



Challenges in the Compliance of Regulatory Framework in Commercial Banks in Kerala

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Abstract

Banking regulations can generally be defined as the frameworks controlling the creation, operation and liquidation of banks in an economy. Since the banking industry in a country is considered as the nerve system of all economic development in the country, strict regulation and supervision is necessary. The Reserve Bank of India (RBI) is the primary regulatory body for all banks in India. In order to strengthen the banking system the RBI introduced several rules, laws and guidelines from time to time. The banks in India have to comply with all these guidelines as per RBI directions. Even though the regulations are meant for strengthening the banking system, but while adopting these regulations the banks might face many challenges and issues such as issues related to NPA and NPA recovery, work burden of the employees, cost of compliance, implementation issues and so on. In this research paper, the challenges in the compliance of regulatory and supervisory framework is analyzed based on regulations such as credit policy regulations, Basel norms, CRR, SLR, priority sector lending, AML and KYC.

Key Words: Commercial Banks, Banking Regulations, Banking Regulation Challenges, credit policy regulations, Basel norms, CRR, SLR, priority sector lending, AML and KYC, RBI, NPA.

Review of literature

The following studies related to challenges of regulations in banking industry conducted in India and abroad were reviewed for identifying the research gap.

Chat Le Nguyen (2014) in his thesis “International Anti – Money Laundering Standards and Their Implementation by Vietnam”, examined the development and underlying rationales of a number of key categories of international AMLs, and differences in the national implementation of each category. The implementation of multifaceted standards in Vietnam required substantial legal and administrative reforms that often-faced numerous domestic hurdles. It is likely that Vietnam, within a short time will revise the laws to obtain a better degree of compliance. But the study argued that the given political, economic and legal factors put a limitation on the enforcement of the laws in practice.

Hayat et al. (2017) investigated the major challenges faced by banks in Indonesia under a regulatory environment. They developed a model to resist negative shock and maintain financial stability of the banking system. Profitability measurement is important in assessing the financial health of banking of banking institutions

S. Manjushree and Dr. K.V Giridhar (2018) made a study on “Problems and Prospects of Priority Sector Lending”. By using primary and secondary data they studied the problems and prospects of Priority Sector Lending in State Bank of India in Bhadravathi. They pointed out many problems in PSL scheme such as low profitability, higher transaction cost, government interferences, burden of nonperforming assets etc. The study suggested that the burden of NPA to commercial banks have to be minimized, low profitability must be improved, government interferences should be avoided, numerous procedures while availing loan under PSL scheme should be avoided, the bank must provide assistance and guidance to the borrowers for the efficient utilization of the amount, and an awareness about the scheme should be provided through newspapers, electronic channel etc.

Tony Clark (2018) reported five top regulatory concerns currently facing financial institutions putting immense pressure on staff to comply with each requirement. According to him, the broad scope of regulation, that is, each regulation comes with numerous clauses, managing risk which means complex risk calculations especially in Basel III, knowing the customer which puts huge pressure on the staff processing this information, reporting standards that require huge amount of time in meeting this requirements and also data management requiring firms to hold client information for several years were the top understated challenges of regulatory compliance..

Statement of the Problem

Bank regulations are a form of government regulation which subject banks to certain requirements, restrictions and guidelines. The main objective of bank regulations are to reduce the level of risks to which creditors are exposed (i.e. to protect depositors), to the risks of banks being used for criminal purposes, to protect the banking confidentiality, to direct credit to favored sectors. Some of the instruments and regulations of bank regulation includes capital requirements, reserve requirements, corporate governance, financial reporting and disclosure requirements, credit rating requirements etc. Regulations are important because it helps in increasing the efficiency of the banking system. But while complying these regulations the bank employees are facing challenges like legal issues, implementation issues, technology challenges, problems related to human resources, lack of data etc. It is in this background that the present study has been conducted.

Significance of the Study

The primary goal of bank regulation is the stability of the banking system. Bank failures are considered to have enormous undesirable effects on the economy as they have the tendency to spread in dominoes way throughout the financial system. A default by one bank on its obligation to another bank can adversely affect that bank's ability to meet its obligation to other banks and so on down the chain of banks and beyond. This constitutes the fundamental rationale for the need for safety net arrangements to ensure financial stability in the financial system. It is opined that in a strict sense, banking regulations may not necessarily always assure welfare

maximization. But banking rules may lead to two broad kinds of distortions viz., excessive risk taking by managers and implicit taxes that may consume surpluses. This study provides some flashes to the authorities in framing regulations and gives some directions for making regulatory and supervisory functions more fruitful by reducing the challenges in complying the same. It also provides a platform for regulatory authorities to underscores areas for improvement. Hence the study is significant.

