

# Comprehensibility Asymmetry and Governance Failure in Banking: The IndusInd Bank Derivatives Case

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## Abstract

This case study examines the governance crisis at IndusInd Bank, one of India's leading private sector banks, triggered by the delayed recognition and disclosure of substantial losses arising from foreign exchange derivative transactions. Between 2017 and 2024, the Bank employed an asymmetric accounting approach to internal and external derivative hedges, resulting in the deferral of economic losses and the smoothing of reported earnings. The issue surfaced only after a regulatory mandate by the Reserve Bank of India (RBI) requiring uniform mark-to-market valuation of all derivatives, leading to the recognition of losses exceeding INR1,500 crore and precipitating a sharp erosion of market value. The episode was followed by senior leadership resignations, regulatory investigations, insider trading allegations, and heightened scrutiny by auditors and credit rating agencies. Rather than treating the episode as a narrow accounting failure, the case situates the crisis within a broader theoretical framework encompassing Agency Theory, corporate governance failure, and regulatory arbitrage. It illustrates how agency conflicts in modern banking increasingly arise from *comprehensibility asymmetry*, where technically complex disclosures limit effective oversight despite formal transparency. The case further highlights the distinction between governance form and governance function, demonstrating that structural compliance with board independence, committee frameworks, and disclosure norms may be insufficient to ensure meaningful oversight in institutions characterized by financial complexity. The analysis also draws attention to regulatory arbitrage arising from institutional gaps and transitional regulatory regimes. The discretionary accounting treatment of internal hedges, while not overtly illegal at the time, exploited ambiguities between accounting standards, banking supervision, and securities regulation. This regulatory lag enabled the accumulation of latent risks that crystallized only after regulatory tightening. The subsequent regulatory, audit, and market responses underscore the interconnected roles of boards, auditors, and regulators in safeguarding financial integrity. By integrating these theoretical perspectives, the case contributes to the corporate governance literature by moving beyond checklist-based models toward a more dynamic understanding of governance as a function of expertise, ethical leadership, and institutional coordination. The IndusInd Bank debacle offers broader lessons for financial institutions in emerging markets, emphasizing that sustainable performance depends not merely on compliance or innovation, but on transparency, accountability, and the capacity of governance mechanisms to engage meaningfully with complexity.

Keywords: Indusind Bank; Corporate Governance Failure; Agency Theory; Regulatory Arbitrage; Derivative Accounting, Comprehensibility Asymmetry

JEL Codes: G21, G34, M41, K22

## 1. Introduction

IndusInd Bank Limited was incorporated in 1994 as a commercial bank under the provisions of the Banking Regulation Act, 1949. The Ashok Hinduja-led promoter group, through IndusInd International Holdings Ltd. and IndusInd Ltd., collectively holds a stake of over 15.83% in the Bank. IndusInd Bank is a publicly held institution listed on both the National Stock Exchange (NSE) and the Bombay Stock Exchange (BSE). It offers a comprehensive suite of banking and financial services to retail and corporate customers, alongside treasury and foreign exchange operations. The Bank's operations span across India, including participation in the International Financial Services Centres (IFSCs).

Over the past three decades, IndusInd Bank has transformed from a relatively small, retail-oriented lender into a diversified financial services institution with capabilities across commercial, transactional, and digital banking. This evolution has been marked by several strategic milestones, including the acquisition of Ashok Leyland Finance in 2004 and the merger with Bharat Financial Inclusion Limited (BFIL), a leading microfinance institution, in 2019. The Bank has also invested heavily in digital platforms and technology-driven delivery channels over the past decade. As of FY 2024–25, IndusInd Bank reported total assets exceeding INR5.5 lakh crore and a loan portfolio of more than INR3.5 lakh crore. In Q3 FY25, the Bank recorded a Net Interest Income (NII) of INR5,228 crore and a net profit of INR1,402 crore. While loan growth of 13% and deposit growth of 11% year-on-year reflected underlying business momentum, profitability was adversely affected by a one-time loss of approximately INR1,500–1,600 crore

arising from the revaluation of foreign exchange derivatives. The Bank's Basel III capital adequacy ratio stood at around 16.5%, with Tier I capital at 15.2%, indicating a relatively strong capital position. Nevertheless, margins showed signs of pressure, with Net Interest Margin (NIM) declining to 3.93%, and gross non-performing assets inching up to about 2.25%, particularly in the microfinance and commercial vehicle lending segments.

