Banks in search of an Ethical Paradigm

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More than any other stream of business, the financial business in general and banking in particular is one that based on trust. The bank's business is fiduciary in nature; after all, depositors place their savings and surpluses with the bank in good faith with the belief that they would be able to earn some return on it and equally or more importantly, that they would be able to get their money back as and when they are in need. Similarly, the world of trade and commerce reposes faith in banking facilities for collecting their bills and on instruments for remittances and bank assurances like bank guarantees and letters of credit. Consequently, banks have traditionally been very conservative when it comes to lending and also while issuing/ opening bank guarantees and letters of credit.

Like all commercial entities, banks are also in business to earn profit. Thus there should be earnings adequate to pay interest to depositors, meet banks' overheads and then leave a tidy surplus. Traditionally interest on loans and advances is the most important source of earning for banks. It is well known that there is a direct relationship between risk and reward: higher the risk, greater the reward. Banks are averse to lend to high risk ventures though they offer attractive returns. For any loan that carries some risk, each proposal has to be scrutinised thoroughly. Rigorous appraisal is the bank's first line of defence ensuring that a loan proposal is basically sound and that the money if advanced would come back as planned. In other words, such a loan would be what can be called a "fair banking risk".

Long before the terms "risk management", "asset-liability mismatch" etc. gained currency, bankers of yore were aware of the need to meet their obligations on time every time and this was a critical input while they considered granting loans. They ensured this by avoiding granting of long duration loans as most of their deposits were payable on demand. Traditionally, in India most of the advances were to traders and took the form of overdrafts and bill purchases. These were short term seasonal advances and were always repaid within a few months at the most. Industrial advances were few and far between and mostly confined to major cities. To ensure that they had enough cushion at all

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times bankers of that bygone era would always take more than adequate collateral securities (in addition to primary securities) so that they were doubly assured of being able to realise their dues in case of any default.

Banks used to lay great stress on the so-called three C's: Character, Capacity and Capital. The character of a promoter and his capacity to carry on the business were as important as his capital. Thus banks used to lay stress on the intangibles as much as tangibles.

Bank is after all manned by people and banks have to rely on its personnel to provide service. The main intangible quality the banks look for in their key staff is their character. In earlier days banks used to recruit only persons who came with top class references but today banks hire through a transparent process that ensures that fresh recruits being taken on the rolls are capable of being moulded into clerks or officers. Banks invest considerable time and money in training their staff. Apart from critical job related knowledge, banks instill institutional values in their trainees. At the end of a two year probation period, a young officer would have been through some months of class room training and also would also have been rotated through all desks in various banking streams. He/she would have imbibed the necessary job skills and also the ethos of the bank.

The system of checks and balances in banks is designed to ensure that mistakes and malfeasance are avoided. Banks were among the first to implement the "maker-checker" concept; in any bank, any given transaction would have to pass at least two persons. Similarly custody of cash and valuables is always with two persons and unless both of them act in concert, operations are not possible. "Trust, but verify", is a maxim that gets drilled into young officers as they embark on their banking career.

Although banks have a perfect system of checks and balances in place, it is a fact that frauds surface every now and then. Frauds are a fact of life in banks and despite taking all precautions, some still happen. But any study of frauds would reveal that the most important cause is human failure.

The greatest threat a bank faces is of loan defaults. To a large extent, this is minimised through sound appraisal and also constant post sanction follow up and scrutiny. If appraising officers are not diligent there is a chance that unworthy proposals getting sanctioned. Similarly if branch staff who conduct the day to day operations are not vigilant, they might miss any deterioration in the quality of loan assets. Then there are cases of 'kite flying' where parties draw bills on each other for mutual benefit without any underlying trade transaction and get such bills discounted with banks. It is possible for branch staff to detect such instances but there are numerous instances of banks losing money in such dubious tricks by fraudsters. Diversion of funds is one of the major causes of loans going bad and the operating staff at banks are required to ensure proper end use of funds lent.

Frauds could be perpetrated by insiders and/or outsiders or both acting in tandem. To cite just one example at the retail level there could be instances of cash shortages. If the cashiers and joint custodians are as diligent as they are expected to be, such incidents would never happen. Similarly there are instances of loans being granted against spurious gold ornaments. In all such cases one or more people would have disregarded the laid down process. Inspections of customers' godowns and factories are an important part of follow up and play an important part in ensuring safety of bank's advances. Any laxity could tempt a potential fraudster to strike.

