DRAFT

Guideline on a Sound Remuneration System

INTRODUCTION

1. Remuneration practices at large financial institutions have been identified as one of the factors contributing to the global financial crisis which began in 2007. Excessive risk-taking has been driven by the potential for generous bonus payments to be made to employees without adequate regard to the longer-term risks their activities imposed on their firms. As a result, to improve compensation practices and strengthen supervision in this area (particularly for systemically important financial institutions), the Financial Stability Board (FSB, formerly the Financial Stability Forum) issued a set of Principles for Sound Compensation Practices (Principles) in April 2009.

2. The FSB urged national supervisory authorities to move cooperatively towards implementation of the Principles, regarding it as particularly important that regulations and supervisory practices should be such that their impact is consistent across nations. Further, the FSB is concerned that supervisors should be alert to regulatory arbitrage activity within, as well as across, borders.

3. The FSB Principles were endorsed by the Leaders of the Group of Twenty (G20) which called for implementation of the Principles by their national supervisory authorities by the 2009 remuneration round. In response to the G20's recommendation, the Basel Committee on Banking Supervision incorporated the FSB Principles into the Supplemental Pillar 2 Guidance issued as part of its package of enhancements to the Basel II capital framework in July 2009. The Pillar 2 Guidance provides that supervisors should include compensation practices within their assessments of firms' risk management practices and procedures, and deficiencies must be addressed promptly with appropriate supervisory action. Banks and supervisors are expected to implement the Pillar 2 Guidance immediately.

4. To strengthen adherence to the Principles, the FSB (with the endorsement of the G20) issued a set of Implementation Standards in September 2009, providing specific guidance on corporate governance reforms, global standards on pay structure and greater disclosure and transparency.

5. This guideline has been developed in response to these international recommendations, in recognition of the incentive effects that remuneration structures and practices may create within institutions and the implications for institutions' risk management.

LEGAL FRAMEWORK

6. Section 7 of the Banking Ordinance (BO) provides that the Monetary Authority (MA) shall promote the general stability and effective working of the banking system and shall promote and encourage proper standards of conduct and sound and prudent business practices amongst authorized institutions (AIs). The MA therefore has a strong interest in ensuring that AIs' remuneration systems are sound and prudent and do not pose risks to AIs' safety and soundness.

7. The principles relating to sound remuneration systems set out in this guideline supplement the Supervisory Policy Manual module on Corporate Governance of Locally Incorporated Authorized Institutions (CG-1) issued under section 7(3) of the BO. This module provides that Boards of locally incorporated AIs should be responsible for ensuring effective internal control systems are in place so that an AI's operations are properly controlled and comply with policies approved by the Board as well as applicable laws and regulation, and for ensuring in this context that the AI's remuneration policy is consistent with its ethical values, objectives, strategies and control environment.

OBJECTIVES

8. The main objective of this guideline is to ensure that AIs have in place remuneration systems that are consistent with and promote effective risk management, in recognition of the fact that remuneration systems which create incentives towards inappropriate and excessive risk-taking could threaten the safety and soundness of the individual AI concerned and potentially thereby the stability of the local banking system. To this end, the guideline also describes the HKMA's supervisory approach to implementing the sound remuneration practices set out in this guideline as part of its risk-based supervision of AIs.

9. The focus of this guideline is the provision of guidance on the governance and control arrangements for, and operation of, AIs' remuneration systems. It is **not** the intention of the HKMA to prescribe particular levels of, or limits on, individual remuneration. The setting of such levels and limits is and remains the responsibility of AIs' Boards of Directors (Boards)[1] and the senior management of AIs. AIs are expected to establish their remuneration policy, structures and incentives awards with due regard to the principles set out in this guideline.

