Remuneration Policy in a Banking Corporation

Introduction

1. Inappropriate remuneration arrangements that create incentives to take exceptional risks can undermine the financial soundness of a banking corporation. Proper remuneration arrangements are among the adequate corporate governance principles that banking corporations must adopt, principles that assist in achieving and maintaining the public's trust in the banking system. This Directive sets rules designed to ensure that remuneration arrangements in a banking corporation are consistent with the risk management policy and the long-term goals of the banking corporation.

2. To eliminate doubt, it is hereby clarified that these provisions are additional to the provisions of the Companies Law, 5749–1999, (hereinafter – the "Companies Law"), and the provisions of the Remuneration of Officeholders in Financial Corporations (Special approval and inadmissibility of expense for tax purposes in respect of irregular remuneration) Law, 5776-2016 (hereinafter, the "Remuneration of Officeholders in Financial Corporations Law").

Scope

3. (a) This Directive shall apply to:

    (1) A banking corporation, as defined in the Banking (Licensing) Law, 5741–1981 (hereinafter, the "Banking (Licensing) Law"), excluding a foreign bank.

    (2) A corporation as provided in Sections 11(a)(3a), 11(a)(3b) and 11(b) of the Banking (Licensing) Law, which is controlled, directly or indirectly, by the banking corporation, as if it were a banking corporation, excluding:

      (1) A corporation incorporated in a country other than Israel. On the matter of these, see Section 8 below.

      (2) A corporation which does not determine the remuneration of all its officeholders and employees.

(b) Notwithstanding the provisions of Subsection (a)(1), a foreign bank is required to ensure that the remuneration arrangements of its employees in Israel do not create incentives to take exceptional risks, including mechanisms similar to those required under this Directive, and that adequate controls on this matter are in place.

(c) Cancelled.

Definitions

4. "**Remuneration Policy**" – a policy regarding remuneration of a banking corporation's employees and senior officeholders.

"**Outsourcing**" – as defined in Section 42 of Proper Conduct of Banking Business Directive no. 350, Operational Risk Management.

"Senior Officeholder" –

(a) An "officeholder" as defined in the Companies Law; and

(b) Chief accountant, chief financial officer, internal auditor, compliance and money laundering prohibition officer, chief risk officer, head of human resources, head of IT management, legal counsel, and any person serving in such function even if under a different title, as well as an individual employed in another position in the banking corporation who holds five percent or more of the nominal value of the issued share capital or of the voting rights, or who holds a material means of control in a banking corporation without a controlling interest as this term is defined in Section 37(e) of the Securities Law, 5728–1968.

"Key employees" –

a. Any person whose activity may have material impact on the banking corporation's risk profile. The banking corporation shall define, as part of the remuneration policy, who is included in this group, as long as it includes at least:

1. A senior officeholder.
2. A person who is not a senior officeholder, who meets at least one of the following conditions:
   (a) He is a manager reporting directly to the CEO.
   (b) The total remuneration attributed to the employee received by him from the banking corporation for the last year or the year preceding it, exceeds NIS 1,500,000.
3. Groups of employees subject to the same remuneration arrangements, which may, cumulatively, expose the banking corporation to material risk, even if each employee separately does not expose the corporation to material risk.

b. Notwithstanding the provisions of Subsection (a), there is no duty to apply the requirements specified in this Directive to key employees who are not "officeholders" to whom the Companies Law (Amendment 20), 5773–2012 applies, who meet at least one of the following conditions:

1. Their entire remuneration is determined pursuant to a collective agreement.
2. Their remuneration meets the two following cumulative conditions:
   (a) The remuneration attributed to the employee that constitutes variable remuneration, for the last year and for the year preceding it, does not exceed 20% of the total annual remuneration.
   (b) The total annual remuneration attributed to the employee for the last year and for the year preceding it does not exceed NIS 500,000.