The Bank's core strengths include a diversified loan book, a well-capitalized balance sheet, and a strong emphasis on digital transformation and environmental, social, and governance (ESG) initiatives. IndusInd Bank has maintained a stable CASA ratio in the range of 33–36%, supporting relatively low-cost funding. The integration with BFIL has strengthened its presence in rural and semi-urban credit markets, while its early participation in India's Central Bank Digital Currency (CBDC) pilots underscores its focus on innovation. At the same time, recent developments have revealed structural and operational vulnerabilities. The derivative accounting issues exposed material weaknesses in internal controls, risk management processes, and oversight mechanisms. Asset quality pressures, rising funding costs, narrowing margins, and higher provisioning requirements pose additional challenges to near-term earnings. Compounding these issues, the resignations of key senior executives, including the Chief Executive Officer, Deputy Chief Executive Officer, and Chief Financial Officer, raised concerns regarding leadership continuity and strategic direction. In response, the Bank sought regulatory approval from the Reserve Bank of India to constitute an interim executive committee to discharge the responsibilities of the CEO until a permanent appointment could be made.

Despite these challenges, IndusInd Bank continues to occupy a significant position among India's leading private sector banks, particularly in segments such as microfinance, vehicle finance, and mid-market corporate lending. Its extensive pan-India footprint, comprising over 3,000 branches and more than 3,000 ATMs, provides a strong platform for retail outreach and rural penetration. Although recent events have slowed business momentum, the underlying franchise remains intact. The pace and sustainability of recovery will depend on the effectiveness of leadership transition, strengthening of internal governance frameworks, and restoration of stakeholder confidence through enhanced transparency.

Historically, IndusInd Bank has projected itself as a responsible corporate entity, publishing detailed ESG and integrated reports on a regular basis. However, the failure to recognize and disclose derivative-related losses over multiple years has raised serious questions about the effectiveness of board oversight, the functioning of the audit committee, and executive accountability. The RBI's directive mandating mark-to-market valuation of all derivatives with effect from 1 April 2024 brought accumulated deferred losses into sharp focus, resulting in disclosures exceeding INR1,500 crore. The fact that these issues surfaced only following a regulatory change has undermined investor confidence and highlighted potential deficiencies in internal audit processes and statutory audit scrutiny. The market reaction was swift and severe: in March 2025, the Bank's share price declined by nearly 27% in a single trading session, significantly eroding shareholder wealth. Since then, the stock has remained volatile and well below its 52-week high. Analyst opinion remains divided, with some brokerages revising target prices downward to the INR600–INR700 range, while others continue to emphasize long-term value based on core business fundamentals. Credit rating agencies have adopted a cautious stance. While Moody's has retained the Bank's long-term rating at Baa1, it has downgraded the standalone credit profile to Ba2 with a negative outlook, citing governance and internal control concerns. CRISIL and India Ratings have maintained AA+ ratings on certain debt instruments but have flagged elevated operational and reputational risks. The Bank's ability to sustain market credibility and preserve its ratings will be closely tied to the pace and credibility of governance reforms and stakeholder communication.

In sum, although IndusInd Bank benefits from a strong infrastructure and broad market presence, recent developments have exposed significant governance weaknesses and operational risks. Navigating the path ahead will require decisive leadership, renewed regulatory confidence, and a demonstrable commitment to transparency and ethical conduct. The episode underscores a broader lesson for the financial sector: profitability built on opaque accounting practices is inherently fragile and ultimately erodes trust. As regulators, rating agencies, and capital markets respond, the IndusInd Bank case serves as a reminder that accountability, transparency, and disciplined risk management are not optional attributes, but essential foundations of financial integrity and long-term resilience.

