Chapter - 1

Introduction

1.1 Introduction

There is a shift in the entire concept of traditional banking from mere lending and borrowing to a modern banking system, where banks are mobilizing the available resources to high investment priorities. Modern Indian banks are responsible for the increased and sustained growth of the economy (Srivastava & Srivastava, 2010).

Modern banks take risk with an intention to earn profits and use derivative for risk management purpose by transferring financial risks to entities willing to manage such type of risks. Banks have been managing their risks through various ways since very long, but the advanced way of risk management using derivatives has become inevitable in the present scenario. Indian financial markets face constant price and interest rate volatility which leads banks to hedge their portfolio using derivatives. Banks using derivatives for risk management purpose are generating income in the process which was not possible from the traditional way of bank activities.

Hence, derivatives are considered as risk management tools which can be used to increase the profits of entities. Derivatives are financial instruments widely used by both financial and non-financial institutions in the modern business world for mitigating unexpected losses and to reduce earnings volatility with stabilization of firm’s future cash flows. The increased usage of these instruments by entities is attributable to the efficiency of these instruments in managing the risks faced by entities. The complex nature of derivatives and its increased usage by different
entities have led to a greater demand for better understanding of these financial instruments and their subsequent disclosures in the annual reports of firms.

Due to their specific nature, derivatives are not recognized in the balance sheet statement as an asset or liability or in the income statement as an unrealized gain or loss. Instead, to increase the user’s understanding about the importance of derivatives and the associated risk factors, these are disclosed in the notes to the financial statements.

1.2 Need for the Study

The use of financial derivatives especially by banks in India has significantly increased over the past several years. Because of the increasing complexity of derivative instruments and hedging strategies, the reporting for derivative activities is a challenging and complex issue. Derivative accounting standards aid in providing appropriate information about derivative activities in order to help investors evaluate the potential benefits and risks associated with derivatives use. Non compliance with these standards can lead to serious consequences.

The substantial hidden derivative risk exposures due to flaws in the present derivative accounting requirements, evidenced high profile cases such as Orange County, Metagesellschaft, Procter and Gamble, Barings Bank and Long Term Capital Management (LTCM) (Papa, 2010). The recent credit crisis have raised questions amongst regulators and investors on the role the accounting standards played in helping banks and other financial institutions to conceal losses. Financial institutions suffered huge losses on their derivatives positions, especially credit default swaps (CDS) resulting in collapse of some firms while the government bailed out several others. The problem was aggravated due to lack of information on counter party
exposure in a range of areas including derivative products, which impaired the ability of banks (and others) to assess the risk associated with these instruments. Subsequently, there have been efforts to provide a comprehensive regulatory framework in order to reduce speculation in derivatives market. The role of derivatives in the financial crisis has highlighted the need to better understand the risks and rewards associated with derivatives use and the effectiveness of current derivative accounting and reporting practices.

Compliance with derivative accounting guidelines should provide useful information to investors in assessing the impact of derivatives use on the banks’ risk and market value. The primary benefit of derivatives use is in the form of reduction in risk exposure though hedging. However, derivatives can increase banks’ risk exposure if they are used for speculative purposes. In either case, the change in risk exposure can also lead to a change in market value of the firm, hence, a greater need is felt for the present study.

Many of the previous studies have focused on the derivative accounting practices followed by non-financial institutions and are single year studies hence, these findings cannot be generalized for Indian banks. Also the regulatory framework for Indian banks is entirely different from that of any other entity of our country or any other country. The focus of this research is firstly, to analyze the derivative accounting guidelines for banks, secondly, to assess the accounting for derivative information needs of informed user of bank annual reports, and finally to evaluate the level of compliance and factors influencing the level of compliance with derivative accounting guidelines by Indian banks.
1.3. Statement of the Problem

The use of derivatives by banks and the extent of information provided in bank annual reports are considered to be opaque. At the same time, even adequate information about a bank’s derivative positions may not indicate the overall riskiness of banks activities, which makes them very different from any other entity that uses derivatives. Using confidentiality as an excuse, previously banks were exempted from limited disclosure practices and were not considered for assessment of transparency in reporting practices. With the increased awareness among various stakeholders, about the growth in the use of derivatives by banks for trading and risk management purposes, banks are expected to clearly reflect the risks and rewards associated with the use of derivatives by complying with the required regulatory requirements.