"Remuneration" – Terms of service or employment, including granting exemptions, insurance, undertaking to indemnify or indemnity under an indemnity permit, severance pay and other retirement terms, and any benefit, other payment or undertaking to make such payment, given due to service or employment as noted.

"Remuneration attributed to employee"- salary and related benefits attributable to an employee, including:

(a) Salaries, as defined in the Reporting to the Public Directives, according to pay slips;

(b) The employer's contributions and payments to various social benefit funds (such as: contributions to pension funds, severance pay and remuneration fund, contributions for advanced training funds);

(c) The employer's payments to various authorities (for example: the employer's payments to the National Insurance Institute);

(d) Expenses deriving from attributable share-based payment transactions.

"Fixed remuneration" – Payment the granting of which is not stipulated on performance, but rather predetermined in the remuneration agreement, at a fixed monetary amount, such as a monthly salary. The remuneration's classification does not depend on the means of payment (cash, shares, etc.).

"Variable remuneration" – Remuneration that is not a fixed remuneration.

Functions of the Board of Directors

5. The banking corporation's board of directors:

(a) Shall discuss, decide and determine, after having weighed the recommendations of the remuneration committee, the remuneration policy of the banking corporation, including criteria for evaluating and measuring performance, and shall supervise the policy's implementation. The processes for approving the remuneration policy shall be clear and well documented.

(b) Shall ensure that the remuneration policy promotes compliance with the corporation's goals and established and effective risk management, does not encourage taking disproportionate risks or risks beyond its risk appetite, and allows maintaining a robust capital base.

(c) Shall examine from time to time the remuneration policy and the need to adjust it to the provisions of this Directive, if a material change occurs in the circumstances from the time it was set, or for other reasons.

(d) Shall discuss and approve the banking corporation's engagements with senior officeholders, after having weighed the recommendations of the remuneration committee.

(e) Shall discuss and approve, after having weighed the recommendations of the remuneration committee, the principles of the remuneration agreements of the banking corporation's employees who are not senior officeholders.

Remuneration Committee

6. A banking corporation's board of directors shall appoint a remuneration committee, the composition and functions of which shall be as provided in Sections 38 and 38a of Proper Conduct of Banking Business Directive no. 301, this even in a corporation to which Proper Conduct of Banking Business Directive no. 301 does not apply.

Remuneration Policy

7. In setting its remuneration policy, the banking corporation shall comply with the following requirements, combined (even in a corporation to which Section 118a of the Companies Law does not apply) with the requirements of Section 267b and the First Addendum A to the Companies Law:

(a) The remuneration policy shall be prepared on a multiyear basis, and shall require the board of director's approval at least once every three years, in addition to the annual discussion evaluating the policy's performances, as provided in Section 18(a) of Proper Conduct of Banking Business Directive no. 301.

(b) The remuneration policy shall be applied to all of the banking corporation's employees and to all types of remuneration.

(c) The remuneration policy shall also be based on organization-wide considerations, such as the total cost of remuneration, desired remuneration differences between various ranks, etc.

(d) The remuneration policy shall be worded clearly, shall be backed by detailed procedures and shall include, at least:

(1) A definition of "key employees."

(2) A description of the remuneration mechanisms for different groups of employees, such as key employees, and particularly senior officeholders.

(3) A description of the key factors involved in the planning, approval, implementation and monitoring of remuneration agreements, and the significant information sources received from such factors to feed and support the remuneration mechanism.

(e) The banking corporation shall inform employees of the key principles of its remuneration policy, in order for them to know in advance how their performance will be measured and how they will be remunerated.

(f) The remuneration policy shall also include principles on the matter of variable remuneration and terms of engagement with factors working with customers of the banking corporation, pursuant to Section 17 below.

(g) Key employees, excluding directors, shall not be involved in formulating the remuneration policy and/or their remuneration agreements and those of the same or higher ranks, except as provided in Section 9(b) below.

