Impact of legislation on banks portfolio risk and its failure effects

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Abstract The banks work on very strong compliance norms, as they are the custodians to the customer’s money. They need to ensure that the money does not belong to them, and it needs to be managed with maximum precision as it becomes a liability on the part of banking institutions. The financial system needs to work on a defined line with a focused approach. There is always a dotted line mechanism to run the business with certain specifics. Banks need to work with the primary objective of protecting depositors’ investments, managing risk and ensuring the proper flow of information to all stakeholders. The banking sector needs to always work on preventive and protective mechanisms, and it needs to manage the critical ratio of assets and liabilities, and its mismatch cannot be afforded at any point in time. In recent times, we saw the failure of two banking giants, Yes Bank and Laxmi Vilas Bank, which makes us think about legislation and regulatory compliance in the right spirit.

Keywords: baking risks, legislation, financial systems, corporate governance, risk analysis

1. Introduction

1.1. Background

Banks in India have been working in a very restrictive manner, but the scenario is taking a transformation, as banks have started working in an open environment with a certain degree of innovation in business and have created a more competitive environment for themselves for a healthy and trending business (Danisman and Demirel 2019). The advancement in technology, cross-border intermingling, innovation in products and processes, advanced technological applications and increase in volume of business have necessitated the proactive strengthening of regulatory and supervisory frameworks (Danisman and Demirel 2019) (Mendoza and Rivera 2017). The banks need to be Basel 3 Compliant on all aspects. Indian banks usually have a capital adequacy of approximately 8%, which should at least be raised to the standard of 10.5%, as capital needs should have an additional margin of approximately 2.5%.

1.2. Legislation and banking regulations

The current legislation in India is primarily managed by the Banking Regulation Act, 1949, which evolved from the Companies Act, 1913, which was also applicable to banking companies. The first failure was of Trangancore National and Quilon Bank in 1938, which actually created the background of RBI’s effective functioning, and it was brought to the notice of general public and media galore. Much deliberation during pro-independence and subsequent analysis led to the creation of the Banking Companies Act. 1949. This act resulted in the proliferation and nontangential growth of unregulated banking services (Faley and Krishnan 2017). There has been regular continuation and updating of the Banking Regulation Act since then. It has become a Paramount medium of Managing Banking structure in our Country. The Onus of Development of Branch Banking was given to Reserve Bank of India. RBI became the solo authority as central banker and has to issue branch licences (Harnay and Scialom 2016).

1.3. Objectives

This paper aims to explore banking risks and the interference of banking regulations, corporate governance and supervision in mitigating and managing associated financial risks and failures.

2. Literature Review

Operational risk management and supporting systems have many aspects attached to it, including works on exposures and incidents resulting from people, processes, information technology networks and uncontrollable events at all points in
time. A very important aspect of this is to integrate qualitative and quantitative data into one aspect, which can be used as a reference point to make all important business decisions.

Cross-border transactions are very critical in terms of BASEL 2, and the same requires multiple levels of approvals at all points of time in different dimensions. The different level of approval in first point checks on FEMA aspect that all transactions are done under regulatory compliance and all parts are taken care of in understanding the taxonomy of transactions and the transaction is also understood best in terms of all compliance aspects at all points of time (Srivastava 2017). The banking group might be managing transactions across the globe, but it needs to obtain approval from all the countries where they are operating in terms of BASEL2 norms, and it needs to comply with the right spirit (Sharifi et al 2016).

3. Monitoring and Risk Management

The Department of Banking Supervision (DBS) was set up within the premise of RBI to monitor the effective functioning of the banking system across all aspects. The Indian banks have now been designed to work on the CAMELS model (Capital adequacy, Asset quality, Management earnings, Liquidity and System). The Foreign Bank works on the CACS standards (Capital Adequacy, Asset Quality, Compliance, Systems and Control). The offsite monitoring and surveillance system (OSMOS) was operationalized in 1955 as a part of Crisis Framework Management for early warning and control. Banks with Growth in Business must also consider managing the critical ratio (Samanta and Chakraborty 2016). All compliance ratios need to be maintained in a very strict manner to have better control of business.

