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Clawback in Executive Compensation: Tackling Managerial Myopia

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Abstract

This paper aims to determine whether clawback provisions are an effective compensation tool for deterring executives from increasing a company's risk exposure. By examining data from two cases involving Indian private banks that implemented clawbacks for their former managing director and CEO, the study argues that regulatory mandates for including clawbacks in executive compensation can promote a long-term focus among executives. This, in turn, helps companies avoid potential financial and reputational damage caused by willful or negligent actions of their executives. In contrast to the western world our findings show that the reasons for implementing clawbacks are more linked to non-financial misconduct than financial. The paper contributes to the literature on clawbacks in executive compensation within emerging economies and underscores their importance in mitigating short-termism in corporate decision-making.

Keywords: Clawback, executive compensation, India, private banks

1. Introduction

For a long time, executive compensation has been used as a tool to align executive incentives with the growth and profitability targets of a company. An executive compensation package typically includes a base salary, bonuses, short-term incentives, long-term incentives, benefits, severance, and retirement payments. However, in recent decades, executive compensation has faced significant criticism for being excessive and for encouraging managerial short-termism (Magnan & Martin, 2019). The issue is complex and contentious, as CEO salaries have continued to rise even when organizational performance falls below shareholder expectations. Furthermore, recent corporate scandals involving executive misfeasance, fraud, and material financial restatements have highlighted the need to revisit executive compensation to ensure effective risk management and reduce managerial short-termism.

Managerial short-termism in strategic decision-making has emerged as a significant challenge for organizations aiming for good corporate governance (Kraft, Vashishtha, & Venkatachalam, 2018; Ridge, Kern, & White, 2014). This issue manifests across various types of organizations, including for-profit, non-profit, and academic institutions. A key reason for managerial myopia is the design of top management team (TMT) compensation, which is often tied to short-term performance measures. This incentivizes executives to prioritize short-term decision-making. A recent report on CEO tenure rates highlights that the median tenure for CEOs of large-cap (S&P 500) companies decreased by one year in the five years leading up to 2017 (Harvard Law School Forum on Corporate Governance and Financial Regulation on CEO tenure, 2018). As tenures shorten, CEOs may be more inclined to engage in managerial short-termism to enhance personal welfare at the expense of long-term firm value. This short-termism has also been linked to excessive risk-taking, which can significantly damage organizational brand image and long-term growth.

In this context, clawback provisions in executive compensation are viewed as a potential solution to reduce managerial myopia (Fung, Raman, Sun, & Xu, 2015). Scholarly research on clawback provisions considers them a risk management tool, allowing firms to recoup previously paid compensation or forfeit deferred compensation, such as unvested stock options, from executives who have underperformed or violated ethical and compliance standards (Erkens, Gan, & Yurtoglu, 2018). Recently, there has been a growing trend of including clawback provisions in executive compensation contracts. However, recent research raises questions about whether clawbacks are an effective corporate governance tool (Erkens et al., 2018; Maag, 2018). Hence, this study investigates whether clawback provisions are an effective governance mechanism by drawing on a qualitative analysis of case studies from two private banks operating in India. Our research is both important and timely, as most existing studies on clawback provisions are based in Western contexts, primarily the U.S. (e.g., Brown et al., 2015; Chen, Greene, & Owers, 2015), making it challenging to apply these findings to emerging economies like India. Our study is particularly relevant given the significance of clawback provisions in reducing shareholder costs associated with executive misconduct (Erkens, Gan, & Yurtoglu, 2014).

2. Legislative background and clawback

The compensation practices of major financial institutions played a significant role in the global financial crisis of 2008. Employees were often incentivized to prioritize short-term profits without adequately considering the risks and long-term impact on their organizations. These flawed incentives resulted in excessive risk-taking, posing a severe threat to the global financial system. Consequently, compensation practices have garnered increased attention in regulatory reform efforts.