SCOPE OF APPLICATION

10. To meet the objective in paragraph 8 above and ensure a level playing field within the local banking sector, this guideline will apply to **all AIs**. AIs are expected to demonstrate to the satisfaction of the HKMA that their remuneration systems (or, in the case of overseas-incorporated AIs, the remuneration systems applicable to officers and employees engaged in the conduct of their business and operations in Hong Kong) are sound and in compliance with the guideline. In any case where the Board or management of an AI decides not to follow certain aspects of the guideline, they should satisfy themselves and the HKMA that either the relevant aspects of the guideline are not applicable to their

[1] In this guideline, the term "Board" is used to mean the Board of Directors of a locally incorporated AI or the Board of Directors and/or local management of an overseas-incorporated AI where appropriate.

institution in the given case, or their institution has adopted alternative control measures which are equally effective.

11. The HKMA acknowledges that a proportionate approach may be adopted by AIs in applying this guideline to the formulation and implementation of their remuneration systems, based on the size, nature and complexity of their business and operations.

SUPERVISORY APPROACH

12. The HKMA will take into account the potential risks that may arise from AIs' remuneration systems in its risk-based supervision of AIs. The HKMA will review and consider remuneration policies, practices and outcomes when assessing the overall risk environment in individual institutions. For this purpose, all information relating to the remuneration systems of AIs should be made available to the HKMA upon request. Where appropriate, the HKMA will expect an AI to implement measures promptly to address and mitigate any risks identified in its remuneration arrangements, such as reducing the risk inherent in its business activities or changing its remuneration policy or structure to bring its remuneration systems into line with the guideline.

13. For locally incorporated AIs, the HKMA will as part of its supervisory review process (SRP), assess the risks emanating from an AI's remuneration policies and practices and determine whether additional capital should be held by the AI to cover any of these risks which are not covered, or not adequately covered, under the AI's existing minimum capital requirements. If the HKMA's assessment indicates that an AI's remuneration system is inconsistent with the guideline, the HKMA may take appropriate measures, including but not limited to a quantitative limit on total variable remuneration payable by the AI (such as limiting total variable remuneration to a percentage of total net revenues).

14. Following issuance of this guideline, the Boards of all AIs should promptly conduct or arrange for the conduct of a review independent of management on their existing remuneration systems (including policies, structures and practices)[2] to assess their compliance with the guideline. Where areas of non-compliance are identified during the review process, the Boards of the AIs concerned should take necessary measures to strengthen their remuneration systems and bring them into line with the guideline. AIs should submit the results of this initial self-assessment exercise to the HKMA and, based on those results, the HKMA may discuss with the Boards any remedial measures or supervisory actions which the HKMA may consider necessary.

15. Following this initial self-assessment, the Boards of AIs should conduct or arrange for the conduct of a review independent of management on their institutions' remuneration systems[2] and assess their compliance with the guideline at least on an annual basis. AIs should submit the results of such review to the HKMA (please see paragraph 21 below).

16. Where an AI in Hong Kong is part of a banking group (i.e. a subsidiary of a banking group or a branch of an overseas-incorporated bank), the institution may adopt the remuneration policy formulated at the group level provided that it can demonstrate to the HKMA's satisfaction that the relevant group remuneration policy is broadly consistent with this guideline, having regard to local circumstances. In these circumstances the AI should also provide, and ensure that it is in a position to provide, to the HKMA such information and documentation as the HKMA may require in order to assess whether the AI's remuneration system is broadly consistent with this guideline. Where appropriate, the HKMA may obtain relevant information and comments regarding the remuneration system from the home supervisor of the AI's parent bank or head office for reference, or may raise any instances of non-compliance with the guideline with them.

[2] In the case of overseas-incorporated AIs, the remuneration systems applicable to officers and employees engaged in the conduct of their business and operations in Hong Kong.