3.1. Corporate Governance

Corporate governance plays a critical role in the long-term financial health of institutions. As we discuss this aspect, the role of Board members becomes very important as they become the Pillar of running the institution. They are experts in framing strategy objectives, compliance, corporate culture and objectives on a long-term and short-term basis. It is very important that banks should be transparent in dealing with both internal and external stakeholders. Every Decision should be communicated in a very rational basis and with Correct Logics and Background. There must also be a periodic internal check in the bank, and it needs to be done on a regular basis. These checks should be performed in addition to external audits or compliance by regulators or any independent agency.

The role of rating agencies such as Standards and Poor, ICRA, CRISIL, and Moody’s on all aspects of rating becomes very important. Apart from compliance control, these agencies provide an important reflection on the bank’s work and the financial health of all the major customers banking with that particular institution. Banks cannot afford to have a distorted credit structure, as it reflects very poorly on the governance of banks at all levels. Incomplete credit information, poor selection of risks, lack of supervision, overdue of interest and classification of assets are some factors that play a very key role (Faleyé and Krishnan 2017; Swain and Samantray 2019).

3.2. Capital adequacy

Capital adequacy is very critical, as banks need to manage optimum capital for all their requirements, whether liquidity conditions or some international cross-border transactions. Banks should always possess a level of liquidity so that they are never out of capital at any point in time. Bank’s capital adequacy requires a better understanding and its constitution. Capital adequacy tries to understand the liquidity positioning in the bank as it becomes important so banks are able to meet all their obligations and liabilities in terms of liquidity and commitment (Sehgal and Agrawal 2017).

3.3. Asset Quality

The asset quality is also measured on various parameters, and if there is any misunderstanding or no clarity, it leads to very serious impacts, which need to be managed in the best circumstantial way.

3.4. Risk Management

Risk management is the key for banking at this moment, and as banks are now expanding in international patents, it becomes more imperative to work on a robust risk management process and schedule. Banks should view compliance as a process to manage profitability (Sindhu 2020) (Haque and Shahid 2016). A more advanced approach for data creation and analysis gives us an advanced method of understanding and managing different asset business data. Banks that are able to manage their risk proposition in an effective manner can utilize their capital in a more optimum manner to obtain the best results in terms of profitability and business expansion.

Therefore, the bank’s risk management function is very important and the role of Audit Committee and Internal Audit is very important, they have some very important and critical role to perform. They help in the identification of business risk and its magnitudes in an independent manner and the evaluation of the efficiency and economy of operations. Risk management has its own role, and the bank’s asset and liability composition play a very important role in the bank’s healthy business management.
3.4.1. Credit Risks

Credit risk is a critical component, as it is determined by assets of bank and off-balance sheet items and comparing it with commitments of various risk assessing factors at all points in time. On the basis of risk weights, there is a rating of particular instruments and institutions. The ratings range from AAA to B- as per the risk weights. The lesser the risk involved, the higher the ratings will be. This is very important currently to assess the level of risk in financial institutions.

3.4.2. Non-Performing Assets

NPA (Non-Performing Assets) became a Regular issue with banks with an immediate focus on resolution, which led to the creation of corporate debt restructuring legislation. In terms of lending, different banks have different levels of authority and decentralization, as large banks have to define authority for all individuals at all levels. The large bank keeps different levels of authority at all places for better management of lending or asset business at all amounts and all points of time (Brahmaiah 2019). The appraisal process is standardized as per the compliance norms, and the rate of lending is decided as per the case and business-specific strategy.

3.4.3. Liquidity Regulations

The liquidity regulation is very important, as the bank needs to manage all its ratios at all points of time in proper control and manage it in a better manner, as the ratios form a very important and critical part in the entire scheme of things at all points of time. There must be a limit on the loan to deposit ratio, loan to capital ratio, proper guidelines for the usage and end usage of funds, managing the liquidity ratio at all points of time, stable liquid assets, proper control system mechanism at all points of time, regulatory framework for off balance sheet items and proper methods for asset-liability management with respect to the compliance and governance guidelines.

