Senior Leadership Equity Compensation Structures – Indian Private Sector Banks

"SIBs are perceived as banks that are 'Too Big To Fail (TBTF)'. This perception of TBTF creates an expectation of government support for these banks at the time of distress. Due to this perception, these banks enjoy certain advantages in the funding markets. However, the perceived expectation of government support amplifies risk taking, reduces market discipline, creates competitive distortions, and increases the probability of distress in the future. These considerations require that SIBs should be subjected to additional policy measures to deal with the systemic risks and moral hazard issues posed by them."

Above excerpt is from Framework for Dealing with Domestic Systemically Important Banks (D-SIBs)[1]. In its recent assessment, Reserve Bank of India (RBI) retained the classification of one public sector bank (SBI) and two private sector banks (HDFC Bank and ICICI Bank) as D-SIBs. While ICICI Bank continues to be in the same bucketing structure as last year, SBI and HDFC Bank move to higher buckets – SBI shifts from bucket 3 to bucket 4 and HDFC Bank shifts from bucket 1 to bucket 2[2]. This also means higher capital requirements for two banks applicable from 1 April 2025 – a risk mitigation mechanism.

Another area where the central bank has established risk mitigation principles is around compensation for Whole Time Directors/ Chief Executive Officers/ Material Risk Takers and Control Function staff. The guidelines issued in November 2019[3] focus on aligning compensation with risk outcomes resulting in the regulator providing guidance on fixed and variable compensation within certain proportions and variable compensation within certain cash and non-cash proportions.

Recently in response to a question on RBI's oversight on compensation, the RBI Governor said: "In private sector banks, the compensation package of only the CEO and other wholetime directors comes to the Reserve Bank for approval. Everybody knows that it is ultimately the nomination and remuneration committee (NRC) of the bank boards and the boards of private sector banks, which are expected to decide the compensation package of the banking executives including the whole-time directors and the CEO. In almost all cases except a few, we find that the increase in the package is not commensurate with the business growth of the bank. On the contrary, if the bank's performance is going down, you cannot have a situation of excessive increase in the compensation package. So, very few cases where such things, we put some restrictions. In most of the cases, we return it to them saying, "Please relook and come back to us." So, we do not put any restrictions on that."[4]

The focus of this article is on the non-cash portion of variable compensation which is in the form of "at the money" Stock Options (options granted at share price on grant date as exercise / strike price) for MD/CEO, WTDs and Senior Management in most private sector banks. We believe that to focus on effective risk management (discourage excessive risk taking), to ensure that the compensation package is aligned with "pay for performance" principles, to align compensation with the interest of all stakeholders including the shareholders and to ensure that compensation remains competitive and not excessive, it is time for the Nomination & Remuneration Committees (NRCs) of the private sector banks to critically evaluate the efficacy of "at the money" stock options for senior leadership. Let's review each of these points one by one.

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[1] https://rbidocs.rbi.org.in/rdocs/Content/PDFs/DSIBFRAMEWORK214867632E8B4A6FAE7FA736322CC2AC.PDF

[2] https://rbidocs.rbi.org.in/rdocs/PressRelease/PDFs/PR1556064BC5B7B7E546818127F654CFA3128A.PDF

[3] https://rbidocs.rbi.org.in/rdocs/notification/PDFs/NOTI898C120D41D0E3465B8552E5467EDD7A56.PDF

[4] https://rbidocs.rbi.org.in/rdocs/Speeches/PDFs/GOVERNORSINTERACTION031120233CBEF2C494514ADD8991795067B6526A.PDF

Effective Risk Management & Discouraging Excessive Risk Taking: The RBI Guidelines on Compensation of Whole Time Directors/ Chief Executive Officers/ Material Risk Takers and Control Function staff are based on FSB Principles and Implementation Standards for Sound Compensation Practices and the Supplementary Guidance issued by FSB in March 2018 on the use of compensation tools to address misconduct risk. Here, we would like to quote from FSF Principles for Sound Compensation Practices: *"Thus, when implementing the principle that the mix of cash, equity and other forms of compensation should be consistent with risk alignment, it is not obvious that more equity and less cash always increases the employee's incentive to align risk with the firm's appetite. The mix is likely to differ across employees and to involve a smaller cash component the more senior the employee.* ***Some evidence implies that traditionally structured options, which are out-of-the-money when granted, are inferior to ordinary equity because the asymmetric payoff properties of options offer incentives to take too much risk"[5].*** As for the evidence, FSF Principles for Sound Compensation Practices also refers to studies that have proved that out of money options induce greater risk in the bank / institution. Simply put, it is being argued that an "at the money" option or "out of money" options put a considerable focus on stock price performance which may lead the senior management to take on strategies that may induce excessive risk for the institution in long-term (recent RBI concerns on growth in amount of bank lending to NBFCs leading to an indirect exposure to unsecured loans and subsequent increase in risk weights on categories of unsecured loans is a case in point).