## 2. Theoretical Framework

Understanding the recent IndusInd Bank episode requires moving beyond a narrow focus on accounting irregularities or individual managerial actions. The episode is more meaningfully interpreted through three complementary theoretical lenses i.e. Agency Theory, Corporate Governance Failure, and Regulatory Arbitrage, which together explain how complex financial practices, incentive structures, and regulatory environments can interact to produce systemic governance breakdowns. Rather than treating the debacle as an aberration, these theories situate it within broader patterns observed in modern financial institutions.

Agency Theory provides a foundational starting point. At its core, agency theory explains how conflicts arise when managers, acting as agents, pursue objectives that may not fully align with the interests of shareholders or other stakeholders (Jensen & Meckling, 1976). Traditionally, this conflict has been attributed to information asymmetry, where agents possess superior information and selectively disclose it. In the IndusInd Bank case, however, the issue appears more nuanced. Information regarding derivative transactions and accounting treatments was not entirely absent from governance forums; rather, it was embedded in technically complex frameworks that limited meaningful scrutiny. This points to a more contemporary form of agency problem i.e. *comprehensibility asymmetry*. Even when information is disclosed, principals may lack the technical capacity to fully understand or

challenge it. As financial instruments and accounting standards become increasingly sophisticated, agency conflicts emerge not merely from concealment, but from the practical inability of boards and stakeholders to interpret what they are shown.

This limitation connects directly to insights from the corporate governance literature, particularly the distinction between governance *form* and governance *function*. Classical governance models emphasize board independence, separation of roles, committee structures, and audit mechanisms as safeguards against managerial opportunism (Shleifer & Vishny, 1997). IndusInd Bank appeared to conform to many of these prescriptions. It had an independent board, multiple committees, and formal compliance with regulatory governance norms. Yet these structures did not prevent prolonged distortions in financial reporting or delayed recognition of risk. This gap illustrates a key governance insight articulated by Fama and Jensen (1983): effective control requires not only separation of decision-making and monitoring roles, but also the capacity to exercise informed oversight.

In this case, governance failed in a functional sense. Board independence did not translate into effective challenge, and audit mechanisms did not uncover issues in a timely manner. This suggests that governance effectiveness depends as much on behavioural and cultural factors—such as willingness to question management and tolerance for dissent—as on formal architecture. The IndusInd episode thus reinforces the argument that governance frameworks can become ritualistic, emphasizing compliance over substance. When oversight bodies rely excessively on managerial expertise in technically complex areas, they risk becoming passive recipients rather than active evaluators of information.

The third lens, Regulatory Arbitrage, helps explain why such practices could persist over time. Regulatory arbitrage refers to the strategic use of regulatory gaps, ambiguities, or transitional phases to achieve favourable outcomes without explicitly violating rules (Boyson et al., 2014; Pollman, 2019). In banking, this often manifests through accounting choices or balance-sheet structures that reduce visible risk or smooth earnings. In the IndusInd case, discretion in accounting for internal derivative hedges, particularly during a period of evolving regulatory expectations, created space for such arbitrage. The use of accrual-based accounting for internal positions, while external hedges were marked to market, allowed economic losses to be deferred and profitability to appear more stable.

Importantly, this behaviour does not necessarily imply illegality. Regulatory arbitrage often operates within the letter of existing rules while undermining their spirit. Jones (2000) notes that such behaviour is especially common during periods of regulatory transition, when legacy practices coexist with emerging standards. The IndusInd episode illustrates how regulatory lag and interpretive flexibility can interact with managerial incentives, enabling practices that later appear problematic once standards tighten.