3.4.4. Operations Risk Management

The consistent framework of operations risk management helps in the improvement of controls and documentation, automation of all activities and control, increased level of risk management understanding, monitoring of risk and control, managing repositories for risk and control processes, and creating proper standards for processes and risk management (Sharifi et al 2016). There are various compliance norms in operations risk management, such as the identification of key risk performance parameters, databases for negative results, mathematical presentation of all data and proper self-assessment processes to understand the operation risk management framework in a better manner.

3.4.5. Market Risk Management

Market risk management is an important tool for compliance, as banks are increasing their ambit of activity, specifically in investment management and trading, as there are the major activities of yielding proper profits and business orientation, and the factor of risk also increases. Banks are now changing very swiftly in their investment activities, and the change is dynamic. A proper risk management structure and strategy need to be placed in a proper and executable manner. Banks need to manage open positions in terms of Commodities, Fixed Income, and Equities and, more importantly, major Trading foreign Currencies at any fixed point in time.

3.4.6. Risk Reporting

Risk reporting is very important, as any dilution can have serious repercussions for bank performance management and impact the health of financial institutions in a very adverse manner. Risk reporting should include an analysis of a portfolio’s risk characteristics and various factors that impact them, such as modified duration, value and changes in currency valuation and rate analysis, which means the level of the existing rate at this point in time. Risk reporting should analyse all aspects of risk in terms of return on portfolio and accrued profit or loss on the portfolio.

3.4.7. Performance Reporting

Performance reporting is a very important part of compliance, as it includes various parameters. There is always a benchmark performing index and banks portfolio is compared with that benchmark performing index, the current portfolio risk is measured using value added returns and its numerous calculations, the uniform performance parameter must be used in price comparing strategies.

3.5. Risk Analysis

The risk scenario is more diversified now as we have a specific agenda to work upon and calculate the risk in a very staggered manner. Banks always have financial, operational and environmental risks that impact them at the majority of
times. The central focus of risk analysis on banks is understanding of balance sheets. The balance sheets of banks appraise us with various quantitative factors, and on the basis of these quantitative factors, we work on various ratios to understand the financial health of a particular institution (Sindhu 2020) (Sehgal and Agrawal 2017). The analysis of these ratios helps us understand how a particular institution is performing in its peer group, what are the good practices that one institution is doing for better results and how it can be replicated in an institution where the expected results are not coming and the same can be implemented by imbibing good practices.

When risk analysis is being performed, certain considerations must be kept in mind while doing the same, and the concerned people making the process should be very familiar with cash flow happening periodically where the control of Portfolio manager is very less and it is also not advisable, Time weighted methods, Internal rate of return and Annualized return.

3.5.1. Compliance and Assessment of Risks

The important part of compliance is risk assessment, and we need to understand the level of risk clearly before dealing with it. The level of risk gives us an understanding of the magnitude of risk and proper management. The primary goal is to understand the sources of risk, which include people, processes, systems and other factors at different magnitudes. As information technology is a critical component, we need to better understand the risks associated with it. There is always some level of marketing and technological risk while implementing a new product and process (Swain and Samantray 2019).

The role of compliance becomes very critical, as compliance ensures that all the functions in the treasury, which involve a high value of transactions and other high-volume and critical business activities, involve compiling with appropriate laws and legislation, policies, guidelines, ethical management techniques and other professional standards, which comes with the passage of time at all points in time (Agrawal and Sehgal 2018). Strong compliance functions bring about customer confidence and stronger business propositions, and customer confidence is built very strongly on these aspects and helps in the long run. One very crucial aspect is that all the open items in compliance should be closed in a time-bound manner, and if anything pertains to customers or any other stakeholder, it should be managed more professionally and, in a time, -bound manner.

3.5.2. Supervision process

The supervisory process in compliance is very important, as this helps us understand that all the institutions are following all the norms necessary for the business at all points of time, as if the business does not follow a single norm, which might lead to some penalty and some restriction in terms of business growth. As we have seen currently, RBI has completely issued the strictures for the issuance of new cards by HDFC BANK due to the periodic issues in their systems. RBI has directed the bank to make the systems full proof and reduce the failure/limitation level to almost negligible level, after which they will be allowed to grow the business in the way they want (Haque and Shahid 2016). These are all limitations in the approach to business growth and reaching the desired and set goals, and it has also resulted in a very strong dent in terms of the profitability of the institution. We all understand the criticality of profitability in terms of customer confidence and business development at all points of time.

