

WHAT DETERMINES EFFECTIVE ENFORCEMENT OF CLAWBACKS IN EXECUTIVE COMPENSATION: EVIDENCE FROM INDIA

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ABSTRACT

Globally, there is increasing usage of clawback provisions (clawbacks) in executive compensation to align better the interests of executives and the company's stakeholders. Clawback conveys that mere resignations do not exonerate executives from their fiduciary responsibilities and violations during their tenure. Research indicates various benefits of adopting clawbacks that include improvement in financial quality reporting, lower abnormal accruals, reduced opportunistic managerial behaviour and more confidence of external stakeholders like shareholders and auditors in the internal control mechanism for firms. Merely adopting clawbacks may not necessarily provide these benefits in the absence of their effective enforcement. Enforcing clawbacks is riddled with challenges, considering the complex and ambiguous responsibilities of the top executives and the broader legal framework for compensation clawbacks. The issue relating to enforcement is more concerning in the case of companies adopting clawbacks for compliance only. Boards in these organizations sometimes may lack the commitment to implementation, which may lead to no enforcement or weak enforcement - such that the clawed-back compensation does not commensurate with the severity of the issue(s). Whilst research on clawback has been growing recently, little or no attention has been given to factors affecting effective clawback enforcement. Moreover, most of these studies have been conducted in the west with different corporate governance frameworks. Given this, drawing data from one qualitative in-depth case study of a private bank in India, we discern various factors that may affect the effective enforcement of clawbacks in an emerging economy context. Theoretically informed by stakeholder theory, our findings highlight the role of various internal and external stakeholders in effectively enforcing clawbacks. Based on our findings, we offer implications for policy and practice.

Keywords: *Clawback provisions, executive compensation, clawback enforcement, India*

INTRODUCTION

For a long time, executive compensation has been used to supplement organisational strategy by tying executive incentives with the growth and

profitability targets of the company. An executive compensation package typically consists of a base salary, bonuses, short-term incentives, long-term incentives, benefits, severance and retirement payments. However, in the last few decades, the compensation given to executives has received significant criticism for being outrageous and rewarding managerial short-termism. The subject has been complex and contentious, as, on average, CEOs' salary has been on the rise, even when organisational performance has fallen below shareholder expectations. Moreover, in recent times, there has been a spate of corporate scandals, where executives have been accused of misfeasance, fraud or material financial restatement, among others. Such scandals have accentuated the need to revisit executive compensation for effective risk management and reduce managerial myopia or short-termism in strategic decision-making, which has emerged as an organisation's key challenge. This problem is manifested in various forms across different types of organisations, including for-profit, not-for-profit and academic institutions. One of the important reasons for managerial myopia is how compensation is designed for the top management team (TMT) - linked to short-term performance measures, thereby incentivising executives to engage in decision-making for the short term [1]. The median tenure for CEOs of large-cap (S&P 500) companies has been reduced by one year in the preceding five years ending in 2017 [2]. With the shortening of tenure, CEOs often tend to engage in managerial short-termism to increase personal welfare at the cost of long-term firm value. Managerial short-termism has also been linked to excessive risk-taking, which can significantly affect the organisational brand image and long-term growth. In this regard, clawback provisions in executive compensation are seen as one of the ways to reduce managerial myopia, inducing better managerial decisions and reducing the risk-taking incentives of managers [3]. Scholarly work defines *clawback* in executive compensation as a corporate governance mechanism to manage risk and reduce managers' opportunistic behaviour by authorising the employer to recover or recoup previously paid compensation or forfeit deferred compensation such as unvested or other stock options in case of the triggering event(s) that result in material harm to the company's stakeholders-including shareholders, customers, suppliers, employees, and the community.

Recent literature states various benefits of adopting clawbacks that include improvement in financial quality reporting, lower abnormal accruals, reduced opportunistic managerial behaviour and more confidence of external stakeholders like shareholders and auditors in the internal control mechanism for firms [4]. Nevertheless, merely adopting clawbacks in compensation contracts may not necessarily provide these benefits in the absence of effective enforcement. Enforcing clawbacks is riddled with challenges, considering the complex and ambiguous responsibilities of the top executives and the broader legal framework for compensation clawbacks. The issue relating to enforcement is more concerning in the case of companies adopting clawbacks for compliance, where boards may lack the commitment to implement, which may lead to no enforcement or weak enforcement - such that the clawed back compensation does not commensurate with the severity of the issue(s). Whilst research on clawback

has been growing recently, little or no attention has been given to factors that may affect effective clawback enforcement. This study aimed to understand the enforcement of the clawback provisions. The research question for this study came from a moment of surprise when the ICICI board indicted and penalised Kochhar in January 2019 after having given her the clean chit for the same accusations in 2016.