In November 2019, the Reserve Bank of India (RBI) mandated that private sector and foreign banks include malus and clawback arrangements in their compensation policies. A malus arrangement allows a bank to withhold part or all of the deferred compensation. At the same time, a clawback is a contractual agreement in which the executive agrees to repay previously paid remuneration under certain conditions. The RBI specified that these banks must incorporate specific scenarios into their compensation policies that trigger the malus and clawback clauses, potentially affecting the entire variable pay. Additionally, the RBI advised that when establishing criteria for applying malus and clawback, banks should specify a period during which these provisions can be enforced (Reserve Bank of India, 2019).
From the perspective of principal-agent theory, clawback provisions serve as a corporate governance intervention, acting as a disciplining device to discourage future opportunistic managerial behavior (Erkens, Gan, & Yurtoglu, 2014; Iskandar-Datta & Jia, 2013). In recent years, firms have adopted clawback provisions to mitigate the dysfunctional effects of executive compensation. Specifically, clawbacks allow firms to recoup excess incentive compensation, such as bonuses, in the event of a later restatement of previously issued financial statements (Fung, Raman, Sun, & Xu, 2015) or due to excessive risk-taking, negligence, and wrongdoing by financial executives (Arena & Nguyen, 2019). By enabling firms to recover compensation from executives in case of a breach of fiduciary duty, clawbacks provide a form of discipline likely to reduce the likelihood of misconduct by corporate managers. Unlike the legal and financial systems, which offer several ex-post disciplinary mechanisms, compensation clawbacks provide an ex-ante form of discipline (Arena & Nguyen, 2019).

3. Methodology

The study employed a case study design, which is well-suited for generating managerially relevant knowledge as it involves detailed interactions with practitioners dealing with real business situations (Gibbert et al., 2008). Unlike single case studies, multiple cases enable a replication logic where cases function as multiple experiments that can validate or invalidate emerging conceptual insights (Yin, 2003). Following the recommended approach for case study research, we selected theoretically relevant cases and conducted analysis on the collected data. Data were gathered from multiple newspaper articles regarding the implementation of clawback at ICICI and Yes Bank, targeting their former Managing Directors and Chief Executive Officers.

3.1 Case description

ICICI Bank

Incorporated in 1994 and headquartered in Mumbai, ICICI is a leading private sector bank in India that offers a wide range of banking and financial services to corporate and retail customers through various delivery channels and group companies. Shareholder activists accused Chanda Kochhar- CEO of ICICI Bank, of not disclosing a potential conflict of interest after ICICI sanctioned loans to Videocon, whose owner, Venugopal Dhoot, had business ties with her husband. Most of the loans given to Videocon group had turned into non-performing assets (NPAs). Amidst increasing pressure from shareholders, investors, media, and whistleblowers, as well as regulatory and probe agency investigations, the board launched an independent inquiry into the matter. Kochhar's defense that she was unaware of her husband's business dealings with Videocon did not satisfy stakeholders. In 2019, the ICICI Bank board treated the exit of its former CEO, Chanda Kochhar, as a dismissal. This decision followed an internal probe under Justice B N Srikrishna, which found that Kochhar had violated the lender's norms or code of conduct. The board resolved to retroactively classify Kochhar's resignation as a termination after the independent inquiry committee set up by ICICI indicted her for failing to manage a conflict of interest and lack of disclosure. Consequently, the board decided to claw back all performance bonuses and stock options awarded to her during her tenure as CEO from April 2009 to March 2018 and revoke her existing and future entitlements.

Although the inquiry did not cover allegations of quid pro quo related to whether Videocon invested in Kochhar's husband's company in exchange for the loans, the committee's findings were sufficient for the board to classify Kochhar's resignation as a termination for cause under the bank's internal policies.

