Governing Compensation: The New CBB Remuneration Rules in Bahrain

by Foutoun Hajjar - f.hajjar@tamimi.com - Manama

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It is widely believed that one of the contributing factors to the global financial crisis during 2008 was the unfettered and inflated remuneration schemes adopted by many of the leading global financial institutions.

Significant bonus payouts to senior executives had become commonplace amongst financial institutions. Said practices raised concerns both in terms of the transparency of banks' policies and as to the sustainability of the financial sector as a whole. In order to address said weaknesses and achieve greater transparency the Central Bank of Bahrain (the "CBB") has released mandatory remuneration rules for licensed financial institutions (applies equally to listed licensed financial institutions) in Bahrain (the "New Regulation") under Module HC-5 of Volume 1 and 2 of the CBB Rulebook. Under the New Regulation financial institutions are expected to disclose remuneration practices, capital adequacy and undergo internal evaluation to align compensation with risk management. The New Regulation came into effect on 1 July 2014.

It is hoped that the New Regulation will introduce tighter controls and monitoring mechanisms relating to compensation practices, whilst taking into account an institution's overall strategy and risk measurements. The New Regulation is aimed at enhancing confidence and building a robust system in Bahrain that brings financial institutions on par with international standards as set by the Basel Committee on Banking Supervision.

This article provides an overview of the New Regulation and analyzes some of the practical implications that its implementation may have on financial institutions.

Scope of the New Regulation

The New Regulation applies to Approved Persons and Material Risk Takers receiving an annual remuneration amount exceeding One Hundred Thousand Bahraini Dinars (BD 100,000) (approximately US$265,000). In calculating remuneration all types of compensation and benefits are included, for example, salary, education, transport and housing allowances, and health insurance.

Governance

Under the New Regulation, remuneration policies require the approval of the licensee's shareholders, and a remuneration committee formed by and consisting of the board of directors and the CBB.

i. Remuneration Committee

The New Regulation entrusts the board of directors (through the remuneration committee) responsibility for oversight of remuneration systems for all Approved Persons and Material Risk Takers by:

- approving the remuneration amount, policy and distribution of total variable remuneration; and

- monitoring and reviewing the remuneration policy and ensuring that effective controls such as back testing and stress testing of the remuneration policy are introduced.

ii. CBB and shareholders' oversight

Further, all incentive plans for Approved Persons and Material Risk Takers must be approved by the shareholders. Said plans are then subject to CBB approval and must be submitted to the CBB within three (3) months of the end of the financial year. Moreover, annual reports detailing the total amounts of remuneration as well as assessing compliance with the overall policies shall be submitted to the CBB. This requisite approval is meant to provide additional stakeholder scrutiny and regulatory control.

Remuneration Policies

In introducing the New Regulation the CBB directed financial institutions in the Kingdom of Bahrain on certain key matters which include: (i) the alignment of remuneration with risks (ii) fixed and variable remuneration (iii) bonus pool (iv) board remuneration (v) deferral of variable pay (vi) shared incentive plans.

i. Compensation and risk alignment:

Remuneration must be adjusted to take into account all tangible and intangible risks such as reputation, liquidity and cost of capital. Furthermore, the combination of forms of remuneration awarded should vary depending on the employee's role and should be consistent with said risk alignment. As such, two employees generating the same profit yet engaging in different levels of risks should not be treated in a similar manner.

ii. Fixed and variable remuneration

Licensed financial institutions are obliged to put in place policies relating to the forms of remuneration and provide a rationale of said policies to the CBB.

The CBB requires that a significant portion of the overall remuneration is weighted towards fixed remuneration for the following roles: risk management, internal audit, operation, financial controls, internal Shari'a review/audit and Money Laundering Regulatory officer. Whilst a significant portion of remuneration is weighted towards variable remuneration for board directors and executive management as said roles generally entail higher risk taking. However, such allocations may prove challenging in practice given that some roles entail an overlap of decision making such that the differences in roles are not as clear-cut.

iii. Bonus pool

The New Regulation tightens the control on bonus payments by ensuring that institutions take into account the overall business performance and shareholders' return. Accordingly, certain payments may be clawed back in cases of poor performance. Licensed financial institutions are required to reflect said concept in the employee's contract of employment and must ensure the aggregate amount of any bonuses does not compromise the institution's financial stability.