Taken together, these three theories provide a coherent explanation for the IndusInd Bank debacle. Agency theory explains managerial motivation and information dynamics; governance theory highlights why formal oversight mechanisms proved insufficient; and regulatory arbitrage clarifies how institutional environments enabled these practices to persist. Their interaction underscores a broader lesson for financial institutions: governance failures often arise not from a single breakdown, but from the cumulative effect of incentive pressures, technical opacity, and regulatory ambiguity.

For academic research, this case encourages deeper examination of *how* boards process complex information, not merely whether they receive it. It also suggests that future governance reforms must pay closer attention to board competence, access to independent expertise, and the timing of regulatory interventions. Viewed through these theoretical lenses, the IndusInd Bank episode is less an isolated failure and more a reflection of structural challenges facing contemporary banking governance (Jensen & Meckling, 1976; Fama & Jensen, 1983; Shleifer & Vishny, 1997)

### 3. Industry and Regulatory Context

The structure of the Indian banking industry is organized within a hierarchical regulatory framework, with the Reserve Bank of India (RBI) functioning as the apex authority overseeing the banking and financial services system. Beneath the RBI operate various categories of banking institutions, including commercial banks, comprising public sector, private sector, and foreign banks, along with regional rural banks and cooperative banks. In addition, development financial institutions play a complementary role by providing long-term financing to priority and infrastructure-intensive sectors of the economy.

India's banking sector underwent a phase of significant expansion following the nationalization of major banks, which led to a substantial increase in branch networks, particularly in rural and semi-urban areas. This expansion greatly improved access to formal credit for agriculture, small businesses, and underserved segments of the population. While nationalization contributed to financial inclusion and sectoral development, it also introduced structural challenges. Public sector banks, in particular, grappled with issues such as operational inefficiencies, overstaffing, mounting non-performing assets (NPAs), and, at times, political influence in lending decisions. These challenges highlighted the need for reforms aimed at improving efficiency, accountability, and asset quality.

A major transformation occurred with the economic liberalization of 1991, which reshaped the competitive landscape of Indian banking. Post-liberalization reforms initiated by the Government of India and the RBI sought to make the sector more market-oriented, efficient, and internationally competitive. These reforms facilitated the entry of new private sector banks, including

institutions such as HDFC Bank, ICICI Bank, Axis Bank, and IndusInd Bank during the mid-1990s. The regulatory environment also became more receptive to foreign banks, albeit within defined constraints. Subsequent licensing rounds and the emergence of banks such as Yes Bank, Kotak Mahindra Bank, and Bandhan Bank further intensified competition within the sector.

As a result, competitive dynamics within the industry began to shift. Although public sector banks continued to dominate in terms of branch reach and deposit base, they increasingly faced competition from agile, technology-driven private sector banks. These newer banks leveraged superior customer service, digital platforms, and product innovation to gain market share, particularly in urban and semi-urban regions. Their focus on retail lending, personal loans, and wealth management enabled them to respond more quickly to changing consumer preferences. Foreign banks, while limited in branch expansion due to regulatory restrictions, concentrated on niche, high-margin segments such as corporate banking, trade finance, and services for high-net-worth individuals. Through the adoption of global best practices, advanced technology, and strong capital frameworks, foreign banks contributed to raising operational and governance standards across the industry.

Despite the growing prominence of private and foreign banks, public sector banks continue to play a critical role in India's financial system, particularly in advancing government-led development initiatives. Over the past decade, beginning around 2014–15, the banking sector has been central to the implementation of major policy programs such as the Pradhan Mantri Jan Dhan Yojana, Direct Benefit Transfers, and the expansion of mobile and digital banking. These initiatives have significantly enhanced financial inclusion and supported the broader aspirations of a rapidly growing economy.

