RBI’s New Guidelines for Compensation of Whole-time Directors, CEO of Private Sector Banking Companies in India

1. Background

1.1 Executive compensation practices in large financial institutions have been apprehended to be one of the reasons of global financial crisis. This led Banking Regulators across the globe including the Reserve Bank of India (“RBI”) to come-up with guidelines requiring checks and balances against rewarding employees on the basis of short-term profits without adequate recognition of risks and long-term consequences of their short-term achievements.

1.2 Up till now, executive compensation meant for Whole-time Directors (“WTD”), Chief Executive Officer (“CEO”), Material Risk Takers (“MRT”), etc. of banking companies in private sector has been regulated under the guidelines issued by the Reserve Bank of India on 13th January 2012 (“Erstwhile Guidelines”) which mainly focused on governance, alignment, and overseeing of compensation vis-à-vis prudent risk taking by concerned executives.

1.3 The Erstwhile Guidelines required private sector banks to ensure a proper balance of the variable pay (“VP”) and fixed pay (“FP”) of total compensation subject to ceiling of VP at 70% of FP in a year. The VP could comprise of cash, stock linked instruments or mix of both and such benefits were subject to deferral. Options/ benefits under employee stock options plan (“ESOP”), however, were not treated as a part of VP. Hitherto, the Erstwhile Guidelines sought to govern the executive compensation.

1.4 Recently, the RBI has notified a new set of guidelines on executive compensation vide Circular no. RBI/2019-20/89, dated 4th Nov 2019 (“New Guidelines”) to be applicable for pay cycles commencing on/ from 1st April 2020 (“Effective Date”) with supersession of Erstwhile Guidelines from that date.

1.5 Provisions of the New Guidelines including that on ESOPs are much different and seem rigorous in terms of counter balancing of pay with refence to potential misconduct, deterioration of financial performance and provisioning for non-performing asset (“NPAs”). Whereas, in certain other respects, these Guidelines seem to have opened-up vistas for favorable pay rationalization.

1.6 In the following paragraphs we are sharing our initial observations on the Guidelines and its implications for the ESOP policy of the companies affected.

2. Our analysis and views

2.1 A comparative study of key provisions in Erstwhile Guidelines and that in New Guidelines may be helpful for a quick understanding of the position:

Sr. No.	Parameters	Erstwhile Guidelines	New Guidelines	Our observations
1	Applicability and scope	• Only banks in private sector including Indian branches of foreign banks • Mandatory for WTD/ CEO/ MRT • Recommended for other staffs	• Additionally, cover Local Area Banks, Small Finance Banks and Payment Banks • Mandatory for WTD/ CEO/ MRT • Recommended for other staffs	A new area of governance and compliance for newly covered entities
2	Norm of VP and FP ratio	• No minimum VP • Maximum VP is 70% of FP	• Minimum VP is 50% of compensation • Maximum VP is 300% of FP *(150% in case an executive is not entitled for share-linked instrument)*	• VP should be linked to performance • Higher VP percentage for higher levels
3	Composition of VP	Cash, share-linked instruments, or both but **excluding ESOPs**	Cash, share-linked instruments, or both but **including ESOPs**	Treatment of ESOP as part of VP may significantly tilt the existing VP-FP ratio and needs revision for new pay cycle
4	Cash and non-cash components of VP	Cash and non-cash components must be consistent with risk alignment	By non-cash disbursal: • At least 50% of VP if VP is up to 200% of FP • At least 67% of VP if VP is above 200% of FP	Cash and non-cash balance is no more subjective
5	Impact of deterioration in financial performance	Should lead to contraction in VP	Should lead to contraction in VP (including ESOPs), even reduced to “Zero”	Requires appropriate structuring to factor-in the spirit
6	Deferral of VP	Deferral required only when VP is substantial	For WTDs/ CEO/MRTs Deferral of 60% of VP 50% of cash bonus. No deferral if cash VP is below Rs. 25 Lac	New regime avoids any kind of subjectivity and is specific
7	Period of deferral	Minimum 3 years with equal or back-ended vesting	• Minimum 3 years with equal or back-ended vesting • 1st vesting after 1 year • Vesting on yearly basis	New regime seeks time for disbursal of VP so as to assess, align and adjust with risk
8	ESOPs	• ESOPs didn’t form part of VP • Reasonable quantum of ESOPs could be granted (“reasonable” was not specified)	• ESOP an integral part of VP • ESOP quantum is specified as non-cash VP • Requires specific mention in Compensation Policy of Bank	ESOPs being included as VP, may be of great help to disburse non-cash VP. However, it needs a careful structuring.
9	Malus/ Claw back	Used to trigger on subdued or negative financial performance	Detailed and stringent conditions are prescribed including reference to divergence in NPA provisioning	RBI requires articulation of scenarios which will trigger Malus/ claw back which needs to be written in relevant VP/ ESOP policy

3. Implications and impact

3.1 Shall ESOPs already granted prior to the Effective Date, be treated as VP or need to be re-visited *ex post facto*? Will the new regime limit the Grants to the affected employees or will it provide an opportunity to rationalize their VP?

3.2 The New Guidelines require linking of fate of VPs including vested or unvested ESOPs with the deterioration in the financial *performance*, divergence in NPA provisioning and asset classification. This requires scenario building at the time of grant itself as to in which circumstances malus and claw back would trigger.

3.3 Even though the New Guidelines are clear, few aspects need clarity like whether the entire Black & Sholes *value* of ESOPs granted shall be treated as VP of that year or only annual amortizable part thereof. How will the treatment on re-pricing of underwater ESOPs, fair adjustment in case of corporate restructuring, etc. will be looked at?

3.4 Given the new approach for ESOPs, the existing ESOP policy and practice may be checked for any potential inconsistency and be aligned so as to ensure compliance in letter and spirit. The new regime though limits the value of ESOPs at the time of grant, but does not cap the eventual upside accruing at the time of *exercise*. This connotes value proposition for a growing banking company seeking to bring win-win for all stakeholders.

Please standby for the announcement of our webinar on this subject for

a more detailed analysis and implications of these Guidelines

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