RBI Draft Rules on Bank CEO Compensation

Why in news?

The RBI recently released the draft rules on compensation for CEOs and full-time directors of banks.

How were violations by bank executives dealt?

- Unlike manufacturing, there is a bigger risk of financial instability when it involves banks and the use of public funds.
- But while addressing this, the governments have failed to address the asymmetry between India's state-owned banks and private banks on compensation practices.
- In India's state-owned banks, executives have been punished by the government and the CBI for offences or violations, even less grave.
- But getting away with informal deals had been possible for private bank executives for quite some time.
- E.g. over a decade ago, a senior executive in one of India's top private banks was identified as being responsible for the bank taking a hit of Rs 200 crore in a quarter
- This was a result of a wrong bet on a complex financial product, prompting the board to seek action.
- Although the executive was moved out a little later, his compensation was not impacted.
- Besides, India's top private bank chiefs have the freedom to hire their own teams.
- Unlike this, in state-owned banks, the CEO has to settle for deputies chosen by the government.

What are the recent developments?

- Increasingly, the field is being levelled between private and public sector banks, at least in terms of being punished for lapses.
- This started during the tenure of former RBI Governor Urjit Patel.
- Under his watch, top private bank chiefs had to exit after major violations.
- E.g. the case involving ICICI CEO Chanda Kochhar who had to quit after allegations of conflict of interest
- There were a couple of other bankers too who had to leave after the RBI

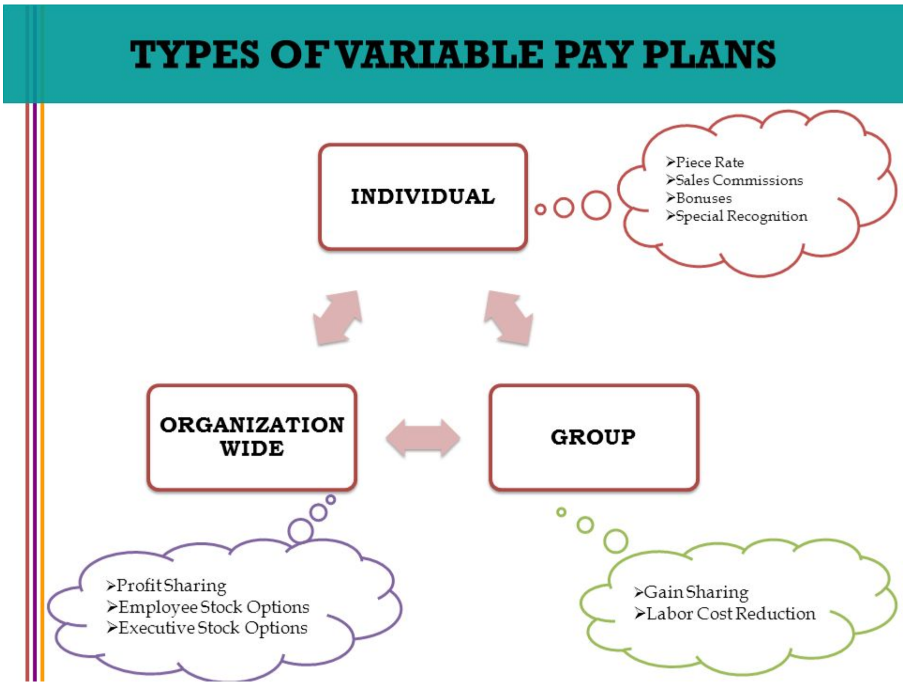
found divergence in financial information or accounts from what their banks published.
- The fact of huge compensations being paid to CEOs despite these over the past several years drives the changes that are now under way.

What are the draft rules for?

- In the Western countries, the regulators and governments decided to discourage excessive risk-taking by banks after the 2008 global financial crisis.
- In the US, the Dodd Frank Wall Street reforms and Consumer Protection Act addresses this issue.
- Likewise, the Indian central bank too is set to tighten the executive compensation.
- The rules aim at making CEOs more accountable for their bank's performance.
- It ensures that rewards for senior executives in private and foreign banks are aligned with the risks undertaken by the banks.
- The first set of such rules has been in force since 2012, but much has changed since then.
- The *Financial Stability Board* (FSB) came out in 2009 with a set of principles and implementation standards on compensation practices.
- India too is a member of the FSB.

What are the key proposals in the draft?

- The mix of cash, equity and other forms of compensation will be consistent with risk alignment.
- RBI proposed that at least 50% of the compensation packages of private bank chief executive officers (CEO) should be variable.
- [While base salary is a fixed one and paid out regardless of employees meeting their goals, the variable pay is paid on certain conditions.]
- Earlier, there was no such threshold, and senior private bankers could take home a substantial amount irrespective of lapses or violations.
- Now, it will be paid on the basis of individual, business-unit and firm-wide measures that adequately measure performance.



- The rules now would allow for a penalty if the concerned bank under-reports bad debt or provision beyond the central bank's tolerance.
- Also, earlier, the variable pay was capped at 70% of fixed pay but did not include stock options as it was outside the scope of the official compensation package.
- [Stock option refers to the benefit in the form of an option where an employee can buy shares in the firm at a discount or at a stated fixed price]
- Now, variable pay, with stock options included, can be capped at 200% of the fixed pay.

- The central bank also said there should be <u>no concept of "guaranteed bonuses"</u> in the compensation plan.
- This will henceforth be consistent with sound risk management and on the basis of the "pay for performance" principles.

Source: The Indian Express

Quick Fact

Financial Stability Board (FSB)

- The FSB is an international body that monitors and makes recommendations about the global financial system.
- It promotes international financial stability by coordinating national financial authorities and international standard-setting bodies.
- The FSB's decisions are not legally binding on its members.
- It, instead, operates by moral suasion and peer pressure, in order to set

internationally agreed policies and minimum standards that its members commit to implementing at national level.