3.6. Case Studies

The cases of Yes Bank and Laxmi Vilas Bank are very fresh in our minds, as RBI has to impose moratorium on withdrawals due to the poor health of these two banks, and had this not been done, it would have led to serious impacts on financial aspects for stakeholders, shareholders and customers. We will analyse this situation with the help of two live ceases that we saw very recently in terms of the moratorium placed on Yes Bank and Laxmi Vilas bank. The compliance part is very critical at all aspects, and the business has to run in sync with compliance principles, and it needs to be grown from that perspective only at all points of time.

3.6.1. Yes, Bank Failure

Yes, bank started as a very conservative bank, but as time passed and its growth in the business started, the bank started taking some risky calls for faster business growth, which led to great growth in terms of customer acquisition and strong portfolio growth, and the best institutions were screened and landed. The institutions included Anil Ambani group, DHFL, CG Power, Essel, IFF& S, Vodafone, Cox and Kings, to name a few. Some of these were big names, but their business model did not work effectively. These companies were not able to manage business in a way it should have been managing and started incurring heavy losses as the time kept on moving.

In the case of Yes Bank, the balance sheet is approximately 3 Lakh crores in the current scenario, with deposits of approximately 1.5 Lakh Crore and Lending of approximately 75 thousand crores and remaining other liabilities with business and compliance compulsions. NPAs have increased from 1% in 2017 to approximately 7% in 2021, and we can see a negative growth of business denting at 700%, which is never a sign of positive business growth and will reduce profitability. The
deposit in March 19 was approximately 2.25 Lakhs crores, which fell to approximately 1 lakh crore in March 2020, this was down by approximately 125%, which was a drastic reduction at all points of time and had a very adverse impact on business. The advances in March 2019 were approximately 2.41 lakhs crores, which decreased to 1.71 Lakhs crores in March 2020, and it was a drastic fall; the bank was not able to meet all its liability obligations, and it was under tremendous stress on its liquidity factor, which is evident in terms of deposit and advance correlations (see Table 1).

However, the Governance and compliance standards of Yes Bank were so weak that the Finance Ministry has been personally monitoring the bank since 2017, various advisories were issued to improve efficiency, and Rana Kapoor’s approval for extension as an MD was rejected by the regulator. If we look at the lending portfolio of the “yes” bank, the growth in lending was approximately 35% on average for the tenure of five years, and looking at its portfolio quality, the NPA increased by approximately 1000%. This was truly an alarming situation, and it was supposed to be controlled in the best possible and compatible manner at all points of time.

Table 1 State of Financial position of Yes Bank for 5 years.

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Advances (in Crore)</th>
<th>Gross NPA</th>
<th>Net NPA</th>
<th>EPS</th>
<th>ROE</th>
</tr>
</thead>
<tbody>
<tr>
<td>2019</td>
<td>Rs. 2,41,500 crores</td>
<td>3.22%</td>
<td>1.86%</td>
<td>7.4</td>
<td>6.5%</td>
</tr>
<tr>
<td>2018</td>
<td>Rs. 2,03,534 crores</td>
<td>1.28%</td>
<td>0.64%</td>
<td>18.4</td>
<td>17.7%</td>
</tr>
<tr>
<td>2017</td>
<td>Rs. 1,32,263 crores</td>
<td>1.52%</td>
<td>0.81%</td>
<td>15.8</td>
<td>21.5%</td>
</tr>
<tr>
<td>2016</td>
<td>Rs. 98,210 crores</td>
<td>0.76%</td>
<td>0.29%</td>
<td>12.1</td>
<td>19.9%</td>
</tr>
<tr>
<td>2015</td>
<td>Rs. 75,550 crores</td>
<td>0.41%</td>
<td>0.12%</td>
<td>9.9</td>
<td>19.0%</td>
</tr>
<tr>
<td>2014</td>
<td>Rs. 55,633 crores</td>
<td>0.31%</td>
<td>0.05%</td>
<td>9.0</td>
<td>25.0%</td>
</tr>
</tbody>
</table>

The problem with Yes Bank was that it could not find proper lenders from the market to support its capital infusion of a minimum of $2 billion, and the regulator also participated in joint meetings with investors, but when nothing materialized, the regulator had to come forth and take the command of Yes Bank, and the moratorium was placed very strongly and restricting the people on withdrawal, as the assessment needed to be done strongly before going ahead on the same.

