

GOVERNANCE CHALLENGES IN FINANCIAL SECTOR

with special focus on fraud



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Financial sector challenges

- Global financial crisis/sub prime crisis
- Credit risk management & capital adequacy
- Social objectives vs profitability margins
- Business mix/customer mix/funding mix
- Manipulations and frauds on increase
- Multiplier impact on Economy
- Stakeholder dimension-
Shareholders/Depositors/Borrowers/Employees/Society/Regulators/Government

Classification of Frauds-RBI

- Misappropriation and criminal breach of trust.
- Fraudulent encashment through forged instruments;
- Manipulation of books or through fictitious accounts –conversion of property
- Unauthorised credit facilities extended
- Negligence and cash shortages
- Cheating and forgery
- Irregularities in foreign exchange transactions.

POINTERS TO VIGILANCE

- **Gross violation of norms**
- **Non adherence to procedures**
- **Lack of authority or jurisdiction**
- **Falsification of documents/data**
- **Being in the know of deficiencies, recommending or not reporting**
- **Continued involvement/interest**
- **Non adherence to safeguards/measures in the interest of the Bank**

TYPES OF FRAUD

- **Fraudulent Financial Statements**
- **Employee Fraud**
- **Vendor Fraud**
- **Customer Fraud**
- **Investment Scams**
- **Bankruptcy Frauds**
- **Miscellaneous**

**The common element
is deceit or trickery!**



Impact of Fraud ...Two Examples

- General Motors
 - \$436 Million Fraud
 - Profit Margin = 10%
 - \$4.36 Billion in Revenues Needed
 - At \$20,000 per Car, 218,000 Cars
- Bank
 - \$100 Million Fraud
 - Profit Margin = 10 %
 - \$1 Billion in Revenues Needed
 - At \$100 per year per Checking Account, 10 Million New Accounts



Select Cases of Governance failures



Madoff



- **Global Trust Bank-**
Using capital Markets as a source of revenue and indulging in price rigging; Ketan Parekh nexus- legitimate deals/murky deals

Factors contributing to Fraud

- Greed-Ethical values given a go by
- Executive incentives
- Stock market expectations
- Nature of accounting rules
- Audit failures- Internal & External
- Aggressiveness of investment banks, commercial banks, Rating agencies & investors
- Weak Independent directors and Audit committee
- Whistle blower policy not being effective



SATYAM CASE-BASIC FACTS

- **4TH largest Indian IT Company**
- **Over US \$ 2 billion annual revenue size**
- **Grown to a size of 53,000 employees**
- **600 plus customers - 185 fortune 500 Cos**
- **Operations in 66 countries across the globe**
- **Listed in US and other jurisdictions**

REVELATIONS BY CHAIRMAN

- **Inflated billing to customers**
- **Non-existent cash & bank balances \$ 1 bn**
- **Overstated Debtors \$ 100 million**
- **Operating margin shown high at 24% in Q2 (Sept 2008) as against 3% real profit margin**
- **Such manipulation done in earlier years(6 yrs-\$ 2 bn)**
- **Increased costs to justify higher level of operations**
- **Attempt to merge Son's Company 'Maytas' with huge land Bank to bridge the gap failed**



Why Confession ?

- **Recession drained the liquidity to run the show**
- **Out standings were piling up**
- **Alarming gap between actual profit and book profit**
- **“Every attempt made to eliminate the gap failed. As the promoters held a small percentage of equity, the concern was that poor performance would result in a take-over, thereby exposing the gap. It was like riding a tiger, not knowing how to get off without being eaten”.**

Consequences of fraud



- **Investors**- Panicked-Class action suits in US
- **Employees**- stranded - social, financial, legal
- **Customers**- shocked and worried about the project continuity and cost over run
- **Bankers** –Financial and non-financial exposure - recalled facilities
- **Regulators** –Initiated investigations
- **Government**- Concerned- image of the Nation & faith to invest or to do business in India

Options before the Government

- **I. Announce bail out plan;**
- **II. Allow market forces to decide; or**
- **III. Think out of the box- PPP Model**
- **Dissolved existing Board**
- **nominated 6 of us to the Board**
- **Complete freedom to take decisions**

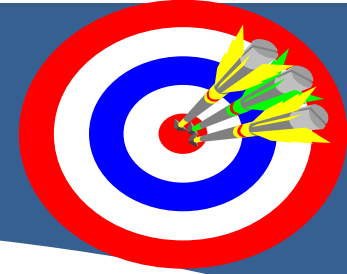


Modus Operandi

- Held weekly Board meetings
- Raised \$135 million from 2 banks
- Cleared all statutory dues;
- Paid global salary, dues and taxes;
- Reached out to employees and customers;
- Video clippings; conference calls; E-News letter & Weekly Bulletin & personal meetings;
- For 15 weeks no owner in control



MOST CRITICAL DECISION



- **Continue to run the Business, clean up and restate and offer for take over; or**
- **Immediately identify a strategic investor who will infuse capital and take control**
- **Chose the second option after due deliberation**
- **Investment Bankers appointed & Bidding process set in motion**
- **Former Chief Justice of India invited as Observer**
- **SEBI and CLB - moved for approvals and reliefs**

STRATEGIC INVESTOR SELECTION

- Virtual and Physical data room access provided
- Campuses site inspection facilitated
- Management presentation made showcasing the facts and potentials;
- Conference call slots to clarify on legal and financial matters separately
- One physical meeting held with Bidders
- Technical and Financial bids received on 13th April and Tech Mahindra emerged highest bidder



GOVERNANCE NORMS REFORMS

- **Effectiveness of the Board & Independent Directors**
- **Audit Committee –role and efficacy**
- **Rotation of audit Firm/partner**
- **Strengthening of Quality review (Peer review)**
- **Joint Auditors & Forensic audit**
- **Internal audit of Financials – scope & efficiency**
- **Effective ‘Whistle blower policy’**
- **Class action suits- rights of shareholders**

Sound Banking Governance

- **Effective risk management system**
- **Adequate capital provision**
- **Sound supervision and Regulation**
- **Transparency of operations**
- **Conducive public policy intervention and Maintenance of macro-economic stability**
- **Strategic objectives and corporate values**
- **Appropriate oversight by senior management**
- **Sound Board with Independent qualified Directors**
- **Robust audit mechanism- Internal & External**

Global regulatory convergence

- **Global convergence of banking Regulations**
- **Stability and resilience of the Financial sector**
- **G 20 mandated International regulatory agencies and standard setters initiatives for a major overhaul**
- **Basel Committee on Banking supervision(BCBS)**
- **Financial Stability Board(FSB)**
- **Committee for Payment & Settlement Systems(CPSS)**
- **International Accounting Standards Board(IASB)**
- **Basel III framework-prescription of a higher quality, quantity, consistency and better risk coverage of capital**



Thank You



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