The paper contributes to the literature on clawbacks in executive compensation and highlights its importance in reducing managerial short-termism in the corporate world. The paper draws on existing literature on clawback and offers a nuanced understanding of its enforcement by providing an in-depth analysis of a clawback decision taken by a top Indian bank against one of the most revered bankers in the country- Chanda Kochhar -former managing director (MD) and chief executive officer (CEO). The paper also provides pointers for designing a broad clawback policy, with clearly defined triggers, coverage of employees, compensation elements, and a look-back period for better enforceability. The authors argue that even without any mandatory requirement by the regulators, companies should include clawback in executive compensation, not limiting to financial misstatement as a trigger. This will increase long-term focus among the executives and help companies to avert any possible monetary and reputational harm that the company may have to bear due to the wilful or negligent actions of executives. Companies should carefully design clawback policies or revisit the existing ones for effective risk management and ease of enforcement. The paper contributes to the literature on clawbacks in executive compensation and highlights its importance in reducing managerial short-termism in the corporate world.

CLAWBACKS IN EXECUTIVE COMPENSATION

Scholarly work on clawback provisions for executive compensation has considered it a way to manage risk as it helps firms recover some of the losses from executives who have failed to perform up to the organisation's expectations or have indulged in ethical and compliance violations. Executive compensation, if not linked to non-financial parameters of corporate governance, can further managerial short-termism by incentivising executives to engage in decision-making for short-term gains. In this regard, the selection and weights of performance measures for providing incentives are essential for promoting executives to engage in behaviours and actions that align with the overall business strategy. Thus, a compensation policy linked to non-financial parameters can communicate to executives what is expected and how their performance will be evaluated.

Clawbacks authorise an employer to recover or recoup previously paid compensation or forfeit deferred compensation such as unvested or other stock options. In recent years, there has been a growing trend of including clawback provisions in executive compensation contracts. Clawback sends the message that

mere resignation from positions does not exonerate executives and directors from their fiduciary responsibilities and violations during their tenure. Few countries have taken measures to provide a regulatory framework to manage executive compensation. In the U.S, the Sarbanes-Oxley Act of 2002(SOX) required CEOs and CFOs of public companies to reimburse the employer any bonus, incentive or equity-based pay or profits derived from disposing of shares of the company in the issuance year of misstated accounts [1]. As mentioned earlier, the act does not mandate companies to have clawback provisions. The USA's Securities and Exchange Commission (SEC) is responsible for enforcing the clawback and can exempt companies if deemed necessary and appropriate (Section 304). The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) provides the framework to recover erroneous payments and mandates the insertion of a clawback provision in executive compensation [2]. Unlike SOX, Dodd-Frank shifts the responsibility of enforceability to individual companies but does not provide for the composition of clawback provisions. In the United Kingdom, the Corporate Governance code of 2014 provides that executive compensation plans should include provisions enabling companies to recover or withhold payment of any amount from paid or accrued income.

In 2012, the Reserve Bank of India (RBI), the banking regulator, introduced guidelines for banking and financial institutions to put in place modalities to include clawback and malus (an arrangement that allows the bank to withhold part or all of the deferred compensation) to enable bank boards to act against senior executives in cases of violations of the code of conduct and governance practices. These guidelines are intended to create more accountability among senior executives. The clawback provisions provide for the initiation of malus or clawback arrangements in executive compensation. A malus arrangement allows the bank to withhold part or all of the deferred compensation. A clawback is a contractual agreement in which the executive agrees to pay back previously paid remuneration under certain circumstances.

CASE DESCRIPTION

Headquartered in Mumbai, ICICI was a leading private sector bank in India. The bank offered a wide range of banking and financial services to corporate and retail customers through various delivery channels and group companies. World over, ICICI has earned numerous national and international awards for its innovative banking services. Kochhar joined ICICI (formerly ICICI Limited) as a management trainee in 1984 and played a crucial role in setting up and scaling the retail business of ICICI. Under Kochhar's leadership, the bank became the largest retail financier in India in five years, starting in July 2000. She was credited with steering the bank out of difficult times following the 2008 global recession [5]. She was promoted to CEO in May 2009 and became the youngest banker to head ICICI Bank at the age of 48yrs. She was a role model for many. She was one of the most revered bankers in the country. Under Kochhar's leadership, ICICI achieved various milestones, expanding its businesses and leveraging technology

to deliver more value to its customers [5]. She was conferred various prestigious awards, including the Padma Bhushan, one of India's highest civilian honours, in 2011. In 2015, she was featured in Time's 100 most influential people in the world, and in 2017 she was among the world's 100 most powerful women ranked by Forbes. She was also bestowed with the Woodrow Wilson Award, a top US award for global corporate citizenship, in 2017.