(h) In determining the policy it is necessary to ensure that the size of the total variable component does not restrict the banking corporation's ability to maintain the robustness of its capital at any time; the Supervisor shall be allowed to order a restriction of the total variable remuneration payment, as a percentage of net profits, when such payment is inconsistent with maintaining a robust capital base.

Remuneration Policy of a Banking Group

8. (a) A banking corporation controlling a banking group (hereinafter, a "Controlling Banking Corporation") shall determine the principles of the group's remuneration policy.
   (b) A Controlling Banking Corporation shall supervise the implementation of the principles of the group's remuneration policy and shall ensure that the corporations under its control and foreign branches have adequate controls over the remuneration mechanism.
   (c) A controlled corporation's board of directors shall take into consideration the principles of the group's remuneration policy determined by the board of directors of the Controlling Banking Corporation, insofar as these are consistent with the best interest of the controlled corporation and with the provisions of Section 11 of the Companies Law.
   (d) Adjustments made by controlled corporations and foreign branches to the principles of the group's remuneration policy, as relevant, shall be reported to the Controlling Banking Corporation.

Controls, Documentation and Audits

9. (a) A banking corporation shall maintain ongoing controls and shall ensure that the existing remuneration agreements and the remuneration mechanism are implemented pursuant to the policy and procedures and in accordance with all law, in an adequate manner that is not subject to manipulation. A banking corporation shall ensure on an ongoing basis that actual remuneration, risk indices and risk index results are consistent with the planned mechanism, and shall adjust these as necessary.
   (b) Risk management, control and audit functions shall be involved in the development of the remuneration mechanism, in the sense that these shall ensure the completeness of risk coverage, examine risk indices and proposed

performance indices and evaluate the effectiveness of remuneration agreements and mechanisms by analyzing the results of taking risks against the remuneration paid. Control functions, for this matter, include compliance, human resources, financial reporting and other functions, as relevant.

(c) The risk management, control and audit functions shall be independent and have appropriate powers to ensure that their influence on the remuneration mechanism as provided in Section (b) above is unbiased. As part of this, such employees shall not approve transactions, make decisions or provide consultation on control issues which may be related to their remuneration.

(d) The banking corporation shall adequately document the remuneration agreements and remuneration mechanism, and all their components, to enable control and auditing of the agreements made; *inter alia*, performance criteria and their results shall be documented and the effectiveness of the mechanism and its compliance with the provisions of this Directive and any law shall be examined.

(e) The internal audit function shall examine at least once every three years the implementation of the remuneration policy in accordance with the provisions of Section 21 of Proper Conduct of Banking Business Directive no. 307, "Internal Audit Function".

Remuneration of Employees Dealing with Risk Management, Control and Audit

10. (a) Remuneration of employees dealing with risk management, control and audit shall be determined by standards that take into consideration the importance and sensitivity of the roles assigned to such functions. Such employees shall be remunerated adequately, so as to allow the banking corporation to employ employees with appropriate training and experience.

(b) Measuring the performance of such employees shall be based on the achievement of the goals of those functions in which they serve. The remuneration of such employees shall not depend on the business results of the business departments whose operations they monitor, control/audit, or supervise.

Remuneration Mechanism for Key Employees

A. General principles of variable remuneration

11. (a) Remuneration must be adjusted for all types of risks, including, as relevant, risks difficult to measure or quantify. The cost and quantity of the capital required to support the risks to which the banking corporation is exposed must be taken into consideration, as are the cost of the liquidity risk assumed in the conduct of business.

(b) There are several approaches to making remuneration more risk sensitive, including: adjusting payments in line with the risk which the employee's activity may impose on the banking corporation, deferring payments and bring them in line with risk realization, extending the performance measurement period and reducing sensitivity to short-term performance. Since each approach has its advantages and disadvantages, the banking corporation is required to combine the different approaches.

