MARKET DISCIPLINE OF BANKS

— *MS Kapur*

Banking industry is an important pillar of any economy. The growth and development of this industry depends on the trust that the society and the customers have in its reliability. Disclosures are, therefore, effective means of informing the society or market about a bank's exposure to risks and simultaneously provide a consistent, safe and sound banking environment. For reasons of safety, soundness and transparency, supervisors require banks to disclose information and make them publicly available. This article aims at triggering a thinking process in the minds of accounting professionals leading to a more meaningful and cost effective comprehension of market discipline, keeping in mind the new Basel recommendations.

Disclosures

We have seen over the years that banks' financial statements are becoming more and more transparent. At the same time, by and large an appropriate balance is kept between the need for meaningful disclosure and the protection of proprietary and confidential information. It is, however, apparent from a review of various banks' financial statements that the interpretation of accounting standards and disclosures differs from bank to bank or person to person which could affect the integrity of published financial statements. A report in the Auditors' Reports attached to balance sheets and the qualifications about banks' non-compliance with any of the Accounting Standards, could affect the confidence of the users of financial statements, viz., counter party banks, host country regulators of foreign branches of Indian banks, national and international rating agencies etc., in the integrity of the published results.

The BCBS (Basel Committee on Banking Supervision) has underlined that disclosures should be consistent with how senior management and the board of directors assess and manage risks of the bank. According to them, management can use its discretion to determine the appropriate medium and location of the disclosure. At the same time, the framework should not be in conflict with the spirit of the accounting standards and other statutory requirements. Where the disclosures are made under accounting requirements or are made to satisfy the listing requirements of regulators, banks may rely on the guidelines to fulfill the expectations. In such situations, banks should explain material differences between the accounting and other disclosures. A number of additional quantitative and qualitative disclosures are recommended by BCBS in the revised capital adequacy norms (Basel-II).

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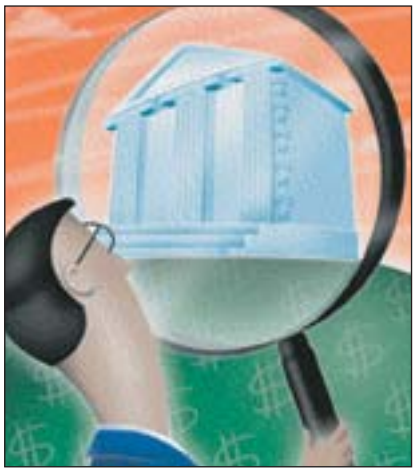
Reserve Bank of India has been continuously making efforts to ensure convergence of its supervisory norms and practices with the international best practices with a view to align the standards adopted by Indian banking system with global standards. It is observed that out of the Accounting Standards, which have been adopted, viz. Accounting Standards (AS) 1 to 29, banks in India are generally complying with all the Accounting Standards except AS-11 (Forex transactions). Convergence should be possible in this AS also, within a couple of years,

According to the Preface to the Statements of Accounting Standards (revised 2004), issued by the Council of the Institute of Chartered Accountants of India, the characteristics and scope of accounting standards include the following:

1. They are intended to apply only to items, which are material.
2. They should enable to achieve uniformity in preparation and presentation of financial statements.
3. The emphasis is on laying down accounting principles and not detailed rules for application and implementation thereof.
4. They should be in conformity with the provisions of applicable law, customs, usages and business environment in India.
5. They cannot and do not override the local regulations which govern the preparation and presentation of financial statements in the country.

Based on these broad characteristics and intent of Accounting Standards, we can refer to some of the interpretations made by different banks and auditors later in this article.



Materiality

A bank should decide which disclosures are relevant to it based on the materiality concept. It is generally accepted that information would be regarded as *material* if its omission or mis-statement could change or influence the assessment or decision of a user relying on that information for the purpose of making economic decisions. Internationally, user test is a useful benchmark to consider the item to be material or not. However, there have been instances of the auditors or bank managements, not taking a practical approach while determining the materiality cut-off, though as mentioned earlier, most of the banks have put in place robust and sound multiple reporting systems to verify compliance with the materiality concept. It should not be forgotten that banks, in view of their large branch network, are utilising huge resources to obtain the data to supplement audit evidences on an ongoing basis, which is in addition to the cost of audit/control system.

