भारतीय रिज़र्व बैंक
RESERVE BANK OF INDIA
www.rbi.org.in

RBI/2011-12/349

DBOD No.BC. 72 /29.67.001/2011-12 January 13, 2012

All Private Sector and Foreign Banks operating in India

Dear Sir / Madam,

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

The compensation practices, especially of large financial institutions, were one of the important factors which contributed to the recent global financial crisis. Employees were too often rewarded for increasing the short-term profit without adequate recognition of the risks and long-term consequences that their 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 centre stage of the regulatory reforms.

2. 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 structure of compensation schemes. The principles call for effective governance of compensation, alignment of compensation with prudent risk taking, effective

बैंकिंग परिचालन और विकास विभाग, केन्द्रीय कार्यालय भवन, 13वीं मंज़िल, शहीद भगत सिंह मार्ग, मुंबई - 400 001
Dept of Banking Operations and Development, Central Office, RBI Bldg. 13th Floor, Fort, Mumbai - 400 001
टेलिफोन /Tel No: 91-22-22701203 फैक्स/Fax No: 91-22-22701240
Email ID: muraliradhakrishnan@rbi.org.in

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.

3. In this background, an announcement was made in the Second Quarter Review of Monetary Policy 2009-10 that in line with the steps taken by the global community, Reserve Bank will issue guidelines to Private Sector Banks and Foreign Banks on sound compensation policy. Accordingly, draft guidelines on compensation of whole time directors /Chief Executive Officers/other Risk takers and Control function staff were framed and placed on the Reserve Bank's website in July 2010 for public comments. A large number of comments/ suggestions were received on the draft guidelines and it was proposed in the Second Quarter Review of Monetary Policy for 2010-11 to issue final guidelines by end-December 2010. Meanwhile, in October 2010, the BCBS brought out a consultative paper titled *Range of Methodologies for Risk and Performance Alignment of Remuneration*, for public comments. Therefore, the implementation of the Reserve Bank's guidelines on compensation policy was deferred till 2012-13 and banks were advised through a press release on February 23, 2011 to refer to the BCBS consultative paper and begin preparatory work.

4. The BCBS has since published in May 2011 the final report on *Range of Methodologies for Risk and Performance Alignment of Remuneration*. The main objectives of the report are to present certain remuneration practices and methodologies that support sound incentives and also the elements influencing the effectiveness of risk alignment that should be considered by banks when developing their methodologies and by supervisors, when reviewing and assessing banks' practices.

बैंकिंग परिचालन और विकास विभाग, केन्द्रीय कार्यालय भवन, 13वीं मंजिल, शहीद भगत सिंह मार्ग, मुंबई - 400 001
Dept of Banking Operations and Development, Central Office, RBI Bldg. 13th Floor, Fort, Mumbai - 400 001
टेलिफोन /Tel No: 91-22-22701203 फैक्स/Fax No: 91-22-22701240
Email ID: muraliradhakrishnan@rbi.org.in

5. In July 2011, the BCBS in consultation with the FSB has also published Pillar 3 disclosure requirements for remuneration.

6. Taking into account the stipulations in these documents and the comments received on the draft guidelines, Reserve Bank has finalized the compensation guidelines enclosed as **Annex** for implementation by private sector and foreign banks from the financial year 2012-13. These guidelines will supersede the Reserve Bank's extant guidelines relating to compensation.

7. As hitherto, private sector 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 (B.R. Act, 1949). The approval process will involve, inter alia, an assessment whether the compensation policies and practices are in accordance with the FSB Principles.

