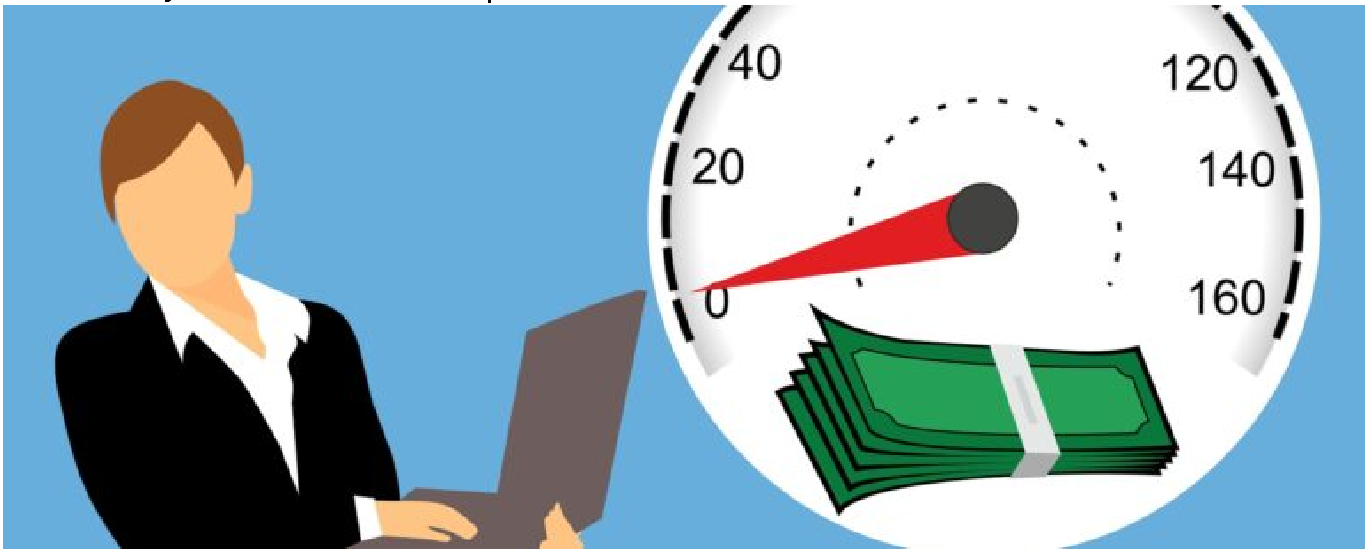
RBI Guidelines On Updated Compensation Policy For NBFCs: An Analysis
written by Aurelia Menezes | June 13, 2022



Compensation Policy For NBFCs

The RBI recently released a notification on the Guidelines on Compensation of Key Managerial Personnel (KMP) and Senior Management in NBFCs dated April 29th 2022 vide Circular RBI/2022-23/36 DOR.GOV.REC.No.29/18.10.002/2022-23 ("Notification"). This has been released in furtherance of para 3.2.3 (h) of Circular DOR.CRE.REC.No.60/03.10.001/2021-22 dated October 22nd 2021 dealing with the framework for Scale Based Regulation for Non-Banking Financial Companies ("NBFCs"). The notification provides a framework for formulating a compensation policy for certain NBFCs based on the applicability, as enumerated later in the article.

Legal Context

NBFCs are defined under Section 45 I (f) of the RBI Act, 1934 as

(i) a financial institution which is a company;

(ii) a non-banking institution which is a company and which has as its principal business the receiving of deposits, under any scheme or arrangement or in any other manner, or lending in any manner;

(iii) such other non-banking institutions or class of such institutions, as the Bank – with the previous approval of the Central Government and by notification in the Official Gazette – may specify.

The notifications seek to increase regulatory oversight by RBI over the management of NBFCs considering its bearings in the financial landscape. RBI's view of ensuring better management outcomes with appropriate compensation packages is expected to result in more efficient decision-making by NBFCs.

Applicability Of The Notification

1. The Notification pertains solely to NBFCs.
2. It is applicable only to the middle, upper and top layers of NBFCs which are not government-owned. This implies NBFCs that are base layer'[1] or government-owned are outside the purview of this Notification. This classification is based on the scale-based regulations of NBFCs by RBI.[2]
3. The Notification references the remuneration of KMPs[3] and senior management[4] members and not any other employees/personnel.
4. The effective date of the Notification is April 1st 2023. This implies that there is no retrospective application of the Notification, giving ample time for NBFCs to make internal changes in line with the Notification prior to its

effective date.

5. Chapter XIII under the Companies Act 2013 deals majorly with the appointment and remuneration of managerial personnel. However, since the guidelines in the Notification are broader, seeing how they concern senior management, both should be read holistically and in tandem.

Legal Analysis Of The Guidelines

- Nomination and Remuneration Committee (“NRC”): The Notification states that the NRC and Risk Management Committee[5] (“RMC”) must work in sync to match the compensation paid with the risks involved. All applicable NBFCs are mandated to form NRCs, which are required to have the constitution, powers, functions and duties as per Section 178 of the Companies Act, 2013. The NRC is entrusted with framing, reviewing and implementing the compensation policy, which must be approved by the board of the company.
- Principles of compensation: The compensation must align with the risk related to the decision-making process. It must be paid keeping in view risk-related timelines. Further, the amount of compensation to be paid must be commensurate with the extent/magnitude of risk involved. The compensation package can comprise both fixed and variable pay and may also be a mix of cash, equity or other forms in line with projected risk factors.