(c) Adjustments to risks shall take into consideration the time horizon used to measure performance and the quality of performance measurement. In addition, adjustments to risks shall be adjusted to the employee's rank and position.

(d) The variable remuneration mechanism shall be set so that the scope of remuneration shall be affected by the actual realization of risks. In particular, it shall be possible to reduce or cancel variable remuneration for the purpose of maintaining the stability of the banking corporation, or if these are unjustified in light of negative performance, such as a drop in revenues and profit, or failure to meet goals. Adjustment to variable remuneration shall be made in both the current variable component and in components deferred from previous years and not yet paid, as relevant. In addition, the existence of the criteria listed in Section (e)(1) below shall lead to the reduction or even cancellation of variable remuneration that was paid.

(e) All variable remuneration shall be granted and paid subject to the stipulation that it is recoverable from the key employee to the banking corporation in accordance with the following conditions:

(1) Setting criteria for clawback

The banking corporation shall establish specific criteria for activating the clawback stipulation in especially exceptional conditions, including clawback amounts or percentages that are appropriate for various conditions. The criteria are to include at least the cases in which:

a. The employee took part in conduct that caused exceptional damage to the corporation, including: illegal activity, violation of fiduciary duty, intentional violation or grossly negligent disregard of the banking corporation's policies, rules, and procedures.

b. Fraud or intentional inappropriate conduct, due to which, data turned out to be mistaken and were restated in the banking corporation's financial statements.

(2) Activating the clawback

The banking corporation shall take all reasonable means, including legal means, in order to recover an appropriate amount equal to part or all of the variable remuneration paid in a case where the criteria for clawback materialized, and subject to all laws. When deciding if, and to what extent, it is reasonable to demand the recovery of part or all of the variable remuneration paid, the banking corporation is to take into account all the relevant considerations, including the level of the employee's responsibility and extent of involvement in the issue.

(3) The clawback period

a. Variable remuneration is to be subject to clawback for a period of 5 years from the date it is granted. The clawback period includes the deferral period of the variable component.

b. The clawback period shall be extended by two years in the case of an officeholder, as defined in the Companies Law, when all of the following conditions exist:

1. During the clawback period the banking corporation launched an internal investigation or was notified by a regulatory authority (including a regulatory authority abroad) that an investigation was opened;

2. The banking corporation is of the opinion that the investigation is liable to reveal that the criteria for clawback, as noted in Section (1) above, existed;
3. An authorized function of the banking corporation decided that the conditions for extending the clawback period for the officeholder, as noted above, were fulfilled.

In deciding on the extension, the banking corporation is to take into account all the relevant considerations, including the officeholder's level of responsibility and extent of involvement in the issue. The extension period will expire when the relevant investigation ends and when the extent of the officeholder's responsibility becomes clear.

(4) Notwithstanding the above, when the total variable remuneration granted to a key officeholder in respect of the calendar year is not more than 1/6 of the fixed remuneration in that year, there is no obligation to implement the clawback mechanism on it.

(f) The banking corporation shall require key employees to undertake not to create personal hedging arrangements to undermine the risk sensitivity effects embedded in their remuneration. The banking corporation must set arrangements to ensure compliance with this requirement, as necessary.

(g) The banking corporation shall ensure compliance with the requirements of Sections 12 to 15 below on the basis of the total variable remuneration components of each key employee in each calendar year.

B. <u>Method of granting and paying the variable component</u>

12. (a) Granting and paying variable remuneration shall depend on meeting pre-determined criteria which shall comply, *inter alia,* with the following conditions:

(1) The criteria shall be based on a combination of the performances of the employee, the business unit and the banking corporation as a whole. The business unit's performance shall include a component reflecting the contribution of the business unit to the overall value of other business units, and it shall not be considered separate from the banking corporation as a whole.

(2) The criteria shall include financial variables such as profit adjusted to risk and to the cost of capital and risk indices, and adequate weight shall also be given to nonfinancial variables, including meeting the general goals of the banking corporation in the field of risk management and in the field of compliance with legislation, regulatory directives and the banking corporation's procedures.

