View: What successful banks do differently, and where PNB failed

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The business of lending is highly process-driven. In the words of Warren Buffett, it must be safe and boringly predictable, even as it generates value for its shareholders.

A bank generates value by carrying out its standard activities in an efficient manner, and its judgemental activities (such as credit choice), to maximise net positive outcomes. These two sets of activities generate revenues for banks, even as they also involve costs and risks. A successful bank focuses on maximising its revenues and minimising its costs and risks.

KYC: Know Your Charter

The revenues and costs are highly predictable, ex-ante, and highly measurable, ex-post. However, the risks underlying the activities are neither easily predictable nor highly measurable. They can only be estimated — 'modelled' with a certain confidence. The accuracy of the measurement outcomes will depend on the robustness of the parameters of the models.

So, logically, bank managements should, first, design their risk management frameworks that match their desired levels of risk. After that, they must continuously ensure that their activities are in line with their predefined risk appetite.

The first lesson to be learnt from the PNB-Nirav Modi case is that banks need to better manage their operational risks: credit, market and operational.

Credit risk (CR) and market risk (MR) are related to potential losses from lending and investment activities respectively. Such losses occur in case of a loan default or in the value of an investment.

Operational risk (OR) indicates a failure in any of the banking systems, processes or people. OR has an impact on a broad range of products and businesses, unlike CR or MR, which affect specific transactions.

While all three types of risks influence the net outcome from the transactions made by the banks, the risks evaluated at the transaction level in a bank are CR or MR. On the other hand, OR is evaluated and monitored at the product or branch or a similar aggregate level. As a result, business managers are behaviourally inclined to take CR and MR more seriously, while often ignoring OR as merely a compliance issue.

It gets worse when the board and senior management of the bank also take a stepmotherly approach to OR, which eventually translates to CR- or MR-related losses. In the PNB case, the process of checking a transaction before disbursing a non-funded loan was not robust enough. This was an OR lacuna, which translated into a CR-related loss.

While there are some exceptions, banks need to change their superficial approach to OR and accord it the same priority as CR and MR.

Second, beyond the banks, various agencies also need to improvise on their attitudes, skills and knowledge of the banking business. Internal, as well as statutory, auditors must be capable — and willing — to raise a flag on any inadequate process being followed by a bank. Even if specific transactions are not always detected, the checking of the loan approval process and its issuance is certainly within the expected accountability of the auditors.

Third, there is a lesson for the regulator as well. The Reserve Bank of India (RBI) has done well to issue suitable guidelines on CR, MR and OR, with appropriate emphasis on each of them. But it also needs to promote better discipline in OR as part of its supervisory activities. The process of reporting Red Flagged Accounts (RFA) needs to be tested on whether a fair balance between type-1and type-2 errors is being adopted by the banks in this process.

Fraudian Slip

RBI must urge banks to demonstrate their focus on a sound OR management. One of the suggested steps could be disclosure of the compensation structure across various domains and verticals. While the decisions on compensation should be entirely left to bank boards and managements, they should serve as a useful data point for inferences by regulators.

RBI should also closely look at, and direct the banks on, some of the points listed in the corporate governance report submitted by the Kotak Committee to the Securities and Exchange Board of India (Sebi). For instance, bank boards must be strengthened with modern and sophisticated risk management expertise. This will help the bank boards to better understand, and act upon, the risks in the banks.

Fourth, GoI, as a policymaker, should evaluate the gaps in its policies leading to ‘stupid’ failures. While any business is prone to failures, there should be minimal room for failures on account of non-business risks. The ministry of corporate affairs (MCA) must review the reporting disclosure standards of corporates, including banks. But rather than blindly increasing the number of compliances required, the MCA must holistically review the disclosure and compliance framework, to make it intelligent and effective.

This is not the first, or last, time that a fraud has occurred. However, the right lessons and required course corrections in the risk management framework of banks, at a systemic and specific level, must be adopted to minimise future incidents of operational losses.

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