  In this context, it is pertinent to mention the two categories of compensation i.e., fixed and variable. Fixed pay is guaranteed pay or fixed salary paid irrespective of risks taken and is not performance-linked. Variable pay, on the other hand, is similar to performance-linked incentive pay which promotes risk-taking measures.

  For this purpose, variable pay may be deferred to the time horizon of the risks. For instance, if the risk takes shape after [*x*] years, then compensation must be deferred by [*x*] years to ensure compensation is not affected by immediate payment. At higher levels of responsibility, the proportion of variable pay needs to be higher since accountability increases proportionally with higher risk-taking.

  The Notification stresses the need for a good balance between both these types of pay structures to promote efficiency. The reasonability of the pay structure in the compensation policy depends on a case-to-case basis, factoring in the role played and the risk factors involved by setting appropriate objective criteria for such compensation.

  For instance, the role of a Company Secretary as a Key Managerial Person (KMP) is primarily concerned with regulations and compliance and does not involve business expertise – as such, they must have a higher fixed pay component vis-a-vis a variable pay component. On the other hand, A Chief Executive Officer, whose role is centred around making risky business decisions, must have a higher proportion of variable pay vis-a-vis fixed pay as they are accountable for risk-taking decisions and ought to be incentivized for the same.
- Guaranteed bonus: A bonus has no bearing on the performance of the individual. The bonus is guaranteed based on the fulfilment of certain criteria as may be specified in the compensation policy. The Notification states that a guaranteed bonus should neither be considered part of fixed pay nor of variable pay and the same is not payable to KMPs and senior management. However, a guaranteed bonus can be paid to new employees as part of a sign-on bonus whereby potential employees can be incentivized to join NBFCs.

- Malus/Clawback: The Notification mentions that *“deferred compensation may be subject to malus/clawback arrangements.”* To elaborate further, a malus arrangement is one where the NBFC is permitted (under certain circumstances) to prevent the payment of deferred compensation. In this arrangement, the compensation once paid cannot be withdrawn at a later point in time. On the other hand, a clawback arrangement is one where (subject to the satisfaction of certain events/circumstances) the employee can be asked to return the variable pay received to the NBFC. The compensation policy with respect to malus/clawback must mandatorily apply for the period equal to at least the deferred and retention period.[6] Provisions for including these arrangements must be made in the compensation policy based on the set criteria which need to be formulated carefully. The events that could trigger these provisions ought to be neither too wide nor restrictive. The Notification itself mentions two such events, namely when the NBFC displays poor financial performance or there is proof of misconduct by an employee. These clauses in the compensation policy enumerate a carrot-and-stick approach where the employees are rewarded only if the risk element materializes successfully based on the business decision taken, failing which the reward (variable pay) is taken back or withheld. Moreover, clear and fair procedures must be formulated in the policy while exercising discretion for assessing the personnel’s performance against the malus/clawback provisions.

Rationale For The Formulation Of Compensation Policy Guidelines

The primary purpose of the Notification is to "... address issues arising out of excessive risk-taking caused by misaligned compensation packages of KMPs and senior management". There is a prevalence of moral hazard problems in the financial industry caused by the too-big-to-fail phenomenon (such as systemically important NBFCs), implicit/explicit government guarantees and deposit insurance systems that might encourage the management of NBFCs to adopt more risky business strategies as they do not have to pay directly for any negative consequences of their extreme risk-taking.[7] These guidelines seek to make the KMPs and senior management more accountable in their decision-making.

Significance Of The Notification In The Functioning Of NBFCs

The Notification certainly helps streamline and systemise compensation packages by creating a policy that enforces proper accountability. On the one hand, low compensation can lead to risk aversion, which can be tactfully handled if the compensation package is designed appropriately, leading to a boost in business and an increase in value for shareholders. On the other hand, high compensation encourages excessive risk appetites which can be detrimental to the NBFC due to systemic imbalance and financial instability. Like the movie, *Top Gun: Maverick* puts forth, “It’s not the plane. It’s the pilot.” Similarly, the success of any NBFC depends on the prudent decisions taken by the KMP, senior management and the board.

Moreover, NBFCs need to bear in mind certain legal considerations and suitably amend and formulate the NRC policy when dealing with ESOP (Employee Stock Ownership) options given to KMPs and senior management. ESOPs and other management incentives must sync with the compensation policy based on the guidelines as provided in the Notification. It also becomes important to review and realign the employment contracts of KMPs and senior management with pre-decided compensation packages to ensure compliance with the

Notification.

The Way Forward

Despite the Notification being applicable from April 1st 2023, the necessary NBFCs must immediately begin aligning their internal procedures to comply with the mandatory guidelines to assist the transition to them smoothly. Existing remuneration policies currently being followed by the NBFCs should be reviewed to make the necessary changes to be compliant with the Notification. The management of NBFCs has sufficient time in this regard to implement the changes.

Through an efficient compensation policy based on the guidelines of the RBI, the right managerial environment will not only help in the growth and profitability of NBFCs but also lower the threat of financial crisis such as the recent IL&FS predicament.

Also, the RBI through this Notification has sought to bring in regulatory measures for NBFCs since banks are considering the extent of their impact on the financial market – especially in the wake of the IL&FS and DHFL crisis among others. The Notification by RBI complements a slew of various other measures taken by the bank for better regulatory oversight over NBFCs.

Contributed by Aurelia Menezes, Partner & Abhilasha SG, Associate