भारतीय रिज़र्व बैंक

# RESERVE BANK OF INDIA

www.rbi.org.in

**DBOD No.BC. /29.67.001/2010-11** **July 1, 2010**

To

**All banks in Private Sector and Local Area Banks**
**and all Foreign Banks operating in India**

Dear Sir/Madam,

## Guidelines on Compensation of Whole Time Directors/Chief Executive Officers/Risk takers and Control function staff

Flawed incentive compensation practices in the financial sector were one of the important factors contributing to the recent global financial crisis. Employees were too often rewarded for increasing the short-term profit without adequate recognition of the risks the employees' activities posed to the organizations. These perverse incentives amplified the excessive risk taking that severely threatened the global financial system. The compensation issue has, therefore, been at the centrestage of the regulatory reforms. To address the issues in a coordinated manner across jurisdictions, the Financial Stability Board (FSB) has brought out a set of principles and implementation standards on sound compensation practices in April and September 2009, respectively. The principles are intended to reduce incentives towards excessive risk taking that may arise from the strcuture of compensation schemes. The principles call for effective governance of compensation and its alignment with prudent risk taking and effective supervisory oversight and stakeholder engagement. The principles have been endorsed by the G-20 countries and the Basel Committee on Banking Supervision (BCBS) and are under implementation across jurisdictions.

2. In this background, an announcement was made in the 2nd Quarter review of Monetary Policy on October 27, 2009 that in line with the steps taken by the global community RBI will issue guidelines to Private Sector Banks and foreign banks on sound compensation policy. In the Annual Policy 2010-11 it was further announced that comprehensive guidelines based on Financial Stability Board principles on sound compensation practices would be issued by June 2010. Accordingly, comprehensive guidelines for implementation by banks in the Private Sector, Local Area Banks (LABs) and foreign banks operating in India are furnished in the annex along with the FSB's Principles for Sound Compensation Practices and Implementation Standards. Comments on the draft guidelines may be emailed by July 31, 2010 to Shri A.K. Khound, Chief General Manager (Click here to send email) and also sent by post/ courier to him at Department of Banking Operations and Development, Central Office, Centre-1, Cuffe Parade, Colaba, Mumbai 400 005.

3. Please acknowledge receipt.

Yours faithfully

**(A.K. Khound)**
**Chief General Manager**

**Encl: As above**

**ANNEX**

**Guidelines on Compensation of Whole Time Directors/**

**Chief Executive Officers/Risk takers and Control function staff**

**Financial Stability Board (FSB) Principles for Sound Compensation Practices**

The principles in brief are as under:

(i) Effective governance of compensation

- The firm's board of directors must actively oversee the compensation system's design operation.
- The firm's board of directors must monitor and review the compensation system to ensure the system operates as intended.
- Staff engaged in financial and risk control must be independent, have appropriate authority, and be compensated in a manner that is independent of the business areas they oversee and commensurate with their key role in the firm.

(ii) Effective alignment of compensation with prudent risk taking

- Compensation must be adjusted for all types of risk.
- Compensation outcomes must be symmetric with risk outcomes.
- Compensation payout schedules must be sensitive to the time horizon of risks.
- The mix of cash, equity and other forms of compensation must be consistent with risk alignment.

(iii) Effective supervisory oversight and engagement by stakeholders

- Supervisory review of compensation practices must be rigorous and sustained, and deficiencies must be addressed promptly with supervisory action.
- Firms must disclose clear, comprehensive and timely information about their compensation practices to facilitate constructive engagement by all stakeholders.

2. The guidelines delineated below are based on the above mentioned Principles and Implementation Standards of the FSB, as well as current statutory and regulatory framework in India. Banks are required to take steps immediately to implement the guidelines by putting in place necessary policy/ infrastructure.

