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.

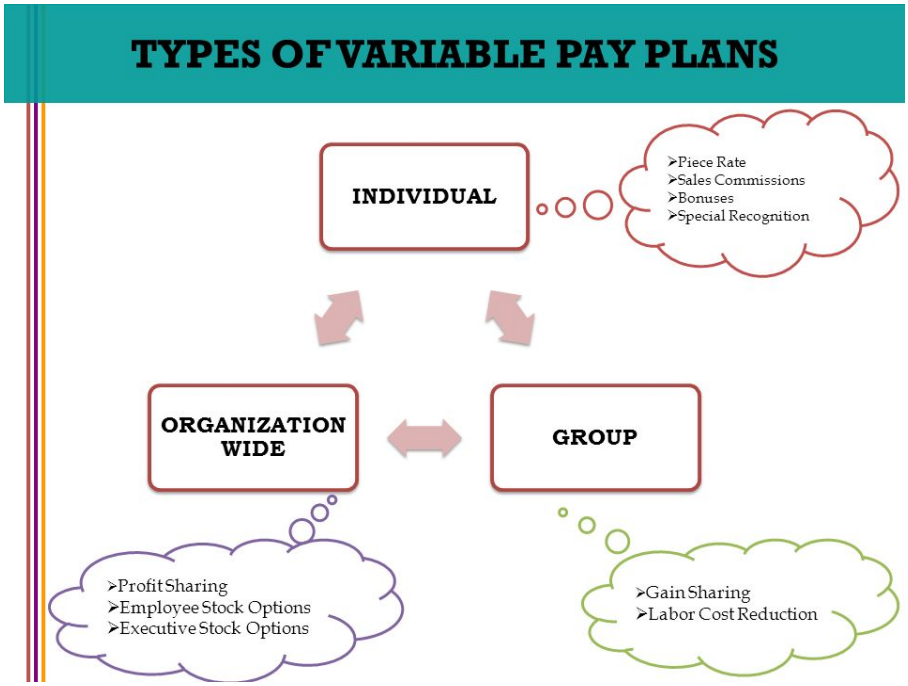
- E.g. the case involving ICICI CEO Chanda Kochhar who had to quit after allegations of conflict of interest
- There were a couple of other bankers too who had to leave after the RBI found divergence in financial information or accounts from what their banks published.
- The fact of huge compensations 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 no concept of "guaranteed bonuses" 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.

IAS PARLIAMENT
Information is Empowering
A Shankar IAS Academy Initiative