IRDAI's Latest Guidelines on Executive Compensation - An Equity Compensation Perspective

With a view to bring-in further reforms in the Executive Compensation in Insurance Companies in India, the Insurance Regulatory and Development Authority of India (**"IRDAI"**) has recently notified new Guidelines in replacement of earlier one. The new Guidelines have significantly redefined the role of Equity compensation (**"ESOPs"**) among other things. This write-up seeks to analyze and highlight the important provisions with particular reference to ESOPs in the new regime.

1. Background

1.1 Insurance companies are an important part of the overall financial system. Executive compensation in some insurance companies tended to base on short-term profits without adequate linkage to the long-term risks emanating from such executives' decisions or actions. The bonuses/ incentives at times used to encourage excessive risk taking by the executives resulting in a potential threat to the financial system

1.2 Keeping these in view and also in alignment with the norms of the Financial Standards Board, recommendation of International Association of Insurance Supervisors, G-20 Nations Forum, and Basel Committee on Banking Supervision, the Insurance Regulatory and Development Authority of India ("**IRDAI**") had issued guidelines ("**Erstwhile Guidelines**") on 5th August 2016 seeking to govern the remuneration of Non-executive Directors ("**NEDs**"), Chief Executive Officer ("**CEO**"), Whole-time Directors ("**WTDs**") and Managing Director ("**MD**") of private sector insurance companies in India.

1.3 Upon observation of the workings of the Erstwhile Guidelines up till now and with a view to bring-in further reforms while keeping the original spirit intact, the IRDAI has issued the 'Guidelines on Remuneration of Directors and Key Managerial Persons of Insurers' ("**New Guidelines**") on 30th June 2023 which has superseded and replaced the Erstwhile Guidelines.

1.4 These New Guidelines have become effective from the financial year 2023-24 and shall apply to all private sector insurers ("**Insurance Company**") excluding the Foreign Re-insurance Branches operating in India.

1.5 The New Guidelines are broadly distinguished from the predecessor on account of the following additional provisions as to:

a) Coverage of the remuneration of Key Managerial Persons ("**KMPs**"); and

b) Redefinition of aspects of Variable pay ("**VP**") including mandatory component of Share-linked Instruments, new norms of ratio of VP with the Fixed pay ("**FP**"), VP deferral, malus and clawback, accounting and disclosures requirements.

1.6 This write-up is primarily oriented towards the Share-linked Instruments ("**ESOPs**") referred to in these New Guidelines and seeks to analyze and highlight the important provisions besides finding-out whether any provision may create difficulties or need further clarity

2. Our analysis and views

2.1 The New Guidelines govern the remuneration of (i) NEDs, on one hand and (ii) KMPs (including WTDs/ CEO/ MD) on the other. As the NEDs are not eligible for any equity linked compensation, the aspects of their remuneration are not further discussed here.

2.2 Aspects of remuneration of KMPs

It is important to know who is or may be classified as a KMP. As per statutory definition given in the IRDAI (Registration of Indian Insurance Companies) Regulations, 2022, this term includes members of the core management team including all WTDs, CEO, MD and the functional heads one level below the MD or the CEO, including the Chief Financial Officer, Appointed Actuary, Chief Investment Officer, Chief Risk Officer, Chief Compliance Officer, and the Company Secretary. It seems that the Chief Human Resources Officer, Chief Information Officer, Chief Marketing Officer and other CXOs, if any, may be covered subject to their being one level below the MD or the CEO.

2.3 A comparative study of key provisions in Erstwhile Guidelines and that in the New Guidelines may be helpful for a quick understanding of the current position:

Sr. No.	Parameters	Erstwhile Guidelines	New Guidelines	Our broad observations
1	Applicability and scope	• All private sector insurers • Remuneration of WTDs/ CEO/ MD	• All private sector insurers (excluding the Foreign Re-insurance Branches operating in India) • Remuneration of all KMPs (including WTDs/ CEO/ MD)	A new area of governance and compliance for newly covered personnel like CXOs and others one level below the CEO or MD.
2	Composition of VP	Cash, share-linked instruments, or both but **excluding ESOPs**	• Cash, share-linked instruments, or both but **including ESOPs** • Cash linked stock appreciation rights ("CSARs"), Phantom, etc. shall qualify as cash benefit	Treatment of ESOPs as part of VP may significantly tilt the existing VP-FP ratio and needs revision for new pay cycle.
3	Norm of VP and FP ratio	• Proper balance between FP and VP • No specific ratio	• Minimum VP is 50% of FP • Maximum VP is 300% of FP	• VP should be linked to performance • Higher VP percentage applies for higher levels.
4	Cash and non-cash components of VP	Proper balance between cash and non-cash components (other than ESOPs)	Mandatory non-cash disbursal (**say by, ESOPs**): • At least 50% of VP, if VP is up to 200% of FP • At least 70% of VP if VP is above 200% of FP	Cash and non-cash balance is no more subjective.