Objective of the Study

To study the challenges in the compliance of the regulatory framework in commercial banks in Kerala

Hypothesis

H₀: There are no significant challenges for commercial banks in the compliance of regulatory frameworks.

H₁: There are significant challenges for commercial banks in the compliance of regulatory frameworks.

Methodology

The study was analytical and descriptive in nature. The population of the study constitutes the employees of the public, private sector and new generation banks in Kerala. Multi-Stage sampling technique was used for selecting the sample. For the purpose of study the State of Kerala is divided into three zones – South, Central, and North. One district from each zone based on number of branches was selected. Accordingly Thiruvananthapuram (south), Ernakulam (central), Kozhikode (north) were selected. In each district the banks were divided in to strata as Public Sector Banks, Private Sector Banks and New Generation banks. From the strata those banks having highest number of branches were selected. State Bank of India (SBI) representing the Public sector banks, Federal Bank representing the Private sector banks and HDFC representing the new generation banks are the sample banks for the study. The employees of these banks were the respondents for the study. Cochran's formula was used for determining the required number of sample for the study. Accordingly a total of 408 respondents as sample size covered under the study. Primary and secondary data were used for the study. Primary data were collected on the basis of scientifically pre- tested structured interview schedule during the period from July 2020 to April 2021. The major tools used for analyzing the data include percentage, mean, standard deviation, one sample t-Test, and one- way ANOVA and confirmatory Factor Analysis.

Results and Discussion

Challenges in the Compliance of Regulatory Framework in Commercial Banks in Kerala – One Sample t-Test

Variables		Mean	SD	t-Value	p-Value
Implementation Issues on Credit Policy	Target oriented lending	2.821	1.273	2.838	0.005**
	Lack of infrastructural facilities	2.176	1.039	16.011	<0.001**
	In sufficient staff for pre loan and post loan appraisal	2.172	1.418	11.803	<0.001**

	Increased number of defaulters	2.603	1.470	5.455	<0.001**
Overall Implementation Issues on Credit Policy		9.772	4.020	34.026	<0.001**
Legal Issues on Credit Policy	Bunching of applications due to Govt. sponsored programme	2.559	1.249	7.137	<0.001**
	Lack of support from the government	2.392	1.316	9.327	<0.001**
	Strict adherence to RBI guideline	3.000	1.597	0.000	1.000
Overall Legal Issues on Credit Policy		7.951	3.181	31.436	<0.001**
Issues Relating to NPA/NPL on CRR	When it is doubtful on the changes in the CRR rate , banks might be forced to hold back credit in fear that it might result to non-performing loans	1.816	0.843	28.366	<0.001**
	Alteration in CRR affects the repaying capacity result to NPA	2.051	0.711	26.936	<0.001**
Overall Issues Relating to NPA/NPL on CRR		3.868	1.444	12.135	<0.001**
Risk Associated with CRR	Compliance risk	2.017	0.843	23.564	<0.001**
	Credit risk	2.667	1.098	6.132	<0.001**
	Liquidity risk	2.779	1.167	3.819	<0.001**
Overall Risk Associated with CRR		7.463	2.335	38.606	<0.001**
Issues Relating to NPA/NPL on SLR	When it is doubtful on the changes in the SLR rate , banks might be forced to hold back credit in fear that it might result to non-performing loans	1.762	0.683	36.598	<0.001**
	Alteration in SLR affects the repaying capacity result to NPA	1.961	1.005	20.879	<0.001**
Overall Issues Relating to NPA/NPL on SLR		3.723	1.539	9.491	<0.001**
Risk Associated with SLR	Compliance risk	2.010	0.870	22.993	<0.001**
	Credit risk	2.488	1.232	8.397	<0.001**
	Liquidity risk	2.728	1.295	4.243	<0.001**
Overall Risk Associated with SLR		7.226	2.683	31.815	<0.001**