The New Regulation also introduced the concept of deferred bonus whereby at least forty percent (40%) of the variable remuneration must be payable under deferral arrangements over a period of at least three (3) years. Moreover, for the CEO, his deputies and the other five (5) most highly paid business line employees, at least sixty percent (60%) of the variable remuneration must be payable under deferral arrangements over a period of at least three (3) years. Furthermore, at least fifty percent (50%) of the variable remuneration (including both the deferred and unoffered portions of the variable remuneration) must be awarded by way of shares where appropriate.

The only instance where deferred remuneration can be paid out before the end of the period is in case of the death of an employee. Whilst this concept has been introduced as a mechanism to maintain long term performance measures, the introduction of deferral bonuses carries with it some challenging practical implications. For instance, what will the position be if an employee with deferred payments resigns?

The implementation of the deferral system will require a proper consideration of the overall legal position in Bahrain in relation to payments and incentives including a review of other related laws such as the Labour Law No. 36 of 2012. Further, the CBB should develop guidelines for the implementation of the deferral system so as to ensure that employees are not deprived of their legal and due entitlements. Setting aside any practical limitations, it is questionable whether the introduction of deferred bonus is the best practice to adopt especially in light of the market recovery. The standard of remuneration according to the New Regulation expects the employees to be retained and motivated, and the introduction of deferred bonus risks may well prove de-motivating to some employees.

iv. Board remunerations

Notwithstanding shareholders' approval, the board remuneration should be capped at five percent (5%) of the financial institution's profit after all deductions as required by the Commercial Companies Law (2001) Regulation are made.

v. Share incentive plans

All share incentive plans are subject to shareholders' approval and are now subject to a minimum share retention policy of six (6) months from the time the shares are awarded, unless the financial institution states otherwise. Where fixed or variable remuneration include common shares, the financial institution must limit the shares awarded to an annual aggregate limit of ten percent (10%) of its' total outstanding issued shares.

Practical Implications

It is without doubt that the introduction of the New Regulation imposes burdensome obligations on financial institutions in terms of disclosure and reporting. Financial institutions in Bahrain are now obliged to undergo extensive assessments to ensure that their operations are compliant with the New Regulation. Furthermore, banks and other licensees must now provide a detailed report explaining the rationale of the remuneration policies to the board of directors, shareholders and the CBB. Said reports should disclose practices and policies in relation to, but not limited to, the remuneration structure, form of review of such structures, risk adjustment measures and performance assessment. Additionally, institutions must review all employment contracts in relation to Approved Person and Material Risk Takers.

The CBB appear to be taking the lead in the region with the implementation of the New Regulations and are aligning themselves with international best practices. However, the Bahrain economy is still at a recovery stage and there is a risk that the New Regulations will put potential licensees off from opening in Bahrain, and that there may be a “brain drain” of those personnel from Bahrain who are directly impacted by the New Regulation.

Nonetheless, the New Regulation aspires to provide financial stability through full engagement of all stakeholders when it comes to remuneration policies. The shift of control and duty to oversee compensation has significantly been moved away from executive management through the establishment of the board remuneration committee and the requirement of shareholder approval. This is meant to decentralize and balance decisions in relation to the manner in which short and long term profits are managed. The involvement of stakeholders should ensure that short term profits are reinvested instead of being paid out as remuneration, consequently benefiting both the financial institution and the employees.

Conclusion

It is imperative that CBB Licensees carefully evaluate their compensation policy as many of the changes brought by the New Regulation are long term in nature and need to be carefully evaluated. The process of implementing the changes required by the New Regulation will be onerous on financial institutions; nevertheless, the long term financial benefits in terms of financial stability should be worthwhile for the financial sector in the Kingdom of Bahrain, and should raise financial institutions' policies and operations to international standards.

[1] Approved Persons include risk management, internal audit, operations, financial controls, head of internal Shari'a review, compliance functions personnel and Money Laundering Regulatory officer.
[2] Material Risk Takers include heads of significant business lines such as fixed income, foreign exchange, commodities, securitization, sales areas, investment banking, commercial banking, equities, structure finance, lending, trading areas