Despite all efforts, some frauds have been thrust on banks through loan melas that were the norm after nationalisation. Though the avowed objective of reaching out to the unbanked masses was indeed laudable, the emphasis on speed and the target driven approach resulted in chaotic situation at many rural branches that were not equipped to handle such volumes. The political class used to sponsor applications and given the urgency, loans were often granted with only cursory scrutiny. Though individual loans were small, the number of such loans was in millions. Middle men thrived as banks struggled to meet unrealistic targets that were thrust on them. Several branch managers and staff also took advantage of the situation and these instances caused huge losses to the banking industry. It is to the credit of banks, however, that all such cases that came to light were investigated and the guilty officials received exemplary punishments.

Another hazard banks face today is the reluctance of most farmers to repay farm loans availed by them. The loan waiver scheme of the government in 2008 has queered the pitch for banks. Farmers, traditionally perceived as being honest have been made to default as the scheme penalized those who repaid their loans and extended benefit of waiver to defaulters!

Educational loans are also a ticking time bomb. Again under pressure from the political class, banks have been releasing loans without asking too many questions. Reports indicate that there are brokers who act on behalf of fly by night operators in other states who readily give admissions and take hefty fees which the poor students find hard to repay once they start working.

The most devastating fraud that shook the Indian banking industry is the securities scam of 1992. At that time, the country was taking bold steps to open up its economy through a slew of measures aimed at liberalisation. These steps were necessitated by the balance of payment crisis which saw the nation having to pledge its gold in London. There were dramatic overseas developments happening at the same time like the collapse of the bastions of socialism in Eastern Europe and their supremo, the USSR and the very visible success of Chinese economy after its conversion to market capitalism. The government ushered in an era of drastic economic reforms and India also embraced competitive market economy, jettisoning its earlier socialistic philosophy.

As part of the economic reforms, Banking Regulation Act was amended in 1993 facilitating setting up of new banks. Axis Bank, ICICI Bank, IDBI Bank, and some others came into being. These banks brought a new aggression to the sedate banking scene. Suddenly, old established banks, comfortable with their largely walk-in business, found that the new generation banks were after their clientele, offering a range of products and services comparable with the best in the world. Even as they tried to cope with this, they had to face interest rate deregulation; used as Indian banks were to an administered rate regime the sudden transition added substantially to their woes. To complicate matters further, this was also the time when banks found themselves having to classify assets (loans and advances) as per strict and transparent norms and book income only on performing assets. The impact on the bottom line was immediate and hard hitting.

The economic reforms brought with it a buoyant stock market as a group of brokers stoked an unprecedented bull run in the market. In January 1991, the benchmark Sensex stood at around 1000. The year that followed was among the worst for the Indian economy with industrial growth rate dipping to 0.9%. Interest rates averaged around 20% and inflation peaked at 15%. The BOP crisis resulted in a drastic import squeeze which throttled import-dependent industries. India's sovereign credit rating registered sharp decline. Despite all these negatives, the Sensex climbed to 1900 by the end of the year and rose further to 2300 by 30th January 1992. While the 1992 budget delighted the nation, the Sensex shot up to 3325 in March, 1992. The rally was unprecedented and though the market was rife with speculation about the brokers' source of funds, the government appeared unconcerned.

The fast and merry money-making depended on the brokers' ability to ensure a steady source of funds. Matters came to a head when the SEBI Bill was passed on 28th March 1992 which required all brokers to register themselves with SEBI before 21st May. On 16th April, trading on all stock exchanges came to a halt as brokers refrained from transacting any business as a protest against the SEBI directive. The result was that the well-oiled roll-over mechanism came to a standstill. Payments for and delivery of securities were no longer possible. Harshad Mehta, the so-called Big Bull had to pay SBI over Rs. 600 crore. Meanwhile, the story of Bankers Receipts being used by brokers to raise funds were headline news and the cookie crumbled and fast.

When the dust settled, major banks were found to have facilitated the bull run by merrily issuing BRs for securities they did not possess and issuing them on behalf of brokers who used them to raise money. They were found to have credited proceeds of cheques favouring themselves to brokers' accounts. The total amount involved was around Rs. 3000 crore; a fraud of this magnitude had never happened in our banking industry till then.

Faith and goodwill reposed in the banking system was shaken badly. The fraud shook the entire financial sector as debt, stock and money markets were all affected.