The Condition is now improving with an inflow of approximately 7000 crores from SBI, and other lenders and banking institutions such as ICICI, HDFC, AXIS, KOTAK MAHINDRA and other lenders have infused a good number of investments coupled with depositors’ confidence, which has improved the financial conditions. Consequently, the RBI has replaced the entire Board of directors of Yes Bank and replaced by its own nominees to run the bank in a healthy and better manner at all points of time across all dimensions.

3.6.2. Laxmi Vilas Bank Failure

The Laxmi Vilas bank failure is also a big eye opener for all of us as the shareholders wanted the top management to be removed due to rise in bad loans and subsequent impact on the liquidity health of the bank, there was mismatch in Assets and Liability composition and due to this mismatch, the bank was in bigger trouble and all the parameters were not working as per the designed aspects.

The bank had done lending of approximately 800 Crore to one of the major corporate groups, and they have secured fixed deposits worth the same amount in lieu of collateral security. Some delinquency in transactions was observed, and some employees were also arrested. As a result of this non-payment of loans, the bank was kept in the category of the PCA (Prompt Corrective Action) Group, and the focus of the regulator due to ill financial health immediately shifted on them. The strategy formulation started to manage the banking institution in a better and professional manner. The regulator also appointed a committee to run the day-to-day business of the bank and maintain effective monitoring and management.

4. Discussion

Banks in business are necessary for the growth of institutions and organizations, but they cannot take the back seat, as compliance is the background of robust business growth, and this can happen only when we support the business in strong terms and all the comparisons and parameters are performed in better aspects and analyses. The regulations have very critical impacts on bank productivity, and they are completely driven by the same. The bank’s total factor productivity has a very strong impact on all its macro and micro economic factors, which impacts the functioning of the bank very strongly and at all points of time.

There are various bank-specific variables of productivity and equity that need to be handled and controlled, which helps in the growth of banks’ balance sheets and productivity across all dimensions. The balance sheet of the new entity gave a very comfortable picture in terms of strong financial health, as the capital to risk weighted asset ratio (CRAR) stands at 12.51% and common equity tier 1 (CET-1) at 9.61%, which made the business a viable one.

RBI constituted a committee headed by Senior Banker Mr. K V Kamath for restructuring the loans in post pandemic impact, the committee recommended for the restriction of a big loan portfolio as many industries are performing below benchmark due to tough business surroundings. Some industries, such as retail, manufacturing, and wholesale trade, were under stress during the pandemic. Some industries, such as reality and infrastructure, power, steel and automobiles, were
already under stress before the start of the pandemic, and the pandemic caused greater damage to them under the complete scenario. This committee studied the Loan portfolio and found that approximately 37 Lakh Crores of Loan portfolio is under stress and borrowers are finding it difficult to serve the debt obligations, which constitutes approximately 72% of the debt portfolio already given to industry by banking institutions at all points of time. This is the calculated debt by banking industry.

The industry needs to be more careful in terms of funding and needs to ensure that strong compliance is practised while lending in the corporate sector, and all the norms, parameters and guidelines are very strictly adhered to with any iota of mistake and prejudice. The lending process should not be an individual decision; it must be a collective decision where all the norms are followed very strictly and compliance is not compromised at any point in time.

5. Conclusion

Three parameters that were the issue of concern for RBI were the capital to risk weighted asset ratio (CRAR), NPAs and return on assets, as these were very critical parameters for analysis, and the things were not moving in very suitable direction in terms of all the compliance ratios and parameters. Thus, the banking system needs to divide the process into different aspects to manage it better on various fronts, including planning, strong governance with a process-driven approach and strong business development with a growth approach and improvements. There are various functions at the operational level that need to be worked on better and managed effectively, including new client setup, portfolio management, settlement and control and proper risk analytics for managing compliance better.

Ethical considerations

Not applicable.

Declaration of interest

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