Information Technology Challenge on Basel Norms	Lack of flexibility in the current information technology systems and interfaces to incorporate new Basel requirements.	2.674	1.472	4.474	<0.001**
	Banks have to upgrade technology and information systems.	3.505	1.518	6.718	<0.001**
Overall Information Technology Basel Norms		6.179	2.761	23.259	<0.001**
Human Resources Challenge on Basel Norms	Skilled personnel are required for detailed reporting and calculations	3.054	1.595	0.683	0.495
	Huge expenditure on recruitment and training of personnel required for the implementation	2.615	1.237	6.284	<0.001**
	Lack of expertise human resources to implement Basel	2.395	1.279	9.563	<0.001**
Overall Human Resources Basel Norms		8.064	3.894	26.265	<0.001**
Data Challenge on Basel Norms	Lack of reliable data for calculations under Basel Framework	1.941	0.912	23.448	<0.001**
	There is difficulty in obtaining loss data, internal data, and external data for Basel calculations	1.895	0.818	27.289	<0.001**
	Basel compliances led to increase in data reporting requirements	2.336	1.048	12.802	<0.001**
Overall Data Relating to Basel Norms		6.172	2.372	27.008	<0.001**
Priority Sector Lending and NPA Issues	Borrower purchase defective assets	1.941	1.155	18.523	<0.001**
	Defective Project appraisal	1.877	0.853	26.594	<0.001**
	Borrower use loans for paying old debts	2.333	1.029	13.091	<0.001**
Overall Priority Sector Lending and NPA Issues		6.152	2.404	26.481	<0.001**
Implementation Issues on Priority Sector Lending	Receiving application in bulk	2.623	1.279	5.961	<0.001**
	Follow the guidelines strictly	3.228	1.388	3.318	0.001**
	Insufficient staff	3.017	1.511	0.229	0.819
	High number of defaulters	3.120	1.373	1.767	0.078

	Assessment of credit worthiness	2.838	1.377	2.374	0.018*
	Political pressure	2.044	1.085	17.794	<0.001**
	Increase administrative and transaction cost	2.456	1.355	8.111	<0.001**
Overall Implementation Issues on Priority Sector Lending		19.326	6.818	48.367	<0.001**
Work Burden on Priority Sector Lending	Bank organizes special programmers' for increasing PSL	2.647	1.448	4.924	<0.001**
	Visits, calls, notices in connection with recovery, reminder are more in PSL	2.630	1.333	5.608	<0.001**
	No. of Accounts are more in PSL	2.988	1.501	0.165	0.869
Overall Work Burden on Priority Sector Lending		8.265	3.660	29.051	<0.001**
Resources Deficit on AML	Insufficient budget to carry out AML activities	1.745	1.153	21.976	<0.001**
	Ineffective AML software to monitor unusual transactions	1.672	0.799	33.573	<0.001**
	Shortage of staff affects AML compliance.	1.968	1.107	18.831	<0.001**
Overall Resources Deficit on AML		5.385	2.487	19.372	<0.001**
Lack of Customer Support Relating to AML	Customers are reluctant to furnish the documents required under AML	2.064	0.917	20.621	<0.001**
	Customers often provide false information with regard to their annual income, details of assets etc.	2.520	1.230	7.888	<0.001**
	Customers feel that their privacy and confidentiality are compromised	2.789	1.452	2.933	0.004**
Overall Lack of Customer Support Relating to AML		7.373	3.094	28.549	<0.001**
Lack of Sufficient Training Relating to AML	There is no periodical training on AML measures	2.059	1.133	16.777	<0.001**
	Training on AML measures is insufficient.	1.836	0.984	23.901	<0.001**

Overall Lack of Sufficient Training Relating to AML		3.895	1.835	9.847	<0.001**
Implementation Issues on AML	There is no mechanism to verify the authenticity of information provided by the client	1.826	0.845	28.062	<0.001**
	The procedures to prevent, detect and report suspicious transactions are unclear and confusing.	1.642	0.817	33.565	<0.001**
	Timely realization of a suspicious transaction is a difficult task	1.662	0.724	37.337	<0.001**
	Insufficient feedback on the reports submitted	1.613	0.592	47.304	<0.001**
Overall Implementation Issues on AML		6.743	2.468	30.625	<0.001**
Resources Deficit on KYC	Insufficient budget to carry out KYC measures	1.431	0.778	40.748	<0.001**
	Shortage of staff affects KYC compliance	2.257	1.442	10.405	<0.001**
	Insufficient time	2.551	1.570	5.771	<0.001**
Overall Resources Deficit on KYC		6.240	3.158	20.726	<0.001**
Operational Challenges on KYC	Changing Regulations	2.745	1.483	3.471	0.001**
	Inadequate infrastructure and Technology	2.424	1.275	9.125	<0.001**
	Ill prepared staff	2.591	1.374	6.016	<0.001**
	Lack of defined process	1.868	1.193	19.179	<0.001**
Overall Operational Challenges on KYC		9.628	4.660	28.725	<0.001**
Implementation Issues on KYC	Lack of consistency	1.841	1.140	20.547	<0.001**
	Time consuming	2.696	1.408	4.362	<0.001**
	Call for more automation	2.799	1.518	2.675	0.008**
Overall Implementation Issues on KYC		7.336	3.571	24.527	<0.001**