Within this evolving landscape, the Indian private banking sector has emerged as a dynamic and competitive space characterized by continuous innovation and strategic diversification. Private sector banks have increasingly emphasized technology adoption, digital delivery models, and targeted penetration of niche segments such as microfinance, agri-finance, and small business lending. IndusInd Bank, one of the prominent private sector banks, has established a strong presence, particularly in semi-urban markets, by offering a balanced mix of retail and corporate banking services. A comparative snapshot of the top ten private sector banks, presented in the Annexure, illustrates their relative scale and key performance indicators.

IndusInd Bank is widely regarded as the fifth-largest private sector bank in India, serving a customer base of over 40 million nationwide. It is also the country's second-largest microfinance lender through its subsidiary, Bharat Financial Inclusion Limited (BFIL), which caters to more than 13 million customers. This positioning underscores the Bank's significance within the broader private banking ecosystem and highlights its role in extending formal financial services across diverse segments of the Indian economy.

#### 4. IndusInd Bank: Business Model and Governance Structure

IndusInd Bank's business model has historically been anchored in a diversified lending strategy designed to balance growth, risk, and sectoral exposure. The Bank's loan portfolio spans multiple segments, including retail lending, vehicle and commercial transport finance, microfinance, and mid-market corporate credit. This diversification has enabled the Bank to avoid excessive concentration risk in any single segment, while also allowing it to participate in both consumption-driven and enterprise-led growth within the Indian economy. Retail and vehicle finance have traditionally provided relatively stable cash flows, while mid-market corporate lending has supported higher yields, albeit with greater sensitivity to economic cycles. Microfinance, largely conducted through the Bank's subsidiary Bharat Financial Inclusion Limited (BFIL), has extended the Bank's reach into rural and semi-urban markets, aligning commercial objectives with financial inclusion goals.

A key feature supporting IndusInd Bank's funding profile has been the stability of its Current Account–Savings Account (CASA) ratio, which has consistently remained in the mid-30 percent range. A healthy CASA base is critical for banks, as it lowers the overall cost of funds and provides a relatively stable source of liquidity compared to wholesale borrowings. This stability has allowed IndusInd Bank to maintain competitive pricing across lending segments and to withstand, to some extent, periods of rising interest rates. At the same time, sustaining a strong CASA ratio requires continuous investment in customer acquisition, service quality, and digital banking platforms—areas in which the Bank has been an active participant.

Through the integration of BFIL, IndusInd Bank emerged as one of India's largest microfinance lenders, serving millions of low-income and underserved borrowers. This segment has played a significant role in broadening the Bank's customer base and reinforcing its presence in rural India. Microfinance operations, however, carry distinctive risks, including exposure to regional economic shocks, regulatory interventions, and borrower vulnerability to income volatility. Managing these risks effectively requires robust credit appraisal processes, close monitoring of portfolio performance, and sensitivity to social and political dynamics in lending regions. While microfinance has strengthened the Bank's growth profile, it has also increased the complexity of its risk management framework.

Parallel to its business expansion, IndusInd Bank established a governance framework intended to reflect best practices in corporate oversight. The Bank's Board comprised eleven members, with a majority being independent directors, and was supported by several committees, including the Audit Committee and the Risk Management Committee. In formal terms, this structure complied with the

requirements laid down by banking regulations, corporate law, and stock exchange listing norms. The presence of specialized committees was intended to ensure focused attention on financial reporting, internal controls, and risk oversight.

However, the effectiveness of governance cannot be assessed solely on structural compliance. In practice, concerns emerged regarding the Board's ability to exercise meaningful oversight over complex and highly technical areas, particularly treasury operations, derivative transactions, and internal control mechanisms. These domains often involve specialized financial instruments and accounting judgments that may not be easily accessible to non-executive or independent directors without deep technical support. As a result, governance challenges arose not from the absence of formal processes, but from limitations in their practical execution. The IndusInd Bank experience thus underscores a broader issue in banking governance: as financial institutions grow in scale and complexity, effective oversight increasingly depends on the depth of expertise, quality of information, and willingness to challenge management, rather than on compliance with governance structures alone.