Derivative accounting practices around the world are under scrutiny as derivatives were blamed for having a role in the recent financial crisis, again, regulators and standard setters at national and international level are in the process of improving the accounting regulations for these derivatives. IASB has released the new standard IFRS 9 – Financial Instruments in replacement of IAS 39, which is now ready for adoption or convergence across the world for harmonized financial statements. With all the developments around the world of derivatives, a need for understanding the derivative accounting practices of Indian banks was identified.

1.4. Research Questions

This study intends to answer the following research questions:

Q1: What are the derivative accounting guidelines for Indian Banks?

Q2: How different are the Indian derivative accounting guidelines different from the derivative accounting reporting guidelines at international level?
Q3 : What are the important information needs of the user’s derivative accounting information in the annual reports of banks?

Q4 : What is the level of compliance with derivative accounting guidelines by Indian banks?

Q5 : What are the important firm characteristics associated with the level of compliance with derivative accounting guidelines by Indian banks?

1.5. Objectives of the Study

The main objectives of the study are

1. To analyze the derivative accounting guidelines for banks by Reserve Bank of India and Bank for International Settlements.

2. To identify, enumerate and prioritize the information needs of accounting for derivative in bank’s annual reports.

3. To determine the level of compliance with quantitative derivative accounting guidelines by Indian Banks.

4. To determine the level of compliance with qualitative derivative accounting guidelines by Indian Banks.

5. To study how the level of compliance with quantitative and qualitative derivative accounting guidelines by Indian banks is influenced by size, age and ownership of banks.

1.6. Hypotheses of the Study

The following hypotheses were formulated in this study.

H1 : There is a significant difference between quantitative derivative accounting guidelines by Bank for International Settlements (BIS) and Reserve Bank of India (RBI).
H₂ : There is a significant difference between qualitative derivative accounting guidelines by Bank for International Settlements (BIS) and Reserve Bank of India (RBI).

H₃ : There exists a significant difference in the level of compliance with quantitative derivative accounting guidelines for the period of five years.

H₄ : There exists a significant difference in the level of compliance with qualitative derivative accounting guidelines for the period of five years.

H₅ : The level of compliance with quantitative derivative accounting guidelines is significantly affected by the size, age and ownership of banks.

H₆ : The level of compliance with qualitative derivative accounting guidelines is significantly affected by the size, age and ownership of banks.

1.7. Research Methodology

Both primary and secondary data are collected for achieving the stated objectives of the study. For the accomplishment of the first objective of the study, an analysis of the derivative accounting guidelines at national and international level is conducted. The Basel Committee on Banking Supervision under Bank for international settlements (BIS) and the technical committee of IOSCO have jointly issued recommendations to put in practice the guidelines on qualitative and quantitative derivative accounting information in the bank’s annual reports. A score of 2 is given if derivative accounting information by BIS guidelines is present in RBI guidelines, a score of 1 is given if the item is partially present or has a scope to be included in the RBI guidelines, and a score of 0 is given if the derivative accounting information is not present in the RBI guidelines. The gap score is calculated by subtracting the actual score from the expected score (2). The items with lower gap score are discussed. Primary data is collected for the purpose of identifying,
enumerating and prioritizing the information needs of users of accounting for derivatives information in the annual reports of banks. Primary data is collected through the execution of survey questionnaires to hundred informed users of derivative accounting information. The frequencies and mean values of the responses were calculated and the derivative accounting information items were ranked based on their importance to the users. Secondary data is collected to empirically examine the level of compliance with derivative accounting guidelines in the bank’s annual reports. Content analysis method is used to determine the level of compliance with derivative accounting guidelines from the annual reports of 20 banks listed in the National Stock Exchange (NSE) of India for a period of five years 2009-10 to 2013-14. A self constructed unweighted compliance index called as Relative Derivative Accounting Compliance index, including quantitative and qualitative derivative accounting information types is used to extract scores from the annual reports of banks. A score of 1 is given if the bank is compliant with derivative accounting guidelines and a score of 0 is given if not compliant by giving due consideration to not applicable items. Simple regression models have been developed to examine the association between the three firm characteristics- size, age and ownership of banks with the level of compliance with derivative accounting guidelines by banks. Statistical tests like mean, median, descriptive statistics, ANOVA and simple regression analysis are conducted using Statistical Package for Social Science (SPSS) in the study.