8. Please acknowledge receipt.

Yours faithfully,

(Murli Radhakrishnan)
Chief General Manager

Encl: As above

बैंकिंग परिचालन और विकास विभाग, केन्द्रीय कार्यालय भवन, 13वीं मंज़िल, शहीद भगत सिंह मार्ग, मुंबई - 400 001
Dept of Banking Operations and Development, Central Office, RBI Bldg. 13th Floor, Fort, Mumbai - 400 001
टेलिफोन /Tel No: 91-22-22701203 फैक्स/Fax No: 91-22-22701240
Email ID: muraliradhakrishnan@rbi.org.in

Annex

Guidelines on Compensation of Whole Time Directors / Chief Executive Officers / Other Risk Takers

A. The Financial Stability Board (FSB) Principles for Sound Compensation Practices

1. The Principles for Sound Compensation Practices issued by the FSB in April 2009 aim to ensure effective governance of compensation, alignment of compensation with prudent risk taking and effective supervisory oversight and stakeholder engagement in compensation. 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 and 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. Implementation Standards issued by the FSB in September 2009 focus on areas in which especially rapid progress is needed. They do not fully cover all aspects of the FSB Principles but prioritise areas that should be addressed by firms and supervisors to achieve effective global implementation of the Principles.

3. 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.

B. Compensation guidelines to Private Sector Banks

1. Effective governance of compensation

1.1 Guideline 1: Compensation Policy

Banks should formulate and adopt a comprehensive compensation policy covering all their employees 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, pension plan, gratuity, etc., taking into account these guidelines.

The process of framing/reviewing the policy should be completed by March 2012 for implementation from the financial year 2012-13.

1.2 Guideline 2: Board and Remuneration Committee (RC)

The Board of directors of banks should constitute a Remuneration Committee (RC) of the Board 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. The majority of members of the RC should be independent non-executive directors. The RC should work in close coordination with Risk Management Committee of the bank, in order to achieve effective alignment between remuneration and risks. The RC should also ensure that the cost/income ratio of the bank supports the remuneration package consistent with maintenance of sound capital adequacy ratio.

2. Effective alignment of compensation with prudent risk taking

2.1 Guideline 3: For Whole Time Directors / Chief Executive Officers

Banks should ensure that for the WTDs / CEOs:

(a) compensation is adjusted for all types of risk,

(b) compensation outcomes are symmetric with risk outcomes, and

(c) compensation payouts are sensitive to the time horizon of the risk.

(d) The mix of cash, equity and other forms of compensation must be consistent with risk alignment.

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

The compensation structure for the WTDs/CEOs of the bank may be as under:

2.1.1 Fixed pay

Banks are required to ensure that the fixed portion of compensation is reasonable, taking into account all relevant factors including the industry practice.

2.1.2 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. However, variable pay should not exceed 70% of the fixed pay in a year. Within this ceiling, at higher levels of responsibility the proportion of variable pay should be higher. The variable pay could be in cash, or stock linked instruments or mix of both. The Employees Stock Option Plan (ESOP) prevalent in India, may be excluded from the components of variable pay. The deterioration in the financial performance of the bank should generally lead to a contraction in the total amount of variable remuneration paid.

Where the variable pay constitutes a substantial portion of the fixed pay, say 50% or more, an appropriate portion of the variable pay, say 40% to 60% must be deferred for over a period. The bank may define what is 'substantial' in its compensation policy. There should be proper balance between the cash and stock / share components (other than ESOP) in the variable pay in case the variable compensation contains stock or share linked instruments (other than ESOP).

ESOP is kept outside the computation of the total compensation of an employee for the purpose of this guideline, but since it is used as a compensation as well as retention tool by banks, the extent of ESOP should be reasonable. However, norms for grant of ESOP should be framed by banks in conformity with relevant statutory provisions and SEBI guidelines, and should form part of the bank's compensation policy. The details of ESOP granted should also be disclosed in terms of the disclosure requirements stipulated in this guideline.

2.1.3 Variable pay –timing

In case of deferral arrangements of variable pay, the deferral period should not be less than three years. Compensation payable under deferral arrangements should vest no faster than on a pro rata basis.

2.1.4 Malus / Clawback

In the event of negative contributions of the bank and/or the relevant line of business in any year, the deferred compensation should be subjected to malus/clawback arrangements. 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. Banks may put in place appropriate modalities to incorporate malus / clawback mechanism in respect of variable pay, taking into account relevant statutory and regulatory stipulations as applicable.

