



**Recommendation No. 1/2010 (I.19.) of the Chairman of the Hungarian Financial Supervisory Authority on the application of the remuneration policy**

**I.**

**The objective and scope of the recommendation**

1. Compliance with the expectations contained in this recommendation serves the fundamental interests of the financial organisations supervised by the Hungarian Financial Supervisory Authority (hereinafter: HFSA).
2. The global financial crisis has drawn attention to the fact – among others – that financial organisations must have adequate remuneration policies. Global experience shows that the remuneration policies of several financial organisations did not constrain excessive risk taking, and encouraged the employees to strive for short-term financial achievements.
3. For the sound operation of financial organisations it is of utmost significance that the remuneration of the members of the management and supervisory bodies, as well as of senior officials responsible for risk taking and control functions shall be in line with the long-term interests, the risk taking and risk management principles of the financial organisation.
4. This recommendation contains the most important expectations regarding the remuneration policy, however it does not specify the method of compliance with the principles laid out in the recommendation. It is the task and responsibility of the financial organisation to develop a remuneration policy corresponding to the nature, scale and complexity of its activities.
5. This recommendation covers the remuneration of all employees of financial organisations, including the members of the board of directors, the members of the supervisory board, and especially the managers of key areas, and employees responsible for risk taking and risk control. The remuneration principles shall be applied both at individual and at consolidated levels.
6. This recommendation contains the principles for remuneration policies published by the Committee of European Banking Supervisors (CEB)<sup>4</sup>.

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<sup>4</sup> CEBS High-level principles for remuneration policies 20 April 2009

## II. General Principles

- i. The financial institution should adopt a remuneration policy that is in line with its business strategy and risk tolerance, objectives, values and long-term interests. The remuneration policy should not encourage excessive risk taking. The remuneration policy should cover the institution as a whole and contain specific arrangements that take into account the respective roles of senior management, risk takers and control functions. Control functions should be adequately rewarded to attract skilled individuals.**
7. The key objective of the remuneration policy of the financial institution should aim at aligning personal and company objectives with a view to the long-term. In accordance with this, during the elaboration of the remuneration policy the overall business strategy as well as other corporate values such as compliance culture, ethics, behaviour towards customers, measures to mitigate conflicts of interest, etc. shall be adequately considered. This also implies that remuneration policies should not encourage excessive risk taking, and should not reward individuals for taking risks in excess of the institution's risk appetite. The remuneration policy shall always give priority to long-term interests.
8. Control functions (such as risk control, compliance and internal audit) should be adequately compensated in accordance with their own objectives. Compensation should not be linked to the performance of the business units they control.
9. In work contracts that are concluded between the organisation and the employee – and are not subject to the Labour Code – severance pay or pay related to other scenarios such as mergers and acquisitions should be related to performance achieved over time and be designed in such a way as not to reward failure. The HFSA recommends that this principle should be included in all contracts signed after the publication of this recommendation, and that contracts that were signed before the publication of the recommendation should be amended within an adequate transitional period.
- ii. The remuneration policy should be transparent both internally and externally.**
10. The remuneration policy should be accessible to all employees. The employees should know in advance the criteria that will be used to determine their remuneration. The appraisal process should be properly documented and transparent to the employee concerned.
11. Whilst respecting confidentiality, relevant information on the remuneration policy should be disclosed in a clear and easily understandable way to external stakeholders. Upon request, the financial institution shall present its remuneration policy to the HFSA.

### III.

#### Governance

- iii. The development and enforcement of the remuneration policy, as well as the determination of the remuneration of the management body shall be the responsibility of the supervisory board of the institution. In the case of public companies limited by shares, Act IV of 2006 on business organisations delegates the decision-making rights related to the remuneration of senior officials, supervisory board members and senior employees to the general assembly of the company. In this case the supervisory board shall be given the right to comment<sup>5</sup>. Application of the remuneration policy shall be reviewed by a central and independent body.**
12. The remuneration policy should be developed by the general assembly of the institution or (in the case of private companies limited by shares, upon authorisation by the statutes of the institution) by the supervisory board. One way of developing, as well as monitoring the enforcement of the remuneration policy could be by setting up a Remuneration Committee, which should be subordinated to the Supervisory Board.
13. Members of the remuneration committee can include the members of the management body. In addition, involvement of the following areas is recommended in the development and review of the remuneration policy:
- risk control and compliance functions
  - human resources, and
  - shareholders, where applicable.
14. A commercial business unit should not assist in the determination of the remuneration of its control functions (risk control, compliance and internal audit).
15. The remuneration policy should be subject to regular (at least annual) and independent internal review, with specific attention to preventing incentives for excessive risk taking and other behaviour conflicting with the interests of the financial institution.

### IV.

#### Measurement of performance as a basis for remuneration

- iv. Where the pay award is performance related, remuneration should be based on a combination of individual and collective performance. When defining individual performance, factors apart from financial performance should be considered. The measurement of performance, as a basis for bonus awards, should include adjustments for risks and the cost of capital.**
16. The measurement of employees' performance is central to a good remuneration policy. However, this may not be applicable to all categories of employees. Therefore, in the case of employees whose performance cannot be accurately determined on the basis of

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<sup>5</sup> This part of the recommendation differs from the above cited CEBS recommendation due to Section 302(c) of Act IV of 2006 on business organisations.

quantitative indicators, the pay award can be defined by using other methods. Defining the pay award should not be a purely mechanical process based on measurable performance criteria, but should include the ability to exercise judgement.

17. Any performance measure should include variables relating to individual as well as collective performance (for example business unit, company and group performance). Remuneration shall first of all be linked to the objectives of the business unit, with consideration to the company and group performance. For individual performance measurement non-financial factors should also be considered, such as expertise, personal development, compliance, commitment, and contribution to the performance of the team. If necessary, other factors should be given priority over financial performance. Where it is appropriate, poor performance in the non-financial variables (e.g. unethical performance) shall not be offset by good financial performance.
18. Bonuses or bonus pools should be calculated using a measure of performance which is adjusted for risks (e.g. liquidity risk, cost of capital). Where possible, the indicator based on the institution's economic capital model should be used. The aim of risk adjustment is to ensure that the longer term interests of the company – such as growth and profitability – are fully taken into account.
19. The remuneration of non-executive directors should not be linked to the financial institution's short-term results, but rather to other factors, such as the time invested and the evaluation of compliance with their respective responsibilities.

## V.

### Form of remuneration

- v. **There should be a proportionate ratio between base pay and bonus. Where a significant bonus is paid, the bonus should not be a pure up-front cash payment but contain a flexible, deferred component; it should consider the risk horizon of the underlying performance.**
20. The relation between base pay and bonus should be of reasonable proportion. Bonuses should not be the source of basic living costs for the employees.
21. Whilst cash pay awards may be appropriate for base pay, when bonus payments are of significant size, the award should include non-cash components too (for example company shares or options where appropriate) to take into consideration the risk horizon of the underlying performance. The deferred payment should be linked to measures of future performance within a pre-defined time horizon. The HFSA requires that these measures used for future performance should be risk adjusted as set out in principle iv.
22. Significant bonuses should not be up-front cash payments. Within the legal regulatory frameworks, the financial institution should ensure the possibility of the repayment or retainment of bonuses if it is later established that they resulted from fraudulent financial activities.