To illustrate my point further through an example, let us assume that a bank's accounting policy on matured deposits states that the ruling interest rate is applicable only in case of deposits renewed within 15 days of maturity. A mere trend analysis or behavioral study would be sufficient to find out the level of compliance or materiality in this regard and it does not certainly call for a separate MIS system. The banks, which enjoy advanced IT support, may also use mathematical and statistical models or tools to generate audit evidences so that their resources are used in a most cost and time effective way.

While on the subject of materiality, it is worth recalling the following Notes on accounts of a public sector bank as on 31.03.04, which quite makes my point:

"Premises include Rs.0.29 crore in respect of properties purchased, for which documents are pending for registration"

The cost of the premises as per the fixed assets schedule of the bank is Rs.313.25 crore. The proportion of the property for which documents are pending for registration works out to only 0.09%. Is the amount material as per the definition of materiality?

Accounting Principles and Uniformity

While glancing through financial statements of some of the banks as on 31.12.04, some important points are worth introspection.

I recollect an incident, which happened during one of my early banking days. I happened to see a big crowd of bank officials around an auditor and enquired what was happening there? He smiled and whispered '*Sir, no such serious issues, but the people should know and feel that audit is going on*'! It is also observed on certain occasions that some of the auditors are even forgetting the basic quality as pointed out by the 'Lord Justice Lopes' in 'Kingston Cotton mills' Case that "He is a watch-dog but should not be a blood hound".

Accounting policy/ Notes on accounts	Comments
Pending finalization of settlement on wage revision, bank has made provision of Rs.....Crore under provisions and contingencies	A number of banks have charged this expenditure under provisions instead of establishment expenses during the quarter ended 31.12.04 though an agreement has already been reached in case of total loading factor between employees union and IBA. As the estimated amount has already been crystallized, is it proper to debit the amount to provisions?
Other operating expenses include an amount of Rs..... Cr on account of depreciation for transfer of investments from AFS to HTM category	The bank has provided for depreciation of Rs.....crore under operating expenses during the quarter ended 31.12.04. Is it proper to treat this investment depreciation as operating expenses?
Interest accrued but not due is included in the relevant deposit account (policy)	Prudent accounting policies require Interest accrued but not due to be shown as 'Other Liabilities & Provisions' instead of adding them to the relevant deposit account.
Interest on matured term deposits is provided for on renewal, on case-to-case basis. (policy)	As there is no contractual obligation for payment of interest during the intervening period, whether the mention about accounting policy is required?

Local Regulations and Business Environment in India

In some areas, proper balance between Accounting Standards and the intention behind the regulatory policies are to be looked into. For example, as per RBI guidelines, as a prudent measure banks are advised to create floating provisions to make the banks healthier to enable them to compete in international market. However, some professionals are of the view that such floating provisions are against AS-29 (Provisions, Contingent Liabilities and Contingent Asset). We can see that the intention behind this guidance is to improve the image of Indian banks in international market by strengthening the financials of banking system and reducing the chances of systemic failure. This helps India to get more Capital inflow and thereby enable overall economic development.

Another divergent area is fixing of discount rates in actuarial valuations as per AS-15. Conventionally, banks as well as actuaries are of the view that the average rate of return of the fund portfolio shall be considered as discount rate, which is quite reasonable under prudence too. But there is also a divergent view that long-term government bond rate (which may be 1-2% lesser than average yield as the price of government bonds are risk free rates) is a better discount rate than the average yield of the fund.

Conclusion

If Banks have their formal disclosure policies approved by the respective board of directors that addresses to the bank's approach for determining what disclosures it will make and to the internal controls over the disclosure process, then freedom needs to be given to individual banks to decide on the extent of disclosures, in consonance with the disclosure requirements under the accounting standards. In addition, banks may also implement a process for assessing the appropriateness of their disclosures. The cost of supervision should not be more than the cost of poor supervision and hence more importance needs to be given for 'management perception' than the emphasis on the present rule based system. The new capital adequacy and risk management disclosures leverage the ability of market discipline by enhancing the degree of transparency in public reporting and hence good convergence with accounting and regulatory bodies is sine-qua- non for better market discipline. It is also important that a change management at organisational as well as auditors' level is necessary to ensure an orderly and effective switch over. ■