

# *Legal Update*

## **Compensation to risk takers with clawback to make them responsible – RBI issues Guidelines on Compensation to Key Personnel in Banks**

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## *Compensation to risk takers with clawback to make them responsible-RBI issues Guidelines on compensation to Key Personnel in Banks*

RBI raising eyebrows on the compensation packages on the likes of Mrs. Chanda Kochar, Mr. Aditya Puri, Mr. Uday Kotak and others spearheading the banking industry in the country by introducing **Guidelines on compensation of Whole Time Directors/ Chief Executive Directors/ Risk Takers and Control function staff, etc<sup>1</sup>** on January 13, 2012.

These guidelines are made applicable on all private sector and foreign banks operating in India and as RBI sees it, compensation of the crème-dela-crème of the large financial institutions, wherein employees were rewarded for short term profits, without considering the risks involved and long term consequences and has been one of the important factors contributing to the recent global financial crisis.

The Financial Stability Board had twice in 2009 come out with standards on sound compensation practices to curb the excessive risk taking attitude of these employees and alignment of compensation with prudent risk taking, effective supervisory oversight and stakeholder engagement. The Basel Committee on Banking Supervision had also published in May 2011 the report on *Range of Methodologies for Risk and Performance Alignment of Remuneration* on the same issue.

The Guidelines require the board of directors of a bank to monitor and review the compensation system; align compensation with prudent risk taking effectively, compensation to be in symmetry with risk outcomes. The Guidelines state that banks to have -

1. A compensation policy to be prepared by March 2012 and be effective from financial year 2012-13.
2. Constitution of Remuneration Committee to oversee the framing, review and implementation of compensation policy of the bank on behalf of the board. The RC should have a minimum of three members and should include at least one member from Risk Management Committee of the Board.
3. Compensation structure for WTDs/ CEOs to have a fixed and variable component. Variable pay should not exceed 70% of the fixed pay in a year and a

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<sup>1</sup> **RBI/2011-12/349, DBOD No.BC.72/29.67.001/2011-12**  
<http://rbi.org.in/scripts/NotificationUser.aspx?Id=6938&Mode=0>

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- part of the variable pay to be deferred over a period. There should be a mix of cash, equity and other forms of compensations.
4. **Malus/ Clawback** – In the event of negative contributions by the bank and/ or relevant line of business in a year, the deferral compensation would be subject to malus/ clawback. A malus arrangement permits the bank to prevent vesting of all or part of the amount of a deferred remuneration. Malus arrangement does not reverse vesting after it has already occurred. A clawback, on the other hand, is a contractual agreement between the employee and the bank in which the employee agrees to return previously paid or vested remuneration to the bank under certain circumstances.
  5. Make disclosures on annual basis on the remuneration paid.

While the rationale behind such a guideline is good, the idea of calling back or withdrawing of a component of the compensation is a far too stretched policy for the topnotch of the banks. Will it make the CEOs/ WTDs/ decision makers in bank, go on a bank foot in being innovative and aggressive rather than being cautious? Should RBI dictate the compensation modes and penal action? Would this take the banking industry on step back are some the questions this Malus/ Clawback Clause has raised.

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