1.8. Major Findings

Major findings of the study show that there exists a significant difference between the quantitative and qualitative derivative accounting guidelines by Bank for International Settlements (BIS) and derivative accounting guidelines by RBI. Most of
the quantitative and qualitative derivative accounting information items used in the survey questionnaire are considered important by the users of accounting for derivatives. The users of derivative accounting information are of the opinion that the present guidelines should be simple, understandable and comparable. The user’s comments show that more enhanced information regarding the use of derivatives, risks associated with the use of derivatives and market risk information has to be provided. The empirical findings show that there is a significant difference in the level of compliance with quantitative and qualitative derivative accounting guidelines among the sample banks. The banks show consistency in the level of compliance with quantitative and qualitative derivative accounting guidelines over the period of study. The results of regression show that, the level of compliance with overall derivative accounting guidelines is significantly associated with size of banks as measured by market capitalization, age as measured by number of years in business and ownership of banks. Size and ownership of banks show positive beta values as they are directly related and age of banks shows a negative beta value as age is inversely related to the level of compliance with derivative accounting guidelines by banks. This shows that as the size of the bank increased the level of compliance with derivative accounting guidelines increases and more private sector banks show higher compliance scores with derivative accounting guidelines whereas, the result shows that as the age of the banks decreases i.e., new age banks tend to comply more with derivative accounting guidelines than old age banks and vice versa.

1.9. Limitations of the Study

The results of the study are based on the level of compliance with derivative accounting guidelines in the annual reports of twenty sample banks listed in National Stock Exchange for a period of five years. The results are specifically applicable to
the sample banks used in the study and any generalization should be made with caution. The study is carried out using the published annual reports of sample banks through content analysis method. Derivative accounting information made anywhere else in the company websites, additional reports and through any other means are not considered in the study.

1.10. Structure of the Thesis

The thesis is organized into ten chapters. The first chapter gives an introduction to the thesis that includes the statement of the problem, need for the study, research questions, objectives, hypotheses formulated for the study, scope and limitations of the study. Second chapter gives a brief review of literature related to compliance with derivative accounting guidelines and related disclosure and determinant studies. Third chapter focuses on the conceptual framework of accounting for derivatives. Fourth chapter illustrates the research methodology adopted in the study covering both the primary and secondary data collection approaches used in the study that includes the population, sample, stratification of banks based on size, age and ownership, construction of index, data collection and analysis methods. Fifth chapter covers the analysis of derivative accounting guidelines for banks, while the sixth chapter analyzes the survey responses of hundred respondents on the importance of various accounting for derivative information needs. The perceptions about the present and expected future derivative accounting information needs of users of bank annual reports are also analyzed. Seventh and the eighth chapters focus on the empirical study of compliance with derivative accounting guidelines for Indian banks and the firm characteristics like, size, age and ownership of banks that are influenced by the level of compliance. The major findings of the study are listed out in the ninth chapter while, the tenth chapter includes the
Conclusion for the study. Bibliography followed by annexure is presented at the end of the thesis.

1.11. Summary

This chapter gives an overview of the proposed study. A detailed description of the entire study including the statement of problem, need for the study, review of related literature, research questions, objectives, hypothesis formulated, research methodology, major findings along with limitations of the study has been discussed.