3. As hitherto, the banks in Private Sector, Local Area Banks and Foreign Banks operating in India would be required to obtain regulatory approval for grant of remuneration to WTDs/ CEOs in terms of Section 35B of the Banking Regulation Act, 1949, on case-to-case basis. The approval process will involve an assessment whether the compensation policies and practices are in accordance with the FSB principles, inter alia, whether there is appropriate balance between fixed and variable pay, whether adequate deferrals are built in the variable component and whether cost/ income ratio supports the remuneration package consistent with maintenance of sound capital adequacy ratio.

4. Banks' compensation policies would be subject to supervisory oversight including review under the Supervisory Review and Evaluation Process (SREP) under Pillar II of Basel II. Deficiencies would have the effect of increasing the risk profile of banks with attendant consequences including a requirement of additional capital if the deficiencies are very significant.

## 5. Compensation guidelines to New / Old Private Sector and Local Area Banks

### 5.1 Effective Governance of compensation

#### Guideline 1: Compensation Policy

Bank Boards should formulate and adopt a comprehensive compensation policy covering all employees of the bank and conduct annual review thereof. The policy should cover all aspects of the compensation structure such as fixed pay, perquisites, bonus, guaranteed pay, severance package, stock/ESOP plan, pension plan, etc. The compensation policy should incorporate the RBI guidelines on compensation and the process of framing/reviewing the policy should be completed before December 31, 2010 for the year 2011-12. Banks are required to submit a copy of the compensation policy to RBI and annually thereafter, after suitable annual review.

**Guideline 2: Board and Remuneration Committee (RC)**

The bank's Board should constitute a Remuneration Committee (RC) of the Board comprising of non-executive independent directors and non-executive Chairman of the board (wherever there is non-executive chairman) to oversee the framing, review and implementation of compensation policy of the bank. The RC should have a minimum of three members and should include at least one member from Risk Management/ Audit Committee of the Board. The RC should work in close coordination with Risk Management committee of the bank, in order to achieve effective alignment between them. The RC should also ensure that the cost/income ratio supports the remuneration package consistent with maintenance of sound capital adequacy ratio.

**5.2 <u>Effective alignment of compensation with prudent risk taking</u>**

**Guideline 3: For material risk–takers, senior management**

Categories of staff whose professional activities have a material impact on the bank's risk profile essentially would include:

i) individuals, such as senior management, material risk –takers (i.e. traders, etc); and

ii) groups of employees who may together take material risks, even if no individual employee is likely to expose the firm to large material risk (e.g. loan officers who, as a group originate loans that account for a material amount of the organisation's credit risk).

The bank should ensure that

(i) compensation is adjusted for all types of risk .
(ii) compensation outcomes must be symmetric with risk outcomes, and
(iii) compensation payouts must be sensitive to the time horizon of the risk.

A wide variety of measures of credit, market and liquidity risks may be used by the banks in implementation of risk adjustment. The risk adjusted methods should preferably have both quantitative and judgmental elements.

The senior management for this purpose should generally include the Chief Executive Officer, Whole Time Directors, Chief Operating Officer, other executive members of the board, senior executives, Head of Treasury and dealers in treasury operations.

***Fixed pay***

Banks are required to ensure that the fixed portion of compensation is reasonable for the employee, taking into account all relevant factors. However, in case of Whole Time Directors (WTDs)/CEOs, the annual increase in fixed pay should not generally be more than in the range of 10% to 15%. Perquisites may be paid by banks in line with their existing practices.

***Variable pay composition and deferral***

While designing the compensation arrangements it should be ensured that there is a proper balance between fixed pay and variable pay. At higher levels of responsibility the proportion of variable pay may be higher. The variable pay could be in cash, stock linked instruments or mix of both. Further, deterioration in the financial performance should generally lead to a contraction in the total amount of variable remuneration paid.

Where the variable pay constitutes a substantial portion of the total pay, 40% to 60% of the variable pay must be deferred for minimum period of three years. A substantial proportion of deferred variable pay should be awarded in shares or share linked instruments (ESOPs, etc), as long as these instruments create incentives aligned with long term value creations and time horizons of risks. Grant of share linked instruments (ESOPs, etc) should also conform to SEBI guidelines. The remaining portion of the deferred compensation should be paid as cash compensation vesting gradually.