Sr. No.	Parameters	Erstwhile Guidelines	New Guidelines	Our broad observations
5	Deferral of VP	• Deferral requirement only in case VP is 'substantial' (i.e. when VP is 50% or more of total pay) • If VP is substantial, 40% to 60% of VP required deferral	• Deferral of minimum of 50% of VP • No deferral if VP is up to Rs. 25 Lac for a particular year	Deferral of VP has become a rule (subject to exception of the threshold of Rs. 25 Lac).
6	Period/ manner of deferral	• Minimum 3 years • Equal/ uniform vesting over the vesting period • Annual vesting was not explicit	• Minimum 3 years with equal vesting • Vesting on annual basis • 1st vesting after minimum of 1 year from the date of grant	• New regime seeks time that too at an annual rest for vesting of VP. • Presumably, this is to assess, align and adjust the vesting of VP with the risks.
7	Quantum of ESOPs at individual level	• ESOPs not a part of VP • 'Reasonable' quantum of ESOPs could be granted ("reasonable" was not specified)	• ESOP entitlement is based on fair value of: i. equity shares in case of an unlisted Insurance Company ii. ESOPs in case of a listed Insurance Company • An unlisted Insurance Company can issue ESOPs of its listed promoter company	• ESOPs being included as VP, may be of great help to disburse non-cash VP. • However, it needs careful structuring. • For the purpose of benefit computation, the methodologies spelled are different for unlisted and listed Insurance Companies; which need clarity[1].
8	Annual / Overall Ceiling of ESOPs at Company level	• There was no ceiling for grant of ESOPs • However, exercise of ESOPs beyond 1% and 5% of paid-up equity required prior approval of IRDAI	Ceiling for grant of ESOPs as a % of paid-up capital: i. 1% per year, in case of unlisted Insurance Company; and ii. 5% overall, in case of any Insurance Company	• These ceilings seem to impact the negotiated VP planned to be delivered by way of ESOPs • Say, more than 1% ESOPs are required in a particular year (for all KMPs), this ceiling may result in curtailment of the KMPs' VPs. • Accordingly, these ceilings may be revisited.
9	Issue of Sweat equity	There was no restriction on issuance of Sweat equity	Issuance of Sweat equity is restricted for KMPs	The reason behind such a change seems to align with the principle of deferment of benefit rather than allotment on day one.

[1] *However, in case an interpretation is made basis what other Regulators have prescribed and with reference to applicable Accounting Standard, valuation basis Fair value of ESOPs (as specified for listed Insurance Companies in the New Guidelines) seems appropriate.*

Sr. No.	Parameters	Erstwhile Guidelines	New Guidelines	Our broad observations
10	Impact of deterioration in financial performance	It should lead to contraction in VP	It should lead to contraction in VP (including ESOPs), even reduced to "**Zero**"	Insurance Companies require appropriate structuring in ESOPs (say in vesting conditions) to factor-in this principle.
11	Malus/ Clawback	• There was no provision on Malus • Clawback upon negative financial performance resulting in forfeiture of unvested VPs	• Introduction of Malus that prevents vesting of unvested VPs/ ESOPs • Reframing of Clawback in great details with stringent conditions that may even result in taking back of paid VP/ vested & exercised ESOPs	• IRDAI requires articulation of scenarios which will trigger Malus/ clawback which need to be specified in the VP/ ESOP policy. • This clause covers the entire VP/ ESOPs.
12	Treatment upon separation from employment/ service	Not specified	• In case of retirement/ resignation/ death of a KMP during the deferral period, the deferred pay may be paid as per the employment contract agreed between the Insurance Company and the concerned KMP • In case of termination due to misconduct, all the VPs/ ESOPs (vested or unvested) shall be forfeited	• In case of ESOPs, the employment contract should comply with the Companies Act, 2013 and relevant SEBI Regulations as to treatment of ESOPs. • This will ensure compliance not only with the provisions of the IRDAI but also with that of other statutes.
13	Accounting	In case of annual remuneration to WTDs/ CEO/ MD in excess of Rs. 1.50 Crs, such excess needs to be borne by the shareholders' account	In case of annual remuneration to KMPs (including WTDs/ CEO/ MD) in excess of Rs. 4.00 Crs, such excess need to be borne by the shareholders' account	While the principle of accounting remained the same, the threshold amount got enhanced.
14	Annual disclosure to IRDAI	Reporting requirement in relation to ESOPs upon grant	Apart from usual disclosures in the Annual Report as regards the WTDs/ CEO/ MD, the details of the remuneration of all KMPs have to be provided to the IRDAI on annual basis in the prescribed format	Additional disclosures of remuneration of all the KMPs (including WTDs/ CEO/ MD) to IRDAI are made mandatory on an annual basis.

3. Overall impact and points needing clarity

3.1 Earlier, ESOPs were not counted as a part of total compensation; however, the New Guidelines changed this scenario.

3.2 The new ceilings of ESOPs in terms of grant of 1% per year in case of an unlisted Insurance Company, with an overall ceiling of 5% of the paid-up equity capital for all type of Insurance Companies (both listed and unlisted) seem to impact the VP of KMPs adversely, particularly when the conversion of the non-cash VP would require more than 1% in a given pay cycle and over the years, the total number of ESOPs granted may reach the overall ceiling.

3.3 Even though the New Guidelines are clear, few aspects need clarity like whether reference to the “fair value of the equity shares” of an unlisted company for the purpose of determination of ESOP entitlement of its KMPs should be read as “fair value of the ESOPs” as this understanding seems in due alignment with what is stated in the context of listed Insurance Companies.

3.4 Further, while referring to “fair value of ESOPs”, prescription as to the methodology for such valuation seems highly desirable as may bring uniformity and ease of compliance across wide cross-section of Insurance Companies in India.

3.5 The New Guidelines require linking of the fate of VPs including the vested or unvested ESOPs with the deterioration in the financial performance, known as malus and clawback. For effective legal enforcement, it requires scenario building and appropriate communication with the KMPs primarily in their employment agreement as to in which circumstance(s) malus and claw-back would trigger.

3.6 Given the new approach for ESOPs, the existing ESOP policy and practice may be checked for any potential inconsistency and be aligned so as to ensure compliance in letter and spirit. The new regime though limits the quantum of ESOPs (as a part of VP) at the time of grant, but does not cap the eventual upside in their value accruing at the time of exercise and consequent sale of shares. This connotes value proposition for a growing Insurance Company seeking to bring win-win for all its stakeholders

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