This fraud happened due to a host of factors. As already indicated, the government, facing an unprecedented crisis on account of scarce foreign exchange resources had to open up an economy that was cloistered for a very long time. This was seen by a select few as a great opportunity to mint money and these freebooters had a dream run.

Banks, under pressure to show ever higher profits, saw profit from investments as a saviour and operating level staff in funds management started trading actively at times at rates that were not always the going market rates. Two banks doing such transactions at rates unrelated to prevailing market rates could boost their profit. Issuing BRs against for sale of securities they did not possess was a logical culmination, probably at the behest of brokers who stood to earn from all such interbank transactions. Rules were bent by many banks and this happened right in Bombay under the nose of top managements and the RBI. It is hard to believe that all these transactions were made by lower level staff without the imprimatur of the top bosses.

Banks were steaming fast through uncharted waters and an accident was waiting to happen. The fraud is a sum total of instances of errors, lapses due to ignorance, greed and corruption. Archaic systems like the BRs which were never reconciled helped brokers take advantage of the system, aided no doubt by the greed of the concerned staff who also obviously benefitted from such transactions. The rot had seeped in even at very high levels otherwise such instances would never have happened.

After the scam, banks went on to adopt technology in a big way. Security transactions are now done electronically so no one is able to peddle instruments like the BRs anymore. As interbank transactions and remittances are real time now, there is no scope for anyone to take advantage of unreconciled accounts. Automation has percolated to the branch level as banks have leapfrogged from the old manual style of working to the centralised, online, real time, electronic (CORE) banking.

Technology has helped in prevention of frauds but unfortunately the weak links in the form of human beings still persist. In public sector banks, older staff members are still uncomfortable with technology and this has made them rely unduly on their tech-savvy younger colleagues. As the process of transition to a computerised and networked environment was fast, it was found that some of them even go to the extent of parting with passwords with disastrous consequences. Mercifully, with increasing awareness, such instances are few and far between of late.

Instances of frauds still surface now and then even among foreign banks and the new generation private banks. There was the case of an officer of a foreign bank siphoning off funds from a high net worth individual pretending to be handling his investments. There are complaints of bank staff misleading customers promising high returns and luring them to invest in equity based mutual funds. Banks promote cross selling of such products to increase their fee based income and operating staff might be tempted to paint rosy pictures of investment opportunities. These are all moral hazards that bankers of an earlier generation never had to face. Banks have to evolve separate verticals to handle such activities if they want to ring fence such business from their primary bread and butter business.

At the highest levels also, unbridled ambition and a poor value system has brought down venerable banks. Nedungadi Bank was one such and it had to be taken over by Punjab National Bank after a new management team went about ‘developing’ business aggressively. Among the new generation banks also Global Trust Bank met a similar fate when it was taken over by Oriental Bank of Commerce.

There were other new generation banks also which had to merge with others in a very short period like Centurion Bank, Times Bank etc. The top officials of these banks pushed too fast and perhaps erred in their credit decisions and these cost the banks their very existence. At top levels, the pressure to bring results is immense and it requires great willpower to resist the temptation to take short cuts.

With increased liberalization and integration of global markets, it is important to put in place strong systems to review operations at all levels. Apart from strong audit and vigilance machinery in banks, we have a strong regulatory mechanism in the form of RBI overseeing the functioning of banks. With SEBI looking after the capital markets and IRDA minding the insurance business, the financial sector is always under the microscope. Progressively, these regulators have been insisting on higher transparency.

The criminal mind is always alert trying to spot lacunae in systems and exploit them. Eternal vigilance is the price banks have to pay to safeguard themselves. As custodians of public money bankers are required to maintain high standard of ethics in their profession. Realizing that a strong value system is the only bulwark against rapacious wrongdoers, banks have been trying to instill these in their personnel at all levels.

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Two Wolves

One evening an old man told his grandson about a battle that goes on inside people. He said, "My son, the battle is between 2 "wolves" inside us all.

One is evil. It is anger, envy, jealous, sorrow, greed, arrogance, self-pity, guilt, resentment, inferiority, lies, false pride, superiority, and ego.

The other is Good. It is joy, peace, love, hope, serenity, humility, kindness, benevolence, empathy, generosity, truth, compassion and faith."

The grandson thought about it for a minute and then asked his grandfather:

"Which wolf wins?"

The old man simply replied, "The one you feed".

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