2.1.5 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, guaranteed bonus should be in the form of ESOPs only since payments in cash upfront would create perverse incentives. Further,

बैंकिंग परिचालन और विकास विभाग, केन्द्रीय कार्यालय भवन, 13वीं मंजिल, शहीद भगत सिंह मार्ग, मुंबई - 400 001
Dept of Banking Operations and Development, Central Office, RBI Bldg. 13th Floor, Fort, Mumbai - 400 001
टेलिफोन /Tel No: 91-22-22701203 फैक्स/Fax No: 91-22-22701240
Email ID: muraliradhakrishnan@rbi.org.in

banks should not grant severance pay other than accrued benefits (gratuity, pension, etc.) except in cases where it is mandatory by any statute.

2.1.6 Hedging

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.

2.2 Guideline 4: For risk control and compliance staff

2.2.1 Members of 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.

2.2.2 Subject to the above, in devising compensation structure, banks may adopt principles similar to principles enunciated for WTD/CEO, as appropriate.

2.3 Guidelines 5: For other categories of staff

For the other categories of staff, banks may devise appropriate compensation structure. However, in doing so, banks may adopt principles similar to the principles enunciated for WTD/CEO as appropriate.

2.4 Banks are advised to refer to the BCBS report entitled *Range of Methodologies for Risk and Performance Alignment of Remuneration* published in May 2011 for guidance. A gist of the methodologies is furnished at the **Appendix 1**. The report is primarily of a technical nature and is not intended to be prescriptive. It intends to enhance the banks' and supervisors' understanding of risk-adjusted remuneration. This report, by providing some clarification on design of risk-adjusted remuneration schemes, could support and facilitate the greater adoption of sound practices in the banking sector.

3. <u>Disclosure and engagement by stakeholders</u>

3.1 Guideline 6: Disclosure

Banks are required to make disclosure on remuneration on an annual basis at the minimum, in their Annual Financial Statements.

3.2 To improve clarity on disclosure, banks may make the disclosures in table or chart format and make disclosures for previous as well as the current reporting year (previous year's disclosure need not be made when the disclosures are made for the first time). The key disclosures required to be made by banks have been given in the **Appendix 2** to the guidelines.

C. Compensation Guidelines to Foreign Banks

1. At present, foreign banks are operating in India through branch mode of presence. The compensation policy of these banks is governed by their respective Head Office policies. In the light of the initiative taken by the FSB, G-20 and the BCBS endorsement of the FSB principles, it is expected that Head Offices of most of these banks would align their compensation policies in line with the FSB principles. Foreign Banks operating in India will, therefore, be required to submit a declaration to Reserve Bank 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.

2. The compensation proposals for CEOs and other staff of foreign banks operating in India which have not adopted the FSB principles in their home country are required to implement the compensation guidelines as prescribed for private sector banks in India, to the extent applicable to them.

D. Regulatory and Supervisory Approval / Oversight

1. Banks may be aware, that in terms of the Section 10(1)(b)(iii) of the Banking Regulation Act, 1949 (B.R. Act, 1949), no banking company shall employ or continue the employment of any person whose remuneration is, in the opinion of the Reserve Bank, excessive.

2. As hitherto, private sector 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 B.R. Act, 1949. The approval process will involve an assessment whether the compensation policies and practices are in accordance with the FSB Principles, including 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.

3. Banks' compensation policies would be subject to supervisory oversight including review under the Supervisory Review and Evaluation Process (SREP) under Pillar 2 of Basel II framework. 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.

बैंकिंग परिचालन और विकास विभाग, केन्द्रीय कार्यालय भवन, 13वीं मंजिल, शहीद भगत सिंह मार्ग, मुंबई - 400 001
Dept of Banking Operations and Development, Central Office, RBI Bldg. 13th Floor, Fort, Mumbai - 400 001
टेलिफोन /Tel No: 91-22-22701203 फैक्स/Fax No: 91-22-22701240
Email ID: muraliradhakrishnan@rbi.org.in

