Bank of Israel

Banking Supervision Department

Jerusalem, April 5, 2009
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To:
Banks and credit card companies—attn. Chief Executive Officer

Re: Bank remuneration policy

1. Inappropriate remuneration arrangements are among the conspicuous factors that led to the development of the current crisis in the global capital markets and economy. Such arrangements sometimes encouraged disproportionate risk-taking with little consideration of long-term risks. Firms paid excessive wages in areas of activity that subsequently generated large losses when the risks materialized.
2. In its report on enhancing the resilience of the capital markets and the economy (April 2008), the FSF cited the adverse effects of inappropriate remuneration policies on the scope and types of risks that banks assumed; accordingly, it included a recommendation that firms in the financial sector align their remuneration policies with their long-term profitability at the organization level. Supervisory authorities abroad take steps to arrange an appropriate remuneration policy, as part of the lessons drawing process of the global financial and economic crisis.
3. As part of the adoption of the FSF recommendations by Israel's Supervisor of Banks and to mitigate risks originating in inappropriate incentive structures,[1] banks and corporations that they control must adopt an appropriate remuneration policy with all possible celerity and by December 31, 2009, at the latest. Said policy shall be determined by the board of directors on the basis of the principles set forth in Section 5 below and on broad organizational considerations such as total wage costs, desired wage differentials among different echelons, etc.
   The remuneration policy should be a comprehensive one that pertains to all employees of the bank, with special emphasis on the remuneration of senior executives and employees who influence the bank's risk-taking.
   The bank shall review existing agreements in view of the remuneration policy that it established and shall act, to the extent possible, to revise/update agreements that are inconsistent with this policy.
4. The Banking Supervision Department will continue to track and examine international publications and guidelines from leading supervisory authorities abroad in regard to remuneration policy and shall update its directives where necessary.

[1] Apart from their possible effect on risk-taking in the conduct of business, risks may occur in additional contexts. Under certain circumstances, for example, inappropriate incentives may adversely affect the reliability of representations in financial statements.

5. Principles for an appropriate remuneration policy follow. They are based on publications of leading regulators abroad and the IIF (Institute of International Finance) document on best practices, published in July 2008.[2]

   5.1 **Incentive pay should be aligned with overall organizational profitability and the bank's long-term goals.**
   Alignment with the bank's long-term goals may be attained via elements that assure a connection between remuneration and the organization's results over time. In the case of equity options, for example—by spreading their distribution over a period of time and requiring a minimum holding period, a bank may ensure that the economic advantages are bestowed gradually or, in the case of bonuses, payment may be deferred for several years, allowing the remuneration parameters to be based on the organization's results over time.

   5.2 **Incentive pay should not encourage risk-taking beyond the bank's risk appetite.**
   The overall remuneration policy and remuneration for individuals or business units should be tested periodically to assure compliance with this principle. Management should examine changes in the bank's risk-return profile and ascertain that the incentive components do not trigger risk-taking that is inconsistent with the bank's risk appetite. For example, in calculating remuneration, an appropriate balance should be maintained between regular and variable components so that the latter do not create a conflict with the bank's interests.

   5.3 **Payout of incentive pay should be based on risk-adjusted earnings and capital cost.**
   Risk measurement should be as expansionary as possible and should include all main risk categories.

   5.4 **Incentive pay should include a component that reflects the effect of the business unit's contribution to the total value of other business units and should not pertain to the business unit only, irrespective of any connection with the bank at large.**

   5.5 **Incentive pay should include a component that will reflect the meeting of the bank's general objectives in risk management and compliance with laws, regulatory directives, and the bank's procedures.**

   5.6 **The bank should maintain strict supervision and control procedures over remuneration policy.**
   Within the framework of these procedures:
   - Remuneration policy for members of senior management should be determined and supervised by the board of directors.
   - Strict controls should be applied to assure that the remuneration matrix chosen is appropriate and immune to manipulations.
   - Risk-adjusted earnings should be calculated by an independent entity at the business units.

   5.7 **Retirement payment agreements with members of senior management should take long-term performance and the reason for retirement into account.**

[2] "Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations," http://www.iif.com

5.8 **Remuneration for personnel in supervision and control functions, including the financial statements, should be determined in accordance with proper standards that take account of the importance and sensitivity of the duties that these functions discharge.**

5.9 **The methodology, principles, and objectives of incentive pay should be transparent to the various stakeholders at the bank.**

6. An appropriate remuneration policy subscribes to appropriate corporate governance principles that banks should adopt as part of the adoption of Pillar 2 of Basel. Guidance on the matter is included in a document published by the Basel Committee in February 2006, *Enhancing Corporate Governance for Banking Organisations*, one of the documents that banks are to apply as part of Pillar 2. (A draft translation into Hebrew was published by the Banking Supervision Department in March 2008, in REG030.) Reference to appropriate remuneration policy was also included in a consultation document for the updating of the Basel II framework (*Proposed Enhancements to the Basel II Framework*, January 2009). This document stated with emphasis that banks are expected to establish appropriate incentive policies as part of their risk management and that the board of directors and senior management are charged with mitigating risks that may flow from an inappropriate compensation policy.

Respectfully,

Rony Hizkiyahu
Supervisor of Banks