## 5. The Derivatives Accounting Controversy

Between 2017 and 2024, IndusInd Bank adopted a two-layer hedging framework to manage its exposure to foreign currency risks arising from external borrowings, deposits, and cross-border transactions. At one level, the Bank entered into derivative contracts with external market counterparties, such as currency swaps and forward contracts, designed to hedge foreign exchange and interest rate risks. These external derivative instruments were accounted for using mark-to-market (MTM) valuation, in line with prevailing accounting norms and regulatory expectations. Changes in their fair value, whether gains or losses, were reflected in the Bank's profit and loss account on a periodic basis, thereby capturing the immediate economic impact of market movements.

At the second level, the Bank relied on internal derivative transactions executed between its Treasury desk and the Asset–Liability Management (ALM) desk. These internal trades were intended to mirror the external hedges and facilitate risk transfer within the institution. However, unlike the external contracts, internal derivative positions were not subjected to MTM valuation. Instead, they were accounted for on an accrual basis, under which gains and losses were spread over time rather than recognized in real time. This divergence in accounting treatment created a structural asymmetry between economically linked transactions.

The practical consequence of this asymmetry was a growing mismatch in the timing of income recognition. Losses arising from external hedges were recognized immediately as market conditions changed, while corresponding losses on internal hedges were deferred and amortized over several accounting periods. In contrast, gains on certain internal positions were, in some cases, recognized upfront. Over time, this practice had the effect of smoothing reported earnings and obscuring the underlying volatility and risk profile of the Bank's derivative exposures. Although the economic risks remained within the institution, their financial reporting impact was delayed, resulting in an overstatement of profitability in the short to medium term.

This accounting approach came under scrutiny following the Reserve Bank of India's directive mandating uniform mark-to-market valuation for all derivative transactions, both internal and external, with effect from 1 April 2024. The implementation of this requirement forced the Bank to revalue its accumulated internal derivative positions on a fair-value basis. As a result, losses that had been deferred over several years were recognized in a single accounting period, culminating in a one-time charge exceeding INR1,500 crore. The magnitude of this adjustment highlighted the extent to which risks had been understated in prior periods.

Subsequent forensic and internal reviews revealed that the accounting treatment adopted was inconsistent with both the spirit and the explicit requirements of Ind AS 109, which mandates fair-value measurement of derivative financial instruments, and Ind AS 21, which governs the recognition of foreign exchange gains and losses. These reviews further indicated that internal control mechanisms had been overridden and that key information regarding the cumulative impact of these practices had not been fully communicated to the Board of Directors or to the statutory auditors. The episode thus exposed deeper governance and control weaknesses, demonstrating how technical accounting decisions, when combined with inadequate oversight, can materially distort financial reporting and delay the recognition of underlying economic realities.

### Accounting Standards Implications: Violations of Ind AS 8, 32, 107 and 109

The accounting issues at IndusInd Bank were not merely technical lapses; they represented a systematic departure from the principles embedded in India's accounting standards for financial instruments. Four standards are particularly relevant: Ind AS 109, Ind AS 32, Ind AS 107, and Ind AS 8.

Ind AS 109 (Financial Instruments) requires all derivatives to be measured at fair value and for changes in fair value to be recognised promptly in profit or loss, unless strict hedge-accounting conditions are satisfied. In the IndusInd case, while external derivative contracts were marked to market, internal derivative positions were accounted for on an accrual basis. This asymmetric treatment delayed the recognition of economic losses and smoothed reported earnings. Such a practice contradicts the fundamental logic of Ind AS 109, which seeks to ensure that financial statements reflect current economic reality rather than deferred or selective recognition of risk.

Ind AS 32 (Financial Instruments: Presentation) governs how financial instruments should be classified and presented as assets or liabilities. By treating internal derivatives differently from external contracts and not presenting them as derivative assets or liabilities at fair value, the Bank blurred the true nature of its financial exposures. This impaired the faithful representation of the balance sheet and obscured the scale of risk embedded in treasury operations. In effect, derivative exposures that should have appeared clearly as valuation-sensitive instruments were embedded within accrual-based accounting entries.