Yes Bank

Yes Bank, headquartered in Mumbai, is an Indian private-sector bank that commenced operations in 2004. It serves retail customers, MSMEs, and corporate clients. The Bank decided to claw back the performance bonus of its former managing director and chief executive officer, Rana Kapoor, who was also one of its founders and promoters. In May 2019, Yes Bank retrieved a US$220k bonus paid to Kapoor following directions from the Reserve Bank of India (RBI).

Facing issues with bad loans, Yes Bank came under scrutiny from the RBI for weak corporate governance. As of March 2019, Kapoor owned a 4.32 percent stake in the Bank. Notably, the RBI had earlier refused to extend Kapoor's tenure in October 2018 due to regulatory concerns, citing serious lapses in corporate governance and a deficient compliance culture at Yes Bank as reasons. Following RBI's directions, the Bank's Board of Directors approved the clawback of 100 percent of the performance bonus paid to Rana Kapoor for FY 2014-15 and FY 2015-16, net of taxes.

4. Discussion

Developing an appropriate compensation system for chief executives and top management is one of the most crucial responsibilities of the board. Typically, this task is delegated to the board's compensation committee in the current business landscape. While business risks can present opportunities for executives to profit personally, they can also increase the company's risk exposure. Therefore, firms must use compensation and other management tools to promote prudent risk-taking. These processes for managing risk should include, at a minimum, ex-ante processes as part of the broader governance and risk management framework.

Among the various tools available, clawback provisions are particularly important. Clawbacks allow the employer to recover or recoup previously paid compensation or to forfeit deferred compensation in cases of severe violation of the company's policies or code of conduct, ethical misconduct, errant financials (e.g., misstated earnings), willful negligence or poor judgment, any kind of cover-up (even if the executive was not involved in the decision-making or action), violation of employment covenants, deterioration in financial performance, and other triggering events.

The ICICI board's response to Chanda Kochhar's resignation is a prime example. They treated it as a dismissal after she was found guilty of breaching the bank's code of conduct. As a result, the board decided to claw back incentives paid from April 2009 to March 2018, along with stock options accrued since 2009, during her tenure as MD and CEO of the bank. Similarly, Yes Bank initiated a clawback following directives from the Reserve Bank of India. The board approved the recovery of 100 percent of the performance bonuses paid to Rana Kapoor for the fiscal years 2014-15 and 2015-16, net of taxes. No bonuses were paid for FY 2016-17 and FY 2017-18.

For ICICI, the key issues leading to the clawback were conflicts of interest, violation of the bank's code of conduct, and the abuse of position to sanction loans to the Videocon group, with which Kochhar's husband was associated. For Yes Bank, the primary concerns were serious lapses in corporate governance and a poor compliance culture. Our findings suggest that the reasons for implementing clawbacks are increasingly linked to non-financial aspects of corporate governance that can exacerbate managerial short-termism by incentivizing executives to make decisions that yield short-term gains but cause material harm to the company's stakeholders, including shareholders, customers, suppliers, employees, and the community. This contrasts with the Western literature on clawbacks, which primarily focuses on clawbacks in the event of accounting improprieties. Our findings indicate that there is now greater scrutiny of executive performance in relation to their remuneration packages, assessed against their governance practices and conduct. Although misconduct and risk management failures may take years to surface, the implementation of clawbacks sends a clear and reassuring message that simply vacating their positions does not absolve executives of their fiduciary responsibilities or any violations committed during their tenure.

5. Conclusion

Clawbacks are increasingly used in executive compensation to enhance financial stability and better align the interests of executives with those of the company's stakeholders (Chan, Chen, Chen, & Yu, 2012). This is necessary to curb managerial short-termism, which often comes at the expense of long-term goals. With a heightened focus on risk management, clawback policies are likely to become a standard feature to prevent potential financial and reputational harm resulting from executives' willful or negligent actions. The clawback clause offers several benefits to employers, including increased shareholder confidence in executive accountability, better alignment of risk and rewards, and a more favorable public perception. Overall, clawbacks can effectively promote sound corporate governance when used alongside risk management processes and effective board oversight.

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