TIMING OF IMPLEMENTATION

17. **The HKMA expects all AIs to take prompt action to implement the guideline and to achieve full compliance within 2010.** AIs should apply the principles set out in this guideline to the remuneration payable by them for the performance year 2009 as far as reasonably possible, taking into account the lead time required for making any necessary changes to their existing remuneration systems (including policies, structures, internal systems, and employment contracts). Where an AI encounters any problems in complying with this timeframe (for example more time is required to effect changes to internal systems or difficulties are encountered in relation to the terms of existing employment contracts), it should approach the HKMA to discuss these issues. The HKMA will closely monitor AIs' progress in implementing the guideline in its on-going prudential supervision of AIs.

18. The guideline will be developed further in the light of implementation experience and the development of best practices, both locally and overseas.

ELEMENTS OF A SOUND REMUNERATION SYSTEM

Governance

Remuneration policy

19. The Board of an AI should establish and maintain a written remuneration policy covering all employees[2] which meets the requirements in this guideline. In particular, the policy should ensure that the remuneration arrangements for employees whose activities during the course of their employment (individually or collectively) could have a material impact on the AI's risk profile and financial soundness, support the institution's overall approach to risk management. In this regard, the policy should have specific regard to the remuneration of the following personnel, as well as their role in the institution's remuneration system

where relevant :

19.1 senior management and key personnel (including but not limited to executive directors, the chief executive, senior executives and managers (as defined under section 2 of the BO);

19.2 staff members whose duties or activities in the course of their employment involve the assumption of risk or the taking on of exposures on behalf of the institution (including but not limited to proprietary traders, dealers, and lending officers);

19.3 staff members who are incentivised to meet certain quotas or targets by payment of variable remuneration (including but not limited to personnel in marketing, sales and distribution functions); and

19.4 staff members within risk control functions (including but not limited to risk management, financial control, compliance, and internal audit).

20. The remuneration policy must be designed to encourage employee behavior that supports the AI's risk tolerance, risk management framework and long-term financial soundness. It should be in line with the objectives, business strategies and long-term goals of the AI and structured in a way that would not encourage excessive risk-taking by the employees but allows the AI to attract and retain employees with relevant skills, knowledge and expertise to discharge their specific functions.

21. The remuneration policy and its implementation should be subject to regular review independent of management (at least annually) by the Board or other party designated by the Board to ensure that the policy remains adequate and effective, and the operation of the remuneration system is consistent with the intended purposes and long-term interests of the AI. Remuneration outcomes, risk measurements, and risk outcomes should be regularly reviewed for consistency with intentions. The AI's internal auditors should provide support to the Board in the assessment process and report any material weaknesses which

are identified. In the review process, information regarding the performance measurement and remuneration of employees should be clearly documented.

22. To enforce desirable employee behavior which is consistent with the AI's strategy and risk management, the general principles underpinning the remuneration policy should be accessible to all employees. Employees should know in advance how their performance will be measured and compensated. Individual remuneration methodology, including the financial and non-financial factors to be used to measure performance; risk adjustments to be made; and the "payout function" to determine how and when the employees will be paid for their performance, should be disclosed to employees.

23. The remuneration policy and information on the AI's regular monitoring and review of the operation of the remuneration policy should be provided to the HKMA on request.

Board oversight and remuneration committee

24. The Board of an AI is ultimately responsible for overseeing the formulation and implementation of the AI's remuneration policy. In exercising its oversight, the Board should ensure that its judgments and decisions relating to remuneration arrangements are taken independently of the management and in the best interests of the AI.

25. To this end, unless otherwise approved by the HKMA, the Board of a licensed bank must have a board remuneration committee to assist the Board in discharging its responsibility for the design and operation of the AI's remuneration system. This remuneration committee should meet the following requirements:

    25.1 It should consist entirely of independent non-executive directors or, where executive directors are members of the committee, the majority of its members should be independent non-executive directors.

25.2 It should have a written terms of reference which clearly defines its role and responsibilities, authority and tenure, and should be updated where appropriate.

25.3 It should be able to exercise competent and independent judgment on remuneration policies and practices and the incentives created for managing risk, capital and liquidity. It should carefully evaluate practices by which remuneration is paid for potential future revenues whose timing and likelihood remain uncertain. In so doing, it should demonstrate that its decisions are consistent with an assessment of the AI's financial condition and future prospects (please see paragraph 27 below).