Ind AS 107 (Financial Instruments: Disclosures) requires entities to disclose the nature and extent of risks arising from financial instruments, including valuation methods, sensitivity to market movements, and fair value information. The delayed public disclosure of the cumulative impact of derivative losses indicates a failure to meet the spirit of this standard. Even if certain technical disclosures existed, the overall risk profile was not communicated in a way that allowed investors and analysts to understand the magnitude of latent losses. The omission of clear, timely disclosure undermined market transparency and prevented stakeholders from making informed judgments about the Bank's financial position.

Ind AS 8 (Accounting Policies, Changes in Accounting Estimates and Errors) becomes relevant once it was evident that prior-period accounting treatments were incorrect. Ind AS 8 requires material errors to be corrected retrospectively and disclosed clearly, with explanations of their nature and impact. In this case, accumulated losses were recognized only after regulatory intervention, rather than through earlier voluntary correction. This delayed correction suggests that what should have been treated as prior-period errors were allowed to persist across multiple reporting cycles, weakening the reliability of earlier financial statements.

Taken together, these violations reflect not a single mistake but a pattern of accounting choices that deferred loss recognition, diluted disclosure quality, and weakened the credibility of reported profits. The episode illustrates how technical deviations from accounting standards can translate into governance failures, market mispricing, and erosion of trust. More importantly, it shows that accounting standards are not merely compliance tools but mechanisms designed to protect stakeholders by enforcing timely recognition, transparent presentation, and meaningful disclosure of financial risk.

## 6. Disclosure, Market Reaction, and Leadership Changes

Although concerns regarding the accounting treatment of derivative transactions had surfaced internally at an earlier stage, IndusInd Bank did not make a public disclosure of the associated financial impact until March 2025. This time lag between internal recognition and external communication proved consequential. In the context of a publicly listed bank, where transparency and timely disclosure are central to market confidence, the delayed announcement intensified investor anxiety and amplified the eventual market response. Once the extent of the derivative-related losses was disclosed, the reaction from the capital markets was swift and severe. In a single trading session, the Bank's share price declined by more than 27 per cent, resulting in a substantial erosion of shareholder wealth and a sharp contraction in market capitalization.

The scale of the market reaction reflected not only the financial magnitude of the losses, but also deeper concerns about governance, disclosure practices, and managerial credibility. Investors appeared to interpret the delay in disclosure as indicative of weaknesses in internal reporting systems and board-level oversight. The episode underscored the sensitivity of financial markets to perceived lapses in transparency, particularly in the banking sector, where trust plays a critical role in sustaining depositor and investor confidence. The volatility that followed further reinforced the reputational damage faced by the Bank, as uncertainty regarding the full extent of the issue and its potential regulatory consequences continued to weigh on market sentiment.

As public scrutiny intensified, accountability at the senior leadership level became a central issue. The Managing Director and Chief Executive Officer, along with other senior executives, tendered their resignations, citing moral responsibility for the events that had unfolded. These resignations were significant not only in symbolic terms but also in their practical implications for organizational stability and strategic continuity. Leadership transitions at the apex of a financial institution during a period of crisis can introduce additional uncertainty, particularly when accompanied by unresolved regulatory and governance concerns. At the same time, the departures were interpreted by some stakeholders as an acknowledgment of responsibility and an attempt to facilitate institutional reset.

Parallel to these leadership changes, multiple regulatory and oversight bodies initiated independent inquiries into the matter. A forensic audit was commissioned to examine the accounting practices, internal controls, and decision-making processes associated with the derivative transactions. The National Financial Reporting Authority (NFRA) began scrutinizing the role of statutory auditors and the adequacy of audit procedures in identifying and reporting the discrepancies at an earlier stage. Simultaneously, the Securities and Exchange Board of India (SEBI) launched investigations into potential insider trading, focusing on transactions by senior executives and connected persons during the period when the derivative losses constituted unpublished price-sensitive information.

