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## COVER STORY



# WHAT WENT WRONG?

The foundation of banking is trust, which is why robust disclosure standards exist. IndusInd Bank's major violation of these standards has deeply undermined this trust.

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**I**magine a blue-chip titan, a heavyweight on the Sensex and Nifty suddenly reeling. Whispers of 'accounting errors' and 'forex derivatives' began to circulate, culminating in an official announcement: IndusInd Bank had uncovered a multi-year (lack of) oversight, a miscalculation of hedging costs. On March 11, 2024, the bank witnessed a financial earthquake: a near 27% plunge in their share price, a single-day freefall that sent shockwaves through trading floors. What triggered this seismic shift? They basically messed up the hedge accounting and costs for five to seven years. Reports suggest the bank had been using internal derivative trades to manage foreign currency risks but failed to account for the actual costs. The stock market didn't take kindly to this revelation. The market's response was swift and unforgiving—IndusInd's share price plunged nearly 27% in a day, wiping out nearly ₹20,000 cr in market capitalization in one day.

### What went wrong?

The problem did not start due to speculative trades but risk-mitigation hedges tied to balance sheet items. In other words, the bank held foreign currency deposits and borrowed funds from overseas—such as yen or dollar-denominated deposits and borrowings—making it susceptible to exchange rate fluctuations. Indian banks often favor these instruments for their ultra-

low interest rates, but they also come with inherent foreign exchange exposure and related risk. These deposits and borrowings involving mainly yen and USD formed a significant portion of IndusInd's liabilities. Like many other banks, IndusInd used forex derivatives to manage this currency risk.

To manage the liabilities exchange risk, IndusInd Bank adopted a two-tiered hedging strategy. The bank internally transferred these forex liabilities to its own "Trading Desk" through internal swaps, valuing them using swap cost accounting. The cost of these internal trades were amortized over time, thereby avoiding mark-to-market (MTM) volatility. In the second tier, the Trading Desk hedged its own exposures arising out of above swaps externally—engaging with other banks or market participants through forex derivatives. Unlike the internal trades, these external hedges were marked to market, reflecting real-time valuations.

This created a critical accounting disparity: external trades were valued at market prices, while internal trades relied on swap valuations. This practice, led to persistent discrepancies in financial reporting over a five-to-seven-year period. The prolonged five-to-seven-year period of divergence led to significant financial reporting errors. This mismatch inflated reported NII, hiding the true trading losses over the years.

Consider this scenario to illustrate the derivative accounting discrepancy: A bank raises a \$1 mn foreign currency deposit for 5 years when the market exchange rate is at ₹75 per USD. Anticipating currency depreciation. The bank's liability desk enters into a swap with its Treasury desk, effectively transferring the exchange rate risk to the Trading Desk. This is called the "internal hedge". The Treasury desk, in turn, hedges its resulting forex exposure with external market participants, say at a rate of ₹77 per USD, thereby restricting its exchange loss maximum up to ₹2.00 per USD. The liability desk employs accrual accounting for the internal hedge, spreading the cost over the 5-year deposit term. The Treasury Desk

utilizes MTM accounting, reflecting real-time market valuations.

After one year, the USD exchange rate rises to ₹82. The liability desk, using accrual accounting, recognizes a loss of ₹1.40 per USD spreading the loss over 5 years. The Treasury desk, using MTM, recognizes a profit of ₹5 per USD. Thus, an accounting mismatch is created: the liability desk has deferred a loss of ₹5.60 per dollar, whereas the treasury desk has shown a profit of ₹5 per dollar. In reality, the net loss for the bank is ₹0.60 per USD (₹600,000 in this case). Prior to 2024, ICAI existing guidelines recommended MTM accounting for derivatives, they were not



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mandatory. The bank's inconsistent application of accounting methods (accrual vs. MTM) across its liability and Treasury desks resulted in the misrepresentation of its financial position. The bank showed MTM profits, while deferring the actual losses. This example demonstrates how the bank's choice of differing accounting methods between departments created a false impression of profitability, while masking the underlying financial loss.

Sensing the accounting gaps in derivative accounting of Indian banks, in September 2023, the Reserve Bank of India (RBI) issued new guidelines effective April 1, 2024, requiring banks to mark all their derivative transactions to market daily. It also prohibited internal hedging, meaning banks could no longer cover forex risk internally but had to go through the market. This prompted IndusInd bank to review its

derivatives portfolio. When it applied these new guidelines, the discrepancy became glaringly obvious. Some transactions were affecting the profit and loss (P&L) statement, while others were impacting the asset book. This review brought the issue to light.

