New RBI guidelines on compensation – A move in the right direction with some grey areas

In November 2019, the Reserve Bank of India (RBI) issued guidelines for all private sector and foreign banks, on compensation of Whole Time Directors (WTDs), Chief Executive Officers (CEOs), Material Risk Takers (MRTs) and Control Function Staff (CFS). Aligned with global Financial Stability Board's (FSB) principles for sound compensation practices, the guidelines are intended to enhance compensation governance, and discourage excessive risk taking. The new standards will place a greater focus on Board oversight of remuneration outcomes, risk-reward alignment, share-linked instruments, deferral of variable compensation, and malus and clawback provisions.

Given recent identification of large non-performing assets and demand from shareholders and investors for stronger governance, compensation of senior executives is under increased scrutiny. Effective from performance periods commencing from April 1, 2020, all private sector banks, local area banks, small finance banks, payments banks, and wholly owned subsidiaries of foreign banks are required to comply with these guidelines. Failing to do so could result in severe penalties, including additional capital requirements.

With these guidelines, RBI joins central banks and regulators of most developed markets in adopting standards that place a greater focus on Board oversight over remuneration outcomes. Although implemented almost a decade after some of the Anglo-Saxon markets, this is a certainly a move in the right direction and will go a long way in strengthening risk-reward alignment.

The new guidelines are aligned with global best practices to strengthen compensation governance. For example, companies are required to establish a formal Nominations and Remuneration Committee (NRC) of the Board, adopt a formal compensation policy, use qualitative and quantitative parameters to define MRTs, prescribe the mix between fixed and variable pay, and between annual bonus and share-linked instruments, implement bonus deferrals, adopt clawback and malus provisions, deleverage compensation for control staff, and adopt defined protocols regarding compensation disclosures. Additionally, companies are not allowed to offer guaranteed bonuses nor severance payments, and executives are prohibited from hedging their compensation structures to offset for the intended risk-reward alignment.

While there are several positives, there are also some areas that warrant additional clarity. In particular, there are four areas where banks are experiencing implementation challenges.

First is the identification of MRTs. The 2019 guidelines go a long way in making the MRT identification process objective across banks, however, they also make it tougher to capture organisation-specific nuances. A key challenge relates to the standardised approach of identifying roles that may expose the bank to credit risk vs operational risk vs market risk. Also the requirement that MRTs should comprise of 0.3% of highest paid staff may not truly reflect the roles that are likely to expose the bank to material risk.

Second is related to triggers for malus and clawbacks. The guidelines allow for reducing or cancelling incentive payments. In some extreme cases executives may even have to return incentives received back to the banks. However, there are also some areas which are left unaddressed, such as quantifying the triggers of non-performing assets, or defining the limits of subdued / negative performance that may warrant malus and clawbacks to be exercised. It is also important to define the roles of NRC and Board Risk Committee in monitoring triggers leading to malus or clawback, including the time horizon for ex-post adjustments.

Third is related to share-linked instruments, with the requirement that between half to two-thirds of overall variable pay should be share-linked. The guidelines mainly refer to share-linked instruments as employee stock option plans (ESOPs), which ignores the whole range of other instruments that are widely used by global banks in other jurisdictions, such as restricted share plans, performance share plans etc. The guidelines go on to specify a requirement that share-linked instruments should be fair valued on the date of grant by the bank using Black-Scholes model. The prescription of Black-Scholes model may be stifling, as it can be used for pricing ESOPs, but not for determining fair value of restricted shares or performance shares – which globally are among the most prevalent share-linked instruments. Besides, whilst ESOPs are mainly linked to share-price performance, other instruments can provide stronger pay-for-performance linkage with multiple performance indicators, including share price, profits, non-performing assets, customer advocacy etc.

Finally, while banks focus on implementing these guidelines, it's also important to watch out for any unintended consequences. For example, in some European markets, adoption of similar caps and limits on variable pay have led to quite significant increases in fixed salary. Such institutional deleveraging of pay may ensure better risk-reward alignment but may dilute the pay-for-performance linkage. Similarly, as an unintended consequence of RBI guidelines, it is likely that banks who currently do not have share-linked instruments may see significant increases in total compensation. To meet the required proportions of deferrals and share-linked requirements, it is possible that banks end up increasing the overall variable pay – as companies generally prefer not to cut fixed salaries.

The new RBI guidelines should be applauded as they are definitely a strong move towards instilling confidence within investors, customers and employees regarding compensation governance, and risk-reward-performance alignment. NRCs and boards will need to maintain their strategic and oversight perspectives, and careful attention will be needed to be given in designing appropriate compensation arrangements that comply with RBI guidelines, align with interests of shareholders and broader stakeholders, and at the same time be able to attract, retain, and motivate high-caliber management talent within the very competitive banking industry.

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