(3) Performance evaluations shall be based on long-term performance indices.

(b) Notwithstanding the provisions of subsection (a), predetermined criteria can include a component of judgment, provided that the amount of such component does not exceed three monthly salaries per year.

(c) The mix of the means of granting and paying variable remuneration (cash, shares, share-based instruments, etc.) shall be consistent with the banking corporation's risk management and shall create incentives that are in line with the time horizon of the risk and to the creation of value in the long-term. In the case of granting variable remuneration via options, the remuneration committee is to hold a detailed discussion on why this means is preferable over shares, and to present the reasoning to the board of directors.

C. <u>Restricting variable remuneration as a function of fixed remuneration</u>

13. (a) Fixed remuneration shall constitute a significant part of the total remuneration, to allow the operation of a fully flexible variable remuneration policy and adjusted to performance, including the possibility to pay no variable remuneration.

Accordingly, appropriate ratios shall be set between the variable remuneration and the fixed remuneration, pursuant to the following:

(1) The maximum variable remuneration shall not exceed 100% of the fixed remuneration for any employee.

(2) Notwithstanding the provisions of Subsection (1), under exceptional conditions, the banking corporation may determine that the maximum variable remuneration shall be up to 200% of the fixed remuneration. Such a determination shall be accompanied by the board of directors' reasoned

and detailed decision, to be presented, as necessary, for the approval of the general meeting; such a decision shall include, *inter alia*, details on its reasons, the number of employees affected, their positions and the impact on the banking corporation.

(b) In determining the appropriate balance between fixed remuneration and variable remuneration, it is necessary to take into consideration the experience, expertise, qualifications, seniority, responsibility and performance of the employee, and to take into account the need to encourage conduct supportive of the risk management and long-term financial resilience of the banking corporation.

(c) The ratio between variable remuneration and fixed remuneration for employees in risk management, control and audit functions and various support functions, shall be more inclined towards fixed remuneration, in comparison with this ratio among employees in business functions.

(d) In implementing this section, variable remuneration shall be that remuneration attributed to an employee, granted or paid for a calendar year, including remuneration for termination of employment classified as variable remuneration and social insurance contributions for variable remuneration, if any.

13A. (a) Notwithstanding the provisions of Section 13 above, members of the board of directors, including the chairperson of the board of directors, shall only receive fixed remuneration.

(b) <u>Remuneration of the chairperson of the board of directors</u>

(1) The amount of remuneration of the chairperson of the board of directors shall be determined relative to the method of remuneration of the banking corporation's board members and taking into account, among other things, the size of the banking corporation, the complexity of its activities, and the scope of the position of the chairperson of the board of directors.

(2) Notwithstanding the above, a banking corporation may pay the chairperson social benefits and ancillary expenses in accordance with accepted terms of employment of the banking corporation's officeholders, as per the definition of "officeholder" in the Companies Law.

(c) Remuneration of other board members

The remuneration of all board members at the banking corporation, except for the chairperson, shall be set in an identical manner and in accordance with the manner of setting remuneration for an external director as per the Companies (Rules regarding remuneration and expense reimbursement for an external director) Regulations, 5760-2000.

D. Deferral of variable remuneration over several years

14. Any variable remuneration payment, including variable remuneration granted in the form of shares and share-based instruments, shall be subject to deferral arrangements, which will meet the following terms:

(a) At least 50% of the total variable component attributed to an employee granted for a calendar year shall be deferred. The share of the deferred component shall increase in accordance with the seniority and position of the key employee and the greater the share of the variable remuneration out of the overall remuneration and its absolute value.

(b) The deferral period of the total variable component granted for a calendar year shall be no less than three years, and shall increase in line with the seniority and position of the key employee, and with the extent that the share of the variable remuneration out of total remuneration, and its absolute value, are greater.

