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Banks in India: Navigating the New RBI Guidelines

The Reserve Bank of India (RBI) has, through a recent discussion paper, proposed new guidelines for executive compensation for private sector banks in India. The planned guidelines entail major changes to the existing guidelines, including a proposed cap on variable pay and inclusion of Employee Stock Option Plans (ESOPs) under variable pay.

The banking regulator in India has recently been taking a series of stern actions on areas related to governance. For instance, it denied approval for the re-appointment of existing chief executives in the case of at least two local private sector banks. The proposed RBI guidelines will only heighten this hardening stance on executive compensation for banks.

The guidelines cover CEO, Whole-time Directors (WTD), Material Risk Takers (MRT), and the Control Function. The RBI has invited comments from banks and other interested parties by March 31st, 2019. The guidelines, if finalized and implemented, are likely to be effective by the subsequent financial year.

Below we've outlined a quick summary of the changes that are occurring, who they will affect, and what banks should consider.

Quick summary of proposed guidelines

	Applicable for	Proposed Change	Prior Guideline
Mandatory Deferral of Variable Pay	Senior Executives including WTDs, MRTs	60% of total variable pay must be deferred and at least 50% of cash component of variable pay must be deferred	The existing guideline did say that a substantial portion of variable pay must be deferred, but did not prescribe a threshold
Composition of Variable Pay	WTDs, CEOs, MRTs	Minimum 50% of variable pay should be in the form of non-cash components, such as ESOPs or share linked instruments	No such provision in existing guidelines
Capping of Variable Pay	WTDs, CEOs, MRTs	Variable pay cannot be more than 200% of fixed pay	Earlier, variable pay was capped at 70% of fixed pay, but didn't include ESOPs
Definition of Variable Pay	WTDs, CEOs, MRTs	ESOPs, or other stock linked instrument, to be included under variable pay	Existing guidelines treated ESOPs as outside the definition of variable pay
Pay Mix	Risk Control & Compliance Staff	The mix should be weighted in favor of fixed pay	This is consistent with current provisions
Trigger for Malus	CEO, WTD, MRT	Mandatory malus in case of divergence in NPA / provision reporting beyond a prescribed threshold	The guidelines prescribed malus provision, but didn't specify any mandatory trigger

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Impact of proposed changes

Some of the changes, specifically the capping of variable pay at 200% and inclusion of ESOPs in the definition of variable pay, may force banks to re-evaluate and restructure senior management compensation significantly. The impact of this change is further accentuated by the fact that RBI has kept certain benefits, such as house, car, club membership, etc., outside the purview of fixed pay. At the CEO level, where ESOPs alone account for more than 50% of total pay, the current variable pay as per the new guidelines is higher than the cap of 200% for most banks.

Aligning to the new guidelines may require one of the following two adjustments, or a combination of both:

- **Approach #1: Correction in Fixed Pay** – If this approach is used, banks may need an increase of 30%* or higher in their fixed pay in most cases
- **Approach #2: Reduction in Total Pay** – If this approach is used, banks may see a decrease in overall pay of 25%* or higher in most cases
- **Approach #3: Combination**

*Note: Calculated basis current average total pay of CEOs of prominent private sector banks in India

It is important to note that the overall wealth creation takes a hit irrespective of the approach taken. While the reduction is more direct in the second approach, even the first alternative will feel an impact. ESOPs in India have seen a realized value several times higher than the Black-Scholes value of options. Reduction in share of ESOPs in overall pay thus leads to a lower wealth creation, even under adjustments to fixed pay.

An added aggravation of the situation is that the regulator needs to approve remuneration for the CEO before it is paid out. Historically, regulators have declined to approve large increases in fixed pay for CEOs. Getting boards to agree to such high increases in fixed pay will be fairly challenging as well, thus hampering approach number one.

This impact also extends directly to other whole-time directors. Further, the proposed guidelines have laid out criteria for identifying material risk takers. With a more defined approach, the impact of the proposed guidelines will likely affect a higher number of employees than just top leadership. Other changes, as well as additional disclosure requirements, will spark a rise in administrative and compliance activities for banks.

In conclusion

If implemented, the proposed guidelines will trigger a major restructuring of pay at executive levels in banks. Irrespective of the approach used to restructure, the attractiveness of overall pay is likely to reduce, thereby weakening the employee value proposition for talent in the banking space.

For over a decade, a high share of ESOPs for bank leadership served as an important lever for retention, making it very difficult for competition to hire talent from banks' C-suite. If the process firms use to restructure is not carefully calibrated, valuable talent may be vulnerable to associated sectors like non-banking financial companies (NBFCs), which have been hiring aggressively from banks already.

It's important to note that the proposed requirements are closely aligned with those that have been in place in Europe since 2014. Some lessons to be learned from firms making similar changes include:

- Recognizing that such developments represent a permanent and meaningful change to the employee value proposition, which will have implications on hiring, retention, performance management, and governance to name just a few.

- Successfully implementing the changes will require a multi-disciplinary effort involving input from HR, compliance, legal, risk, and communications teams, as well as business leaders. External independent guidance can help ensure that all relevant inputs and aspects are considered.
- Consistent and continuous communication is key across the stakeholder groups.

We are here to help you navigate the impact of regulatory decisions. As trusted advisors to boards and compensation committees, we provide direction in benchmarking pay and performance for strategic compensation programs that align to business strategies.

To learn more about the new RBI guidelines, expected changes, and how to best navigate the potential impact they will have on the banking sector in India, please contact our team.

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