As per media reports, while most other Indian banks complied with the new rules by June 2024, IndusInd Bank couldn't do it until November 24, thereby ballooning the losses. The bank is said to have hired an external agency in October 2024 to review its derivative books in line with the new RBI's circular. This probably caught the attention of the central bank and the RBI had to step in. The RBI asked the bank to declare its losses to investors after the private sector lender delayed provisioning. When the bank was unable to comply with the norms till February 25, the RBI stepped up its vigilance. This reportedly may have led to the bank making the disclosures on March 10.

While internal estimates peg the hit at 2.35% of net worth (₹65,102 cr December 2024), external agency validation is awaited. The bank says that it has disclosed this information as soon as the review was complete to RBI and its profitability and capital adequacy can absorb this one-time blow, but it'll likely dent Q4 FY25 P&L. According to former ICAI President Amarjit Chopra, unreported losses leading to inflated profits create a distorted financial picture, making net worth an inadequate measure.

### A failure of oversight?

The IndusInd Bank debacle raises deeply disturbing questions. How could such a significant and prolonged accounting discrepancy, involving complex derivative trades, remain undetected despite multiple layers of audits—internal, statutory, and compliance—over several years? The failure of key personnel, specifically the Head of Market Risk and the CFO, to identify and report these accumulating losses is particularly alarming.

Technically, this cannot be termed as fraud or reckless trading. But it raises big questions about internal con-

## WORST DAYS

IndusInd stock clocked its biggest single-day decline since listing

One-day fall (%)



Note: The one-day fall is arranged in descending order  
Source: Bloomberg

trols at IndusInd Bank. This situation transcends a mere technical error, revealing a critical lapse in both risk management and accountability. The protracted delay in reporting these losses—spanning June, September, and ultimately November 2024—raises serious questions. Derivative accounting, while complex, should not pose an insurmountable challenge for a bank of IndusInd's scale and expertise, suggesting a deeper systemic failure.

A significant, yet frequently ignored, issue is the composition of bank boards. The scarcity of independent directors possessing practical expertise in foreign exchange and interest rate derivatives creates a critical knowledge gap. This deficiency likely exacerbates banks' susceptibility to complex financial risks, revealing a systemic flaw in board governance.

### The transparency (or lack of it) issue

The timing of key events surrounding IndusInd Bank's accounting irregularities has ignited serious concerns about potential misconduct and a lack of transparency. In June 2024, prior to the public disclosure of the accounting discrepancies, designated persons, including the CEO and Deputy CEO, executed

significant share sales at peak prices. This raises the critical question of whether they possessed and acted upon undisclosed material information, potentially violating insider trading regulations.

The bank's failure to disclose the discovered accounting discrepancies to stock exchanges in October 2024, upon initial detection, constitutes a severe breach of disclosure norms. This delay suggests an intentional withholding of material information, potentially to manage market perception and avoid immediate regulatory scrutiny.

The abrupt resignation of the CFO immediately preceding the release of the December 2024 quarter results, followed by the RBI's unusually short one-year extension for the CEO, has intensified investor unease. These closely-timed events raise serious questions about potential internal discord and regulatory concerns regarding the bank's governance. The release of the information regarding the negative impact on the bank's net worth, occurring precisely one day after the announcement of the CEO's shortened extension, reinforces the perception of delayed and strategically timed disclosures, further damaging investor confidence.

Investors are now left to question the reliability of the bank's financial reporting and the adequacy of its oversight mechanisms. The ongoing external audit, while necessary, does little to alleviate the pervasive uncertainty about the true extent of the financial impact and the potential for further undisclosed issues. This situation underscores a systemic problem: a lack of timely and accurate response to regulatory changes, coupled with a potential failure to maintain robust internal controls, has severely damaged the bank's credibility.

These intertwined events

indicate potential lapses in corporate governance and a lack of transparency. The question is not just about the magnitude of the financial impact, but about the integrity of the bank's internal controls and the reliability of its disclosures. The real issue is that the bank's actions have made it very difficult for investors to have faith in its leadership.