***Variable pay –timing***

In case of deferral arrangements of variable pay, the deferral period should not be less than three years and the period should correctly align with nature of business, its risks and the activities of the employee in question. Compensation payable under deferral arrangements should vest no faster than on a pro rata basis.

***Clawback***

In case of deferral compensation, in the event of negative contributions of the bank and/or the relevant line of business in any year during the vesting period, any unvested portions are to be clawed back, subject to realized performance of the bank and the business line. For legal enforceability, the clawback system be driven by observable and verifiable measures of risk outcomes. Banks may put in place appropriate mechanism to incorporate clawback mechanism in respect of variable pay.

***Guaranteed bonus***

Guaranteed bonuses are not consistent with sound risk management or the pay-for performance principles and should not be part of compensation plan. Therefore, joining / sign on bonus should only occur in the context of hiring new staff and be limited to first year. However, payment should be in ESOPs only since payments in cash upfront would create perverse incentives and promote undue risk taking. Further, banks should not grant severance pay other than accrued benefits (gratuity, pension, etc.) to WTDs/CEOs.

***Hedging***

The banks should not provide any facility or funds or permit employees to insure or hedge their compensation structure to offset the risk alignment effects embedded in their compensation arrangement. To enforce the same, banks should establish appropriate compliance arrangements.

**Guideline 4: For risk control and compliance staff**

Members of senior management and other staff engaged in financial and risk control should be compensated in a manner that is independent of the business areas they oversee and commensurate with their key role in the bank. Effective independence and appropriate authority of such staff are necessary to preserve the integrity of financial and risk management's influence on incentive compensation. Back office and risk control employees play a key role in ensuring the integrity of risk measures. If their own compensation is importantly affected by short-term measures, their independence will be compromised. If their compensation is too low, the quality of such employees may be insufficient to

their tasks and their authority may be undermined. The mix of fixed and variable compensation for control function personnel should be weighted in favour of fixed compensation.

### 5.3 Disclosure and engagement by stakeholders

**Guideline 5: Disclosure**

In addition to the existing disclosures relating to compensation, banks may be required to disclose the following in their Annual Financial Statements, from March 2011, to ensure effective engagement by all the stakeholders:

- The decision making process used to determine the firm-wide compensation policy, including the composition and the mandate of Remuneration Committee;
- The most important design characteristics of the compensation systems of WTDs/CEOs as also other risk takers;
- Aggregate quantitative information on compensation, broken down by senior executives and by employees whose actions have a material impact on the risk exposure of the firm, indicating:

    a. amounts of remuneration for the financial year, split into fixed and variable compensation and number of beneficiaries;

    b. amounts and form of variable compensation, split into cash, shares and share linked instruments and others;

    c. amounts of outstanding deferred compensation, split into vested and unvested;

    d. the amounts of deferred compensation awarded during the financial year, paid out and reduced through performance adjustments;

    e. sign-on ESOPs granted during the financial year and number of beneficiaries of such payments.

## 6. Compensation Guidelines to Foreign Banks

At present, all Foreign Banks are operating in India through Branch presence. The compensation of these banks is governed by their respective Head Office policy. In the light of the initiative taken by the FSB and G-20 and BCBS endorsement of the FSB principles, it is expected that Head Offices of these banks would also align their compensation policies in line with the FSB principles.

Foreign Banks would be required to submit a declaration annually from their Head Offices to the effect that their compensation structure in India, including that of CEO's is in conformity with the FSB principles and standards. RBI would take this into account while according approval of CEOs' compensation. In case it is observed that compensation is not properly aligned to risks or there are other regulatory and supervisory compliance issues in relation to the Indian operations, the compensation issue would be appropriately taken up with the Home country regulator, on case to case basis.

------------X----------