role and functions of banking bodies in the decision-making on remuneration policies beyond what is said in statutes, regulations and reports. A qualitative approach, for instance, could be used to shed light on key factors, such as

the involvement of boards and bodies, as well as the quality of internal reporting on the topic inside financial institutions. Definitively, a significant contribution could be made by a more effective involvement of supervisory boards and control functions in the decision-making on compensation policies.

Finally, disclosure on remuneration practices should significantly improve, for instance, through the development of a real comprehensive report, which could be able to provide information on all variables impacting on the soundness of a remuneration system. In particular, transparency is still lacking in relation to the composition of the remuneration committee and the quality of its members, the pay-performance relationship, the cash-instruments mix, the deferral periods, the performance management system, the risk adjustment and the identification process. Hopefully, this information gap can be filled by intervention from regulators and supervisory authorities.

REFERENCES

1. Adams, R. B. and Mehran, H. (2012), "Bank Board Structure and Performance: Evidence for Large Bank Holding Companies", Journal of Financial Intermediation, 21(2), 243-267.
2. Bai, G. and Elyasiani, E. (2013), "Bank Stability and Managerial Compensation", Journal of Banking & Finance, 37(3), 799-813.
3. Banca Centrale Europea (2014), Elenco dei Soggetti Vigilati Significativi ed Elenco degli Enti Creditizi Meno Significativi, Frankfurt.
4. Basel Committee on Banking Supervision (BCBS) (September 1999 and February 2006), Enhancing Corporate Governance for Banking Organisations, BCBS, Basel.
5. Bebchuk, L.A., Cohen, A. and Spamann, H. (2010), "The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008", Yale Journal on Regulation, 27, 257-282.
6. Becher, D.A., Campbell II, T.L. and Frye M.B. (2005), "Incentive Compensation for Bank Directors: The Impact of Deregulation", Journal of Business, 78(5), 1753-1777.
7. Bhagat, S. and Bolton, B. (2014), "Financial Crisis and Bank Executive Incentive Compensation", Journal of Corporate Finance, 25, 313-341.
8. Bosworth, W., Mehdian, S. and Vogel, T. (2003), "Executive Compensation and Efficiency: a Study of Large and Medium Sized Bank Holding Companies", American Business Review, Jan., 91-99.
9. Chen, J.J., Zhang, H., Xiao, X. and Li, W. (2011), "Financial Crisis and Executive Remuneration in Banking Industry – an Analysis of Five British Banks", Applied Financial Economics, 21, 1779–1791.
10. Dell'Atti, A., Intonti, M. and Iannuzzi, A.P. (2013), "The Effectiveness of Remuneration Committees in European Banks Regulation and Best Practices", Journal of Financial Regulation & Compliance, 21(4), 373-396.
11. DeYoung, R., Peng, E.Y. and Yan, M. (2013), "Executive Compensation and Business Policy Choices at U.S. Commercial Banks", Journal of Financial & Quantitative Analysis, 48(1), 165-196.
12. Doucouliagos, H., Haman, J. and Askary, S. (2007), "Directors' Remuneration and Performance in Australian Banking", Corporate Governance: an International Review, 15(6), 1363-1383.
13. Draghi, M. (2008), Concluding remarks, Bank of Italy, Annual Report, Rome, 31 May.
14. European Banking Authority (EBA) (2015), Guidelines on Sound Remuneration Policies under Articles 74(3) and 75(2) of Directive 2013/36/EU and Disclosures under Article 450 of Regulation (EU) No 575/2013, EBA/GL/2015/22, December, London.
15. European Commission (EC) (2010), Green Paper. Corporate Governance in Financial Institutions and Remuneration Policies, COM(2010) 285 final, COM(2010) 286 final, SEC(2010) 669.
16. Fahlenbrach, R. and Stulz, R.M. (2011), "Bank CEO Incentives and the Credit Crisis", Journal of Financial Economics, 99(1), 11-26.
17. Financial Stability Board (FSB) (2009), FSF Principles for Sound Compensation Practices, April.
18. Financial Stability Board (FSB) (2009), FSB Principles for Sound Compensation Practices. Implementation Standards, September.
19. Fortin, R., Goldberg, G.M. and Roth, G. (2010), "Bank Risk Taking at the Onset of the Current Banking Crisis", Financial Review, 45(4), 891-913.
20. Guo, L., Jalal, A. and Khaksari, S. (2015), "Bank Executive Compensation Structure, Risk Taking and the Financial Crisis", Review of Quantitative Finance & Accounting. 45(3), 609-639.
21. Handorf, W.C. (2015), "Bank Risk Management, Regulation and CEO Compensation After the Panic of 2008", Journal of Banking Regulation, 16(1), 39-50.
22. Jansen, D.-J., Mosch, R. and Cruijsen, C. (2015), "When Does the General Public Lose Trust in Banks?", Journal of Financial Services Research, 48(2), 127-141.
23. Joyce, W.B. (2011), "Return and Reward: Bank Performance and CEO Compensation", American Business Review, June, 93-99.
24. Kampkötter, P. (2015a), "Pay-Performance Sensitivity of Compensation Contracts for Nonexecutive Employees: the Case of the Financial Crisis", Applied Economics Letters, 22(9), 734-738.
25. Kampkötter, P. (2015b), "Non-Executive Compensation in German and Swiss Banks Before and After the Financial Crisis", European Journal of Finance, 21(15), 1297-1316.
26. Kostyuk, O.M., Govorun, D.A., Sarkizova, O.A., Manzhula, I.P. and Shablii, A.V. (2012), "Independent Directors' Remuneration in Various Corporate Governance Systems: Empirical Evidence from Banks", Business Inform, 4, 191-195.
27. Levine, R. (2004), The Corporate Governance of Banks: a Concise Discussion of Concepts and Evidence, Working Paper 3404, World Bank Policy Research.
28. Magnan, M.L. and St-Onge, S. (1997), "Bank Performance and Executive Compensation: a Managerial Discretion Perspective", Strategic Management Journal, 18(7), 573-581.
29. Mulbert, P.O. (2010), "Corporate Governance of Banks after the Financial Crisis. Theory, Evidence, Reforms", ECGI Working Paper Series in Law, n. 151.
30. Organisation for Economic Co-Operation and Development (OECD) (2004), OECD Principles of Corporate Governance, originally issued June 1999.
31. Proctor, R. and Murtagh, J. (2014), "Incentive Compensation for Bank CEOs and CFOs Before