Source: Primary Data

Credit Policy Regulations

Most of the employees responded that they are facing implementation issues such as target oriented lending, lack of infrastructural facilities, insufficient staff for pre loan and post loan appraisal, and increased number of defaulters to a moderate extent. The overall implementation issues exposed average level ($\bar{x}=9.772$)

Majority of the respondents responded on a moderate level with regard to legal issues like bunching of applications due to Govt. sponsored programme, lack of support from the government and strict adherence to RBI guideline. The overall legal issues are equal to average level ($\bar{x}=7.95$)

Cash Reserve Ratio (CRR)

The responses showed that to some extent there are challenges with regard to the variable, the changes in CRR results in NPA and to a moderate extent, challenges in case of the variable, alteration in CRR affect the repaying capacity that result in NPA. The overall NPA issues on CRR were exposed to an average level ($\bar{x}=3.868$)

The analysis showed that the risk associated with CRR such as compliance risk, credit risk, and liquidity risk is to a moderate extent. The overall risk on CRR exposed to an average level ($\bar{x}=7.463$)

Statutory Liquidity Ratio (SLR)

The responses showed that to some extent they are facing the following challenges: changes in SLR results in NPA and alteration in SLR affects the repaying capacity that results in NPA. The overall NPA issues on SLR exposed below the average level ($\bar{x}=3.723$)

The analysis showed that the respondents face the risks associated with SLR such as compliance risk, credit risk, and liquidity risk to a moderate extent. The overall risk on SLR exposed to an average level ($\bar{x}=7.226$)

Basel Norms

The analysis showed that challenges due to lack of flexibility in the current IT infrastructure where present to a moderate extent and challenges in upgrading their system and process where present to a great extent. The overall information technology challenges showed above average level ($\bar{x}=6.179$)

In case with human resources, the study showed that challenges with regard to skilled personnel requirement for detailed reporting and calculations were present to a great extent and challenges involved in expenditure for recruitment and training of personnel and lack of expertise human resources for the Basel implementation were present to a moderate extent. The overall human resource challenges exposed an average level ($\bar{x}=8.064$).

The study exposed to some extent, the challenges to the variables such as lack of reliable data for calculations, difficulty in obtaining data and to a moderate level issues in increased data reporting requirements. The overall data challenge revealed an average level ($\bar{x}=6.172$).

Priority Sector Lending (PSL)

Based on the opinion of the respondents, it was found that there were challenges with regard to borrower purchase defective asset, defective project appraisal to some extent and challenges in using of loan amount for paying of old debts were to a moderate extent. The overall NPA challenges exposed a moderate level ($\bar{x}=6.152$)

Majority of respondents opine that challenges with regard to the variables strict adherence of RBI guidelines, insufficient staff, high number of defaulters are present to a great extent and challenges in receiving

application in bulk, assessment of creditworthiness, political pressure and increase in transaction cost to some extent. The overall challenges in PSL exposed to a moderate level. ($\bar{x}=19.326$)

Based on the opinion of the bank employees, the challenges on work burden related to organizing programmes for increasing PSL, number of visits, calls, notices for reminder, recovery etc., and maintain of a greater number of accounts exposed a moderate level. The overall work burden on PSL exhibited moderate level challenges ($\bar{x}=8.265$).

Anti-Money Laundering (AML)

Most of the employees respond that challenges in insufficient budget for carrying out AML activities were present to some extent and challenges in shortage of skilled personnel to a moderate extent. Overall resources deficit exhibits to some extent of challenge ($\bar{x}=5.385$).