Appendix 1

Methodologies for risk and performance alignment of remuneration

The Basel Committee on Banking Supervision (BCBS) in consultation with the FSB has published a report in May 2011 entitled *Range of Methodologies for Risk and Performance Alignment of Remuneration*. The main objectives of the report are to present (i) some remuneration practices and methodologies that support sound incentives and (ii) the challenges or elements influencing the effectiveness of risk alignment that should be considered by banks when developing their methodologies and by supervisors, when reviewing and assessing banks' practices. Some of the key stipulations of the report are as under:

- In order for incentive-based remuneration to work, the variable part of remuneration should be truly and effectively variable and can even be reduced to zero in line with the symmetry principle defined by the FSB. A key element that supervisors expect is the ability for banks to demonstrate that the methodologies they developed to adjust variable remuneration to risk and performance are appropriate to their specific circumstances.
- The methodologies for adjusting remuneration to risk and performance should also be consistent with the general risk management and corporate governance framework.
- Performance measures and their relation to remuneration packages should be clearly defined at the beginning of the performance measurement period to ensure that the employees perceive the incentives mechanism. The usual annual determination of bonuses should be based on rules, processes and objectives known in advance, recognizing that some discretion will always be needed.
- Banks should use a combination of financial and non-financial measures to assess employee performance and adapt the measurement to each employee's specific situation. Qualitative factors (like knowledge, skills or

abilities), might play an important role when it comes to judging and rewarding some activities- particularly when these serve to reinforce the bank's risk management goals.

- The nature and extent to which risk adjustments are needed depends first on the extent to which performance measures capture risks, but in all cases, some form of risk adjustment is needed as remuneration is often awarded before the final outcome of an activity is known. Risks taken need to be estimated (ex ante), risk outcomes observed (ex post) and both ex ante estimates and ex post outcomes should affect payoffs.
- Risk adjustments need to take into account the nature of the risks involved and the time horizons over which they could emerge. The impact of remuneration adjustments should be linked to actions taken by employees and / or business units, and their impact on the level of risk taken on by the bank.
- The nature of the award process, which links the variable remuneration of each individual employee with bonus pools and the total amount of variable remuneration at a bank's level, is also an area that should be carefully considered by banks and supervisors, as it directly influences how and when performance and risk adjustment are or can be used.

Appendix 2

Disclosure requirements for remuneration

Remuneration		
Qualitative disclosures	(a)	Information relating to the composition and mandate of the Remuneration Committee.
	(b)	Information relating to the design and structure of remuneration processes and the key features and objectives of remuneration policy.
	(c)	Description of the ways in which current and future risks are taken into account in the remuneration processes. It should include the nature and type of the key measures used to take account of these risks.
	(d)	Description of the ways in which the bank seeks to link performance during a performance measurement period with levels of remuneration.
	(e)	A discussion of the bank's policy on deferral and vesting of variable remuneration and a discussion of the bank's policy and criteria for adjusting deferred remuneration before vesting and after vesting.
	(f)	Description of the different forms of variable remuneration (i.e. cash, shares, ESOPs and other forms) that the bank utilizes and the rationale for using these different forms.
Quantitative disclosures (The quantitative disclosures should only cover Whole	(g)	• Number of meetings held by the Remuneration Committee during the financial year and remuneration paid to its members.
	(h)	• Number of employees having received a variable remuneration award during the financial year.

Time Directors / Chief Executive Officer/ Other Risk Takers)		• Number and total amount of sign-on awards made during the financial year. • Details of guaranteed bonus, if any, paid as joining / sign on bonus. • Details of severance pay, in addition to accrued benefits, if any.
	(i)	• Total amount of outstanding deferred remuneration, split into cash, shares and share-linked instruments and other forms. • Total amount of deferred remuneration paid out in the financial year.
	(j)	• Breakdown of amount of remuneration awards for the financial year to show fixed and variable, deferred and non-deferred.
	(k)	• Total amount of outstanding deferred remuneration and retained remuneration exposed to ex post explicit and / or implicit adjustments. • Total amount of reductions during the financial year due to ex- post explicit adjustments. • Total amount of reductions during the financial year due to ex- post implicit adjustments.