25.4 It should make recommendations in respect of remuneration policy and, where appropriate, on specific remuneration arrangements or packages for the AI's senior management and key personnel for the Board's approval. In so doing, it should ensure that the AI's remuneration policy is in compliance with this guideline and any other legal or regulatory requirements applicable to employees' remuneration.

25.5 It should ensure that an annual review of the bank's remuneration system and its implementation, either internally conducted or externally commissioned, is carried out independently of management and the result is submitted to the HKMA. Such review should include an assessment of compliance with this guideline.

25.6 It should work closely with the AI's risk committee in the evaluation of the incentives created by the remuneration system, and report any material issues in relation to AI's remuneration system to the Board on a regular basis (please see paragraph 28 below).

26. In the case where a licensed bank is part of a banking group (i.e. subsidiary of a banking group or a branch of an overseas-incorporated bank), the establishment of a remuneration committee at group level will be regarded as compliance with

this guideline if the committee complies with the criteria in paragraph 25 above.

27. Those members of the Board most involved in the formulation and implementation of the AI's remuneration policy (including the members of the remuneration committee) should possess sufficient expertise and experience to form an independent judgment on the suitability of the AI's remuneration policy and its implications for risk and risk management. If the Board (or the remuneration committee) seeks professional advice (including, amongst other things, in respect of a review of the remuneration policy and its implementation) from external advisors, the advice should be commissioned by, and provided directly to, the Chairman of the Board (or of the remuneration committee as the case may be) independently of management. To avoid conflicts of interest, executive directors should play no part in making decisions in respect of their own remuneration.

Risk control functions

28. Risk control personnel, independent of the business units within an AI's organization structure, should have appropriate authority and be actively involved in the process of design and implementation of the AI's remuneration policy. The Board (or its remuneration committee) should consult risk management, financial control and compliance personnel to obtain input, independent of the relevant business lines, on how compensation relates to risk at various levels within the organization.

29. Remuneration of risk control personnel should be determined in accordance with their performance objectives and commensurate with their key role in the institution. To avoid possible undue influence from business units, they should be compensated in a manner that is independent of the performance of the business areas which they oversee. Management of business units should not be able to determine the remuneration of personnel in risk control functions.

Structure of remuneration

Proportionate balance of fixed and variable remuneration

30. Fixed remuneration (or base salary) paid to employees should constitute a sufficient portion of their overall remuneration package to attract and retain employees with relevant skills, knowledge and expertise to discharge their specific functions. Where an AI's remuneration structure consists of a performance-related element that is paid to its employees in the form of variable remuneration in addition to their fixed remuneration, it should be structured in such a way as to attain a total remuneration package with a reasonable and appropriate proportion of both fixed and variable remuneration according to their role and responsibilities and market conditions. A substantial proportion of the remuneration of the senior management and other employees whose activities could have a material impact on the risk exposure of the AI should however be paid in the form of variable remuneration.

Use of instruments for variable remuneration

31. Further, the mix of instruments used for payment of variable remuneration should be consistent with the alignment of an employee's incentive awards to risks and reflect the employee's position and role. A substantial proportion (such as more than 50 percent) of the variable remuneration awarded to senior management and other employees whose activities could have a material impact on the risk exposure of the AI should be in shares or share-linked instruments (or other non-cash instruments) provided that these instruments create incentives aligned with long-term value creation and the time horizons of risk. Awards in shares or share-linked instruments should be subject to an appropriate share retention policy, which should require employees to retain such instruments for a specific period of time before they are allowed to dispose of them.

Exceptional use of guaranteed minimum bonuses

32. Guaranteed minimum bonuses, that have no regard to an employee's performance, are not consistent with sound risk management and should not be included in an AI's remuneration policy. If, in exceptional circumstances, an AI considers it absolutely necessary to offer a minimum bonus, the offering of such a bonus should be restricted for the purpose of hiring new staff and should be limited to the first year of employment. The award of any such guaranteed minimum bonus should be subject to the approval of the Board (or its remuneration committee).