The variables such as the customers' reluctance to furnish the documents, customers often provide false information and customers feels that their confidentiality are compromised exposed a moderate level challenge. Overall challenges in lack of customer support stood at a moderate level ($\bar{x}=7.373$)

Most of the employees opined that lack of periodical training caused challenges to a moderate level and insufficient training on AML measures create a challenge to some extent level in complying AML regulations. Overall challenge related to lack of sufficient training exhibits to some extent level. ($\bar{x}=3.895$)

Greater number of employees opined challenges arising from the following were present to some extent there is no mechanism to verify the authenticity of information provided by the client, the procedures to prevent, detect and report suspicious transactions are unclear and confusing, timely realization of a suspicious transaction is a difficult task and insufficient feedback on the reports submitted. The overall implementation issues exposed to some extent level ($\bar{x}=6.743$)

Know Your Customer (KYC)

Most of the employees opined that to some extent of challenges related to insufficient budget to carryout KYC activities, were present to some extent while challenges in shortage of staff and insufficient time were present to a moderate level. Overall resource deficit showed to a moderate level challenge ($\bar{x}=6.240$).

The analysis showed that a moderate level of challenges were caused by changing regulations, inadequate infrastructure and technology, ill prepared staff and lack of defined process. The overall operational challenges exposed a moderate level ($\bar{x}=9.6289$)

The variables used for analyzing the implementation issues such as lack of consistency exposed to some extent of challenges, while challenges exposed in time consuming and call for more automation were to a moderate extent. Overall implementation issues exposed a moderate level ($\bar{x}=7.336$)

Testing of Hypothesis

H₀: There are no significant challenges to the commercial banks in the compliance of regulatory frameworks

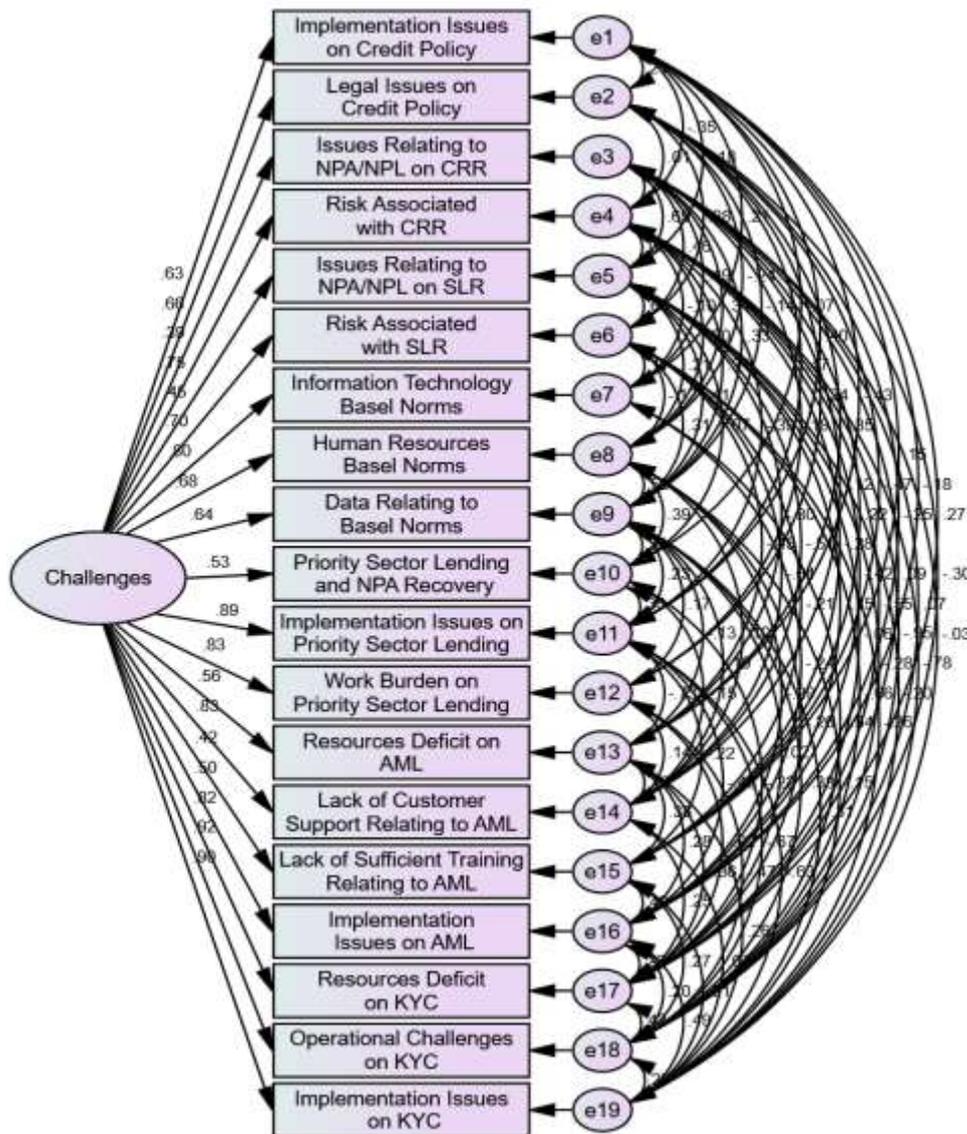
The Confirmatory Factor analysis model is applied for the hypothesis testing related to challenges in the compliances of regulatory frameworks of commercial banks in Kerala.