Alignment to Pay for Performance Principles: The question here is how we define performance and is it right to see it only from the lens of stock price performance, something that "at the money" options drive. In a classic traditional stock option, there is an inherent performance condition of stock price increase, if there is no increase, the executive doesn't gain anything from the option. Quoting from the FSF Principles for Sound Compensation Practices again: ***"However, options that are in-the-money when granted might have different properties in that they would be similar to ordinary equity in terms of upside payout but, like a clawback, would reduce compensation in event of poor firm performance. The goal should be a mix of cash, ordinary equity, and appropriately structured options that generates a closer match between executive incentives and the long term stewardship of the firm than in the past"[5]***. Hence, "at the money" stock options are not the only way to uphold the pay for performance principles. An "in the money" option plan structured with appropriate linkages with Bank's performance can be explored.

Competitive and not Excessive Compensation: Since the compensation guidelines are structured in a way whereby a portion of variable pay needs to be converted to non-cash component, there has to be a methodology to convert the rupee value to stock options. Using option fair value (most often calculated using a Black-Scholes model) is perhaps the most preferred approach. In our view, there are a number of pitfalls in this approach e.g., does fair value of option based on Black-Scholes represent true worth or potential. The answer may vary depending on the entity whose share price we are talking about. Today, the private sector banking industry in India has institutions that are at varied life cycle stages, varied strategies (some are in turnaround situations) and the long-term payoffs may differ considerably from what Black-Scholes tells us today and these payoffs could be way excessive than what was intended. Secondly, if the stock price is under pressure / stagnant for whatever reasons (may also be due to exogenous factors), executives don't see value in stock options, so while the compensation gets delivered on paper, there is no or low realized compensation from option plan which in turn puts pressure on increasing the fixed pay. Since variable pay and consequently equity compensation is based on fixed pay, the same also goes up leading to an excessive pay spiral and higher dilution for the shareholders.

In Conclusion

India is a market where financial inclusion has a long way to go and considerable value to be created for financial institutions. One may argue that stock options align with this objective and there is no denying that fact. However, we do see an opportunity for NRCs not to have heavy reliance on "at the money" stock options and balance the non-cash portion with mix of equity instruments that balance multiple objectives e.g., a combination of "at the money" stock options and Performance Based Restricted Stock Units (structured as stock options with face value

[5] https://www.fsb.org/wp-content/uploads/r_0904b.pdf

as exercise price and where the vesting is contingent on both continued employment and performance of the bank on certain fundamental metrices that reflects and balanced performance on growth as well as effectively managing the risk). Over that last one year, at least three private sector banks have introduced such a structure, albeit for the lower than leadership levels of management. In fact, one of the banks in its shareholder resolution has clearly specified that MD & CEO, EDs, KMPs, Senior Management Personnel and Material Risk Takers are excluded from the plan. The risk often flows from the top, if the incentive structure of leadership team encourages excessive risk taking, the same will flow down at lower levels in some form. Post financial crisis, globally, there has been a significant shift away from "at the money" options in banking sector and performance-based share plans have come to the fore with performance metrics like Return on Tangible Equity (RoTE), Return on Tangible Capital Employed (RoTCE), Return on Assets (RoA), sustainability goals etc.[6] – the selection of performance metrics obviously depends on the Bank's strategy in medium to long term and should be defined and governed by the NRC / Board. The answer for India, in our view, presently lies around exploring a mix of instruments. The institutional shareholder advisory bodies in India also need to appreciate this point of view while taking a call on their stand on an equity-based compensation plan resolution.

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[6] Source: Proxy Filings / Annual Reports of various global banks

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