The controversy of quid pro quo and conflict of interest erupted in 2016 when a whistleblower and shareholder activist accused Kochhar of favouring Videocon by sanctioning loans against the bank's code of conduct and corporate governance standards [5]. It was alleged that Kochhar received gratification through her husband, who had a business relationship with Videocon's Dhoot. Dhoot, in return, enacted some dubious transactions to benefit Kochhar's husband.

PHASE 1

In July 2016, the Reserve Bank of India (RBI), the regulator for the banking sector, conducted a probe into the matter after the prime minister's office referred to the accusations of Kochhar's husband receiving windfall gains from his association with Dhoot's Videocon. RBI could not establish any conflict of interest in the approval of loans; however, it flagged that it could not determine funding sources in some transactions involving Kochhar's husband's firm, NuPower. ICICI board hired a law firm Cyril Amarchand Mangaldas, to probe the allegations. The law firm submitted its report in December 2016 and found no evidence of nepotism and conflict of interest against Kochhar, and the matter was treated as closed by ICICI. The ICICI board gave a clean chit to CEO Kochhar, reposing full confidence in her, and urged investors to be not "misled by rumours". The bank went on to highlight that its internal processes for credit approval were robust to state that no individual employee, irrespective of their position, could influence credit decisions at the bank. The board highlighted that most of its credit committee members were independent directors. In strident support of Kochhar, the bank mentioned about collective approval of the loan to Videocon by the board's credit committee. It stressed that Kochhar was not the committee chairperson that sanctioned the loans. Moreover, the board accepted Kochhar's explanation that she was not privy to her husband's business dealings with Videocon. The Chairman of the board, M. K. Sharma, openly came out in Kochhar's defence stating that the unfounded rumours were being spread to malign the bank and its top management.

PHASE 2

In March 2018, the media picked up Gupta's (whistleblower and shareholder activist) post, and the matter became a major headline. On March 31, 2018, the Central Bureau of Investigation (CBI), India's federal investigating agency, initiated a preliminary inquiry to investigate the nexus allegations between Kochhar's husband and Dhoot. In an exciting development, contrary to Kochhar's

assertions, her husband wrote to the ICICI board acknowledging his relationship with the Videocon Group in April 2018. In the same month, the Ministry of Corporate Affairs also ordered an inspection of NuPower and other companies related to the ICICI loan controversy. Following these developments, on May 24, 2018, the Securities and Exchange Board of India (SEBI) started proceedings against Kochhar and ICICI, issuing a 'show cause notice about the alleged violation of listing disclosure requirements in the case involving Videocon and NuPower. Recommending adjudication, it stated that "by not disclosing the details of her husband's dealings with Videocon, Kochhar has not complied with the provisions of listing agreement. Further, the bank failed to ensure that its directors comply with listing rules". Denying all charges levelled against her, Kochhar mentioned that she was unaware of the business dealings between her husband's firm and Dhoot in her reply to the notice.

Kochhar was placed in the dock for not disclosing a possible conflict of interest after ICICI sanctioned loans to Videocon's Dhoot, with whom her husband had business interests. Amidst growing pressure from shareholders, investors, media, and yet another complaint from a whistleblower, the stance of the board changed after regulatory and probe agencies started investigating the matter. Then only the BOD decided to institute an independent inquiry into the matter. Pursuant to this board decision, the audit committee appointed former Supreme Court of India Judge Justice B.N. Srikrishna as the Head of Inquiry on June 06, 2018. On June 18, 2018, the board announced Kochhar's leave until the closure of the investigation to facilitate an independent search into the charges. Around the same time, a new chairman-BOD was appointed after the term of Mr Sharma ended on June 30, 2018. Midway through the investigation, in October 2018, Kochhar sent her resignation, duly accepted by the ICICI board. In January 2019, the independent internal inquiry committee indicted Kochhar with the findings that she violated the bank's code of conduct, its framework for dealing with conflict of interest and fiduciary duties. That she violated applicable Indian laws, rules, and regulations. And her lack of diligence concerning annual disclosures while sanctioning loans to parties related to her played a role in making the bank's processes ineffective.