Measurement of performance for variable remuneration

Pre-determined criteria for performance measurement

33. The determination of the award of variable remuneration should depend on the fulfilment of certain pre-determined and assessable performance criteria. These criteria should include both financial and non-financial factors so that the quality of the performance of employees in the overall course of their employment (and not solely their financial performance) can be assessed as an integral part of their performance measurement and hence be appropriately reflected in their awards of variable remuneration.

34. Performance in relation to non-financial factors such as adherence to risk management policies, compliance with legal, regulatory and ethical standards, results of internal audit, adherence to corporate values, and customer satisfaction should form a significant part of the overall performance measurement of employees, given that poor performance in these factors can be indicative of significant risks to the AI. Adverse performance in non-financial factors, where appropriate, should override outstanding financial achievements, and be reflected by a reduction to, or elimination of, any variable remuneration.

35. To better align remuneration with long-term and sustainable performance,

performance measurement should take a longer-term perspective by measuring performance of employees over a multi-year horizon (e.g. by reference to financial results spanning three to five years or by using a moving average of financial results). This is particularly relevant to employees whose activities expose the institution to risks that might not be fully reflected in current year performance.

Adjustments to performance assessment

36. AIs may adopt financial factors (e.g. profit, revenue, turnover, or volume) as a basis for assessing the performance of their employees and determining their variable remuneration. However, the size and allocation of AIs' total variable remuneration should take into account the full range of current and potential risks, and in particular (i) the cost and quantity of capital required to support the risks taken; (ii) the cost and quantity of the liquidity risk assumed in the conduct of business; and (iii) the timing and likelihood of potential future revenues incorporated into current earnings. For this purpose, AIs should incorporate adjustments for risk and capital charges based on the risk measures (e.g. regulatory capital, economic capital reflecting VaR or other metrics, or economic profit) most appropriate to the business in question.

37. To control individual employees' risk appetites and to bring remuneration practices into line with an AI's broader strategies and the maintenance of shareholder value, the performance measurement for, and allocation of, variable remuneration should take account of the overall performance of the relevant business units and the AI as a whole as well as the contribution of individual employees to such performance.

38. Variable remuneration should be symmetric with performance. Subdued or negative financial performance of an AI should generally lead to a considerable contraction of the AI's total variable remuneration, taking into account both current remuneration and reductions in payouts of amounts previously earned and deferred, including through clawback arrangements.

39. An AI should operate a truly discretionary and fully flexible policy such that it may withhold all or part of the variable remuneration if the payment is not justified by the performance of the institution or if business objectives are not achieved, or when it is necessary to protect the financial soundness of the institution.

Exercise of judgment

40. A purely mechanical process based on pre-determined performance criteria or solely reliant on a formula-based assessment for measuring employees' performance will have its own limitations and weaknesses. Whatever performance measurements are adopted and whatever adjustments are made, a substantial amount of judgement and common sense will be required during the process to arrive at a fair and appropriate remuneration decision. The exercise of any judgment should support sound risk management and be consistent with the spirit of an AI's remuneration policy. The rationale for the exercise of judgment and the final outcomes should be clearly recorded in writing.

Alignment of remuneration payouts to the time horizon of risks

Deferment of variable remuneration

41. For the senior management and other employees whose activities could have a material impact on the risk exposure of the AI, a substantial portion (such as 40 to 60 percent) of their variable remuneration should be payable under deferral arrangements over a period of years to ensure that the employees' underlying performance, including the associated risks, can be properly observed and validated. The proportion of variable remuneration that is subject to deferment should be increased in line with the seniority and/or responsibility of the employee in question within the hierarchy of the AI. For the most senior management and the most highly paid employees, the percentage of variable remuneration that is deferred should be substantially higher (for instance above 60 percent).