(c) The vesting rate of the total variable component given for a calendar year shall be no faster than straight line.

(d) Actual payment for deferred variable remuneration shall be adjusted to performance, both financial and nonfinancial, as realized in retrospect over the period and subject to the provisions of Section 11(d) above.

(e) Termination of employment shall not cause prepayment of deferred remuneration under deferral arrangements.

(f) Notwithstanding the foregoing, there is no obligation to defer payment of the variable remuneration granted in a specific calendar year:

(1) for a key employee whose remuneration meets the requirements of the Remuneration of Officeholders in Financial Corporations Law

regarding the remuneration ceiling, when total variable remuneration granted to the key employee in respect of the calendar year does not exceed 40 percent of the fixed remuneration in that same year;

(2) For a key employee in a corporation controlled by the banking corporation and whose remuneration exceeds the ceiling set in the Remuneration of Officeholders in Financial Corporations Law, when total variable remuneration granted to the key employee in respect of the calendar year does not exceed 1/6 of the fixed remuneration in that year.

E. <u>Other remuneration</u>

15. (a) A banking corporation shall not grant and shall not pay remuneration that is variable in nature which is not stipulated on performance, except for:

(1) A signing bonus for a new key employee of the banking group, restricted to the first year of employment.

(2) A retention bonus for a key employee who is not an "officeholder" as defined in the Companies Law.

In this regard, a bonus contingent solely upon the completion of a predefined employment period, or designed to ensure continued employment (for example, a stay-on bonus or retention bonus) constitutes variable remuneration not stipulated on performance.

(b) Remuneration for termination of employment, beyond the provisions of the terms of employment of all employees of the banking corporation, shall take into consideration actual performance over time and the reasons for termination of employment, and shall be classified accordingly as variable remuneration. Payment of such remuneration shall be subject to payment deferral arrangements beyond the date the key employee ceases to be employed, over a minimal period of no less than 3 years, to increase in accordance with his seniority and position, as well as the exercise of ex-post performance adjustment mechanisms, to ensure that these do not encourage taking excessive risk.

Method of Paying Key Employees

16. All remunerations to key employees, excluding directors, shall be paid directly to such employees, rather than through any other corporation or entity.

Functions Working with the Corporation's Customers

17. (a) Variable remuneration to employees of the banking corporation dealing with the marketing or sale of products and services, or provision of service or consultation to customers of the banking corporation, shall be consistent with the banking corporation's risk management. In particular, it must be ensured that such remuneration does not encourage unfair conduct in the relationship with the customer, for example selling a product that is inappropriate for the customer, providing partial or misleading information, etc.

(b) Banking corporations shall ensure that terms of engagement for outsourcing with functions working with the banking corporation's customers (such as attorneys working with borrowers in difficulty and sale promoters hired for the purpose of marketing products) do not include mechanisms that increase the corporation's exposure to risks and/or increase conflict of interest between the corporation and/or its customers and the outsourced service provider.

Other guidelines related to remuneration

18. (a) A corporation in a banking group shall not bear the costs of employment of a senior officeholder or an employee in the corporation in respect of their serving in a position in another corporation in the group. This means that each corporation in a group is to bear the costs of its senior officeholder or employee, in accordance with the scope of the position, its authority and responsibility in that position.

This guidance does not serve as a prohibition on actual payment of remuneration by one corporation in the banking group.

(b) A key employee shall not receive any type of remuneration from the holder(s) of the control permit or from a material holder in the banking corporation, including their relatives, or corporations that any of them control, that do not belong to the banking group.

For this matter, “holder of control permit” and “material holder” are per their meaning in the Banking (Licensing) Law, 5741-1981.

This subsection shall not apply to a director that is not an “external director”, but it shall apply to the chairperson of the board.

Revisions

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2403	1	Original directive	November 19, 2013
2484	2	Revision	August 13, 2015
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