Kochhar's explanation that she did not know about her husband's business deals with Videocon did not cut much ice with the stakeholders. Even though allegations of quid pro quo concerning whether Videocon invested in Kochhar's husband's company in exchange for loans given by ICICI were beyond the scope of investigation by the aforesaid committee, the findings of the committee were enough for the board to treat Kochhar's resignation as termination for cause' under bank's internal policies.

Pursuant to the indictment by the enquiry committee, the ICICI board decided to retroactively treat the former managing director (MD) and chief executive officer (CEO) of ICICI, Chanda Kochhar, resignation as termination after the independent inquiry committee set up by ICICI indicted her for failing to deal

with a conflict of interest and lack of disclosure. They decided to claw back all performance bonuses and stock options given to her between April 2009 and March 2018 and revoke her existing and future entitlements.

ANALYSIS AND DISCUSSION

The clawback policy was in place for ICICI bank. The series of events stated in phase 1 and phase 2 showcases the role external stakeholders can play in implementing clawbacks when boards may fail to fulfil their fiduciary responsibilities. In phase 1, the BOD was standing with the CEO, having confidence in her, thereby compromising the enquiry process, which might have led to an unfair investigation resulting in a clean chit to the CEO. The top management team (TMT) headed by the CEO plays a vital role in the decimation of information required for investigation. Hence, it is not easy to have a fair investigation against a TMT member when they have the support of the BOD. The board, including the independent directors, not only failed to perform their duties of administrative supervision but also failed to ensure compliance with legal frameworks and reporting systems through proper and timely disclosures, failing in its accountability duties. In many ways, Kochhar's indictment later highlights the board's failure and its processes in the initial phase. The board could have taken remedial actions before things blew out of proportion.

In phase 2, the pressure created by the investigating agencies and supported by the media, investigating agencies and regulators forced the BOD of ICICI bank to set up an independent enquiry. After setting up an independent internal enquiry, the correct process was followed to send the CEO on leave until the investigation was on. Meanwhile, a new Chairman-BOD had been appointed, and the new board wanted to set the right tone at the top and demonstrate its commitment to corporate governance. Midway through the investigation, the CEO sends her resignation. It signals that something is wrong, and she wants to prevent her reputation and future damage. In the second phase, given the pressure from external stakeholders and the CEO not having the complete support of the BOD, a fair inquiry process followed, culminating in the indictment of the CEO.

The above case highlights the challenges faced in implementing clawback even in a highly regulated banking industry, wherein the regulators very well define the processes. It is important to note that, from the implementation perspective, clawbacks are difficult to enforce, particularly where judgement is required to decide whether the executive can be held accountable for the material, reputational, and financial harm suffered by the organization. In such situations, boards necessarily have to be vested with a reasonable level of discretion for implementing clawback in the company's best interest through a response team or a designated committee. It should be seen that the penalty on compensation should be commensurate with the severity of the issue or events that have occurred.

CONCLUSION

Globally, there is an increase in the use of clawbacks in compensation to improve financial stability and better align the interests of executives and the company's stakeholders. *Clawback* is warranted to check managerial myopia at the cost of long-term orientation. With increased focus on risk management, clawback policies are likely to be a standard feature to avert potential monetary and reputational harm that the organisation may have to bear due to wilful or negligent actions of executives. The clawback initiated by ICICI after the invocation of 'cause' termination was in line with the growing scrutiny of organisational performance measurements against governance practices and conduct. As a lesson, other companies' boards should understand that their actions should be guided by stakeholders' interests and not only the management. Many countries still do not have any regulations or guidelines for clawback in executive compensation. However, this should not deter boards from incorporating clawback provisions - which can enhance executives' accountability and keep a check on excessive risk-taking behaviour and managerial myopia. Broadly designed clawback policies can better serve as a strategic tool to focus on long-term value creation. External stakeholders like media, regulatory bodies and investigating agencies have to play an active role in implementing the clawback policy. Nevertheless, companies can tailor a well-thought-of clawback policy in alignment with the overall compensation philosophy and ensure effective enforcement through a responsible board (or a designated committee), particularly for discretionary clawback provisions. Otherwise, clawbacks will be another gimmick to deceive short-termism.

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