Challenges Faced in the Compliance of Regulatory Framework -Construct Validation with CFA

Variables		Regression Coefficient (β)	Critical Ratio (CR)	p	Variance Explained
Challenges	← Implementation Issues on Credit Policy	0.634	13.587	<0.001**	0.810
	← Legal Issues on Credit Policy	0.665	7.579	<0.001**	0.205
	← Issues Relating to NPA/NPL on CRR	0.388	11.734	<0.001**	0.665
	← Risk Associated with CRR	0.752	7.918	<0.001**	0.256
	← Issues Relating to NPA/NPL on SLR	0.446	12.676	<0.001**	0.737
	← Risk Associated with SLR	0.699	15.770	<0.001**	0.854
	← Information Technology Basel Norms	0.802	12.633	<0.001**	1.022
	← Human Resources Basel Norms	0.682	11.517	<0.001**	0.586
	← Data Relating to Basel Norms	0.638	10.015	<0.001**	0.491
	← Priority Sector Lending and NPA Recovery	0.529	18.048	<0.001**	2.349
	← Implementation Issues on Priority Sector Lending	0.889	14.668	<0.001**	1.170
	← Work Burden on Priority Sector Lending	0.827	9.059	<0.001**	0.553
	← Resources Deficit on AML	0.556	14.801	<0.001**	0.986
	← Lack of Customer Support Relating to AML	0.832	8.641	<0.001**	0.307
	← Lack of Sufficient Training Relating to AML	0.422	8.713	<0.001**	0.475
	← Implementation Issues on AML	0.500	16.416	<0.001**	1.010
	← Resources Deficit on KYC	0.824	15.133	<0.001**	1.610
	← Operational Challenges on KYC	0.916	15.324	<0.001**	1.230
← Implementation Issues on KYC	0.899	9.995	<0.001**	2.401	

Source: Primary data

All the identified variables are significantly loaded on the latent constructs due to the standardized regression coefficient variables is more than 0.4. The 'p' value is also significant at 1% level. Hence the null hypothesis explaining that there are no significant challenges to the commercial banks in the compliances of regulatory and supervisory frameworks failed to accept i.e., there are significant challenges to the commercial banks in the compliances of regulatory frameworks.



Challenges Faced in the Compliance of Regulatory Framework -Construct Validation with CFA

Findings

Most of the regulations under the study exposed a moderate level of challenges. PSL, Basel norms, credit policy regulations have slightly higher challenges than other regulations. Receiving more number of applications, its processing and maintaining of more number of accounts caused work burden under PSL. Lack of flexibility in the current IT system led to IT challenge, lack of training and skilled personal caused human resources challenge in respect of Basel norms compliance. Legal issues like strict adherence to RBI guidelines, bunching of applications in government sponsored programme caused challenges to credit policy regulations. AML regulations have least challenges compared to other regulations.

Recommendations

Bank management are responsible for the effective management of the compliance function and compliance risk. One of the challenges in the compliance of banking regulation was the lack of information technology infrastructure and lack of flexibility in the current information system to incorporate new regulations. Hence the bank management should take necessary steps to implement high technology in banks that helps in accessing data easily, strengthens the reporting function and increase the efficiency of banks. Bank should adopt some

process reengineering to improve loan application processing and to reduce the cost and time involved in processing, managing and reviewing loans. The authority should recruit sufficient human resources and provide necessary training to them.

Conclusion

From the above analysis it was found there were many issues and challenges that the banks confront in the compliances of regulatory and supervisory framework. The challenges of different regulations such as credit policy regulations, Basel norms, CRR, SLR, PSL, AML and KYC exposed average level. It is important to note that these regulations have certain consequences on commercial banks like the regulations affect the loan supply of banks, increase costs, affect the interest rate, profitability etc. It is recommended to implement high technology infrastructure to incorporate up to date regulations and give periodical training to employees in this regard.

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