### Regulators react

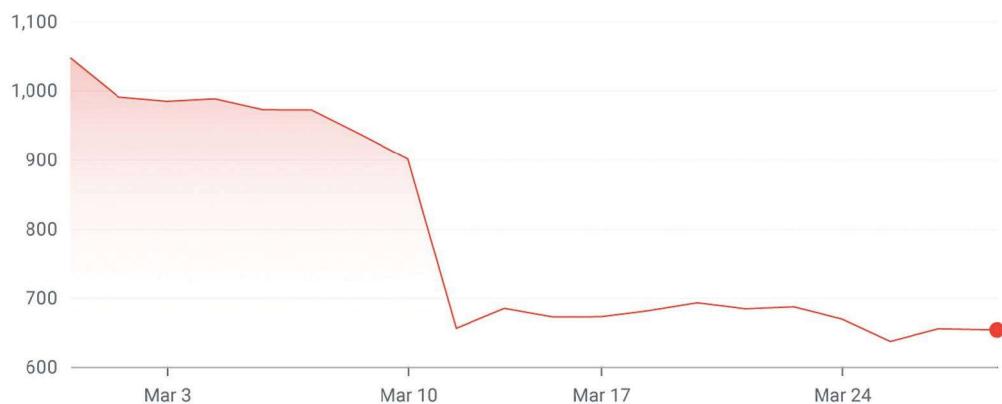
The RBI is conducting a comprehensive assessment of forex risk across the banking sector by actively verifying the hedging effectiveness and positions of major banks in the forex derivative market. The regulator is investigating whether the issues at IndusInd Bank represent isolated incidents or indicate a systemic vulnerability related to unhedged forex liabilities. To this end, a thematic review of forex exposures and risk management practices may be underway at other banks. On March 15, the RBI issued a statement to reassure the market regarding IndusInd Bank's financial health. The statement highlighted the bank's strong capital and liquidity positions, with a capital adequacy ratio of 16.46%, a provision coverage ratio of 70.20% (both as of December 31, 2024), and a liquidity coverage ratio of 113% (as of March 9, 2025), all exceeding regulatory requirements. The RBI has mandated that IndusInd Bank finalize corrective actions and provide necessary disclosures by the end of Q4FY25. *The Economic Times* reports that the RBI has also directed IndusInd Bank's board to nominate two external candidates for a senior leadership position.



**₹653.75** ↓37.54% -392.95 1M

Mar 27, 10:17:05 AM UTC+5:30 · INR · NSE · Disclaimer

1D 5D 1M 6M YTD 1Y 5Y MAX



Capital market regulator Securities and Exchange Board of India (SEBI) is also conducting a thorough examination to determine if IndusInd Bank adhered to all applicable accounting standards and disclosure requirements, aiming to identify any violations of SEBI's listing regulations. SEBI's actions are aimed at restoring investor confidence, enforcing transparency, and safeguarding the integrity of the Indian securities market. Specifically, SEBI is questioning why the bank failed to report derivative-related lapses issues to stock exchanges in October 2024, when it claims to have commenced its internal investigation. A key focus of SEBI's investigation is the reported sale of shares by key executives. SEBI is actively investigating whether these individuals possessed and acted upon unpublished price-sensitive information (UPSI) related to the derivative losses.

### More concerns emerge

Concerns over IndusInd Bank's derivatives portfolio have escalated, with its joint auditors reportedly urging the board to conduct a forensic audit. This comes alongside potential scrutiny from the ICAI's Financial Reporting Review Board, which may examine the bank's compliance with financial reporting and auditing guidelines. Some rating agencies have put the bank under review as required under SEBI regula-

tion and the possibility of a rating downgrade may not be ruled out. The incidence will dampen the business growth of the bank and reputational damage will take longer to recover.

### In banking, and elsewhere, trust is everything

As a component of the Sensex and Nifty 50 indices, IndusInd Bank's situation has broader implications for Indian market credibility. Given the significant holdings by institutional investors, the potential removal of the bank from these indices during next rebalancing could initiate forced selling by passive funds. This would generate high trading volumes, potentially causing market volatility and undermining investor sentiment.

To conclude, the substantial derivative discrepancies exposed at IndusInd Bank reveal critical vulnerabilities in its internal controls and risk management framework. Furthermore, the effectiveness and diligence of the bank's auditors are now subject to serious doubt. The confluence of delayed financial disclosures and the timing of the CEO/MD's term extension warrants meticulous scrutiny to determine if there was any impropriety. Central to this investigation are critical questions surrounding the potential deliberate concealment of material information from investors and regulators. This in-

vestigation must not only identify the root causes of the discrepancies but also implement robust measures to prevent similar occurrences in the future, thereby restoring confidence in the bank and the broader financial system. An impartial inquiry to establish accountability for these failures and to address the substantial financial losses suffered by shareholders is needed. IndusInd Bank's board is appointing an independent professional firm to investigate discrepancies

in its derivatives portfolio, identify the root cause, and establish accountability. The timing of the IndusInd Bank situation, following closely on the heels of the New India Co-operative Bank's troubles and the RBI's earlier actions against other cooperative banks, creates a potentially significant negative impact on depositor confidence and the overall banking sector. The foundation of banking is trust, which is why robust disclosure standards exist. IndusInd Bank's major violation of these standards has deeply undermined this trust. To protect the financial system's integrity, the RBI must deliver a decisive, strong and transparent response, clearly signaling the consequences of non-compliance.

The IndusInd Bank incident reveals critical lessons: strong internal controls, robust risk management, and transparency are paramount. Boards require expertise in complex instruments. Regulators must enforce timely compliance. Delayed loss reporting harms investor confidence and destabilizes markets, especially index-linked stocks. Independent oversight is vital for systemic stability. ■

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