42. The award of deferred remuneration should be subject to a minimum vesting period and pre-defined conditions in respect of the future performance of an AI, the relevant business units and the employee in question. The deferred remuneration should generally vest gradually over a period of years and no faster than on a pro rata basis, subject to fulfilment and validation of the pre-defined performance conditions. If the conditions are not fulfilled in any year during the vesting period, all or part of the unvested portion of the deferred remuneration should be clawed back (subject to the realised performance of the AI or the relevant business unit). The vesting period and performance conditions should be determined by the AI's Board (or its remuneration committee) and be subject to review where appropriate. The Board should strike a reasonable balance between providing effective incentives and validating the performance measures according to the nature and associated risks of the business undertaken by the employees. In this regard, the minimum vesting period applicable should not be less than 3 years, provided that the period is appropriately aligned with the nature of the business, its risks and the activities undertaken by the employee in question.

43. In addition to the "claw-back" provision referred to in paragraph 42 above, a claw-back provision should also operate in respect of unvested deferred remuneration in circumstances where it is later established that any performance measurement was based on data which is later proven to have been manifestly misstated, or it is later established that there has been fraud or other malfeasance on the part of the relevant employee, or violations by the employee of internal control policies.

44. The departure of employees from an AI should not trigger early payout of deferred remuneration that is still within the deferment period. Such deferred remuneration should instead be forfeited. Subject to any prevailing legal requirements, severance pay, if any, should be related to performance achieved over time and designed in a way that does not reward failure. To this end, provisions in existing employment contracts relating to payments on termination of employment should be re-examined and, where appropriate, amended to align

with prudent risk-taking and long-term value creation. Practices that involve payment to a prospective employee to effectively compensate him/her for the deferred remuneration which he/she will forfeit on leaving his/her previous employer as a term to attract and recruit that employee are not in line with the spirit of deferment of variable remuneration (please see paragraph 32 above).

Restriction on hedging exposures

45. AIs should establish an appropriate policy and procedure (including specific measures that would be taken in the case of breach) to restrict employees who receive variable remuneration from using personal hedging strategies or remuneration- and liability-related insurance to hedge their exposures in respect of the unvested portion of their deferred remuneration to the extent that this undermines the risk alignment effects of deferment of variable remuneration.

Adequate disclosure on remuneration

46. To increase transparency and promote market discipline, AIs should take steps to enhance disclosure of information in relation to the design and implementation of their remuneration systems.

47. In this regard, AIs should disclose information in relation to their remuneration systems to the public on a timely basis. Such information should include, without limitation:

    47.1 the decision-making process used to determine the firm-wide remuneration policy, including the composition and the mandate of any remuneration committee;

    47.2 the most important design characteristics of the remuneration system, including criteria used for performance measurement and risk adjustment, the linkage between pay and performance, deferral policy and vesting criteria, and the parameters used for allocating cash versus

other forms of remuneration;

47.3 aggregate quantitative information on remuneration, broken down by the senior management and by other employees whose activities could have a material impact on the risk exposure of the AI, indicating:

(i) amounts of remuneration for the financial year, split into fixed and variable remuneration, and number of beneficiaries;

(ii) amounts and form of variable remuneration for the financial year, split into cash, shares and share-linked instruments and other;

(iii) amounts of deferred remuneration during the financial year, split into vested and unvested;

(iv) amounts of deferred remuneration awarded during the financial year, paid out and reduced through performance adjustments;

(v) new sign-on and severance payments awarded during the financial year, and number of beneficiaries of such payments; and

(vi) amounts of severance payments actually made during the financial year, number of beneficiaries, and highest such award to a single person.

48. Overseas-incorporated AIs are not required to make separate disclosures in respect of the remuneration system applicable to their local operations, provided that the information as set out in paragraph 47 above forms part of the disclosures made by the institutions' head offices.

Hong Kong Monetary Authority

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