and After the Financial Crisis", Journal of Legal, Ethical & Regulatory Issues, 17(2), 61-75.
32. Shiwakoti, R.K. (2012), "Comparative Analysis of Determinants of Executive Remuneration in the UK Financial Services Sector", Accounting and Finance, 52, 213–235.
33. Sigler, K.J. and Porterfield, R. (2001), "CEO Compensation: its Link to Bank Performance", American Business Review, June, 110-114.
34. Słomka-Gołębiowska, A. and Urbanek, P. (2014), "Executive Remuneration Policy at Banks in Poland After the Financial Crisis - Evolution or Revolution?", Comparative Economic Research, 17(2), 25-44.
35. Szego, B., De Vincenzo, A. and Marano, G. (2008), The Evolution of Corporate Governance of Italian Listed Banks: What Happened in the Boardroom?, Preliminary draft presented at the conference "Corporate Governance in Italy: 10 years after the Consolidated Law on Finance (TUF)", Rome.
36. The Committee on the Financial Aspects of Corporate Governance (1992), The Financial Aspects of Corporate Governance (Cadbury Report), London.
37. The Committee of European Banking Supervisors (CEBS) (2010), Guidelines on Remuneration Policies and Practices, December, London.
38. Vallascas, F. and Hagendorff, J. (2013), "CEO Bonus Compensation and Bank Default Risk: Evidence from the U.S. and Europe", Financial Markets, Institutions & Instruments, 22(2), 47-89.