The convergence of these regulatory actions highlighted the multi-dimensional nature of the crisis, spanning accounting compliance, governance effectiveness, and market conduct. Together, they signalled a heightened regulatory emphasis on accountability, particularly in systemically important financial institutions. For IndusInd Bank, this phase marked a critical juncture, as the outcomes of these investigations would have significant implications for its credibility, regulatory standing, and future leadership framework.

More broadly, the episode underscored the importance of timely disclosure, ethical leadership, and robust internal escalation mechanisms in preserving trust in financial markets.

## 7. Insider Trading and Ethical Concerns

SEBI's interim findings brought an additional and particularly troubling dimension to the IndusInd Bank episode by revealing that several senior executives had engaged in share sales during a period when information relating to derivative accounting discrepancies had not yet been disclosed to the public. At that time, the existence and magnitude of the potential losses clearly constituted unpublished price sensitive information. Trading by senior management under such circumstances raised fundamental concerns about adherence to insider trading regulations and the ethical standards expected of individuals occupying positions of trust within a publicly listed financial institution.

From a governance perspective, senior executives are not merely employees but fiduciaries who are entrusted with safeguarding the interests of shareholders and other stakeholders. Their access to privileged information imposes a heightened duty of care, loyalty, and restraint in personal dealings with the company's securities. The sale of shares during a sensitive period therefore went beyond technical non-compliance and called into question the ethical judgment exercised by those at the helm of the organization. Even in cases where intent may be contested, the appearance of impropriety alone is sufficient to undermine confidence in leadership and weaken the moral authority of management.

The episode also exposed potential weaknesses in internal compliance frameworks designed to prevent insider trading. Large financial institutions typically maintain detailed codes of conduct, trading window restrictions, and pre-clearance requirements to regulate employee share transactions. The occurrence of such trades by senior executives suggests either lapses in the enforcement of these controls or deficiencies in their design and monitoring. This raises broader questions about the effectiveness of compliance functions in challenging senior leadership and ensuring that rules are applied uniformly across hierarchical levels.

Beyond the immediate institution, the IndusInd Bank case intensified debate regarding the adequacy of existing enforcement mechanisms for insider trading in India. While regulatory frameworks have become progressively more stringent, their deterrent effect ultimately depends on timely detection, consistent enforcement, and meaningful penalties. High-profile cases involving senior executives tend to attract significant public and market attention, amplifying perceptions about whether regulatory oversight is sufficiently robust to curb opportunistic behaviour at the top of corporate hierarchies. As a result, the episode renewed calls for stronger surveillance, faster adjudication, and clearer accountability in cases involving complex financial disclosures.

Equally important is the insight the case provides into the ethical culture within large financial institutions. Ethical culture is shaped not only by formal rules but also by informal norms, leadership behaviour, and organizational values. When senior executives engage in actions that appear to prioritize personal financial interests over fiduciary responsibilities, it sends a powerful signal throughout the organization. Such signals can erode ethical standards at lower levels, weaken compliance discipline, and foster a culture where regulatory boundaries are viewed as negotiable rather than binding.

In this sense, the insider trading allegations at IndusInd Bank highlight the intersection between ethics, governance, and regulation. They underscore the importance of ethical leadership as a cornerstone of effective governance, particularly in institutions whose stability and credibility are integral to the broader financial system. The episode serves as a reminder that maintaining market integrity requires more than compliance with formal rules; it demands a sustained commitment to ethical conduct, transparency, and accountability at all levels of management.

## 8. Regulatory and Audit Responses

In response to the unfolding developments, the Reserve Bank of India (RBI) sought to balance the need for market reassurance with the imperative of regulatory scrutiny. The central bank emphasized that IndusInd Bank continued to remain adequately capitalized and that the losses arising from derivative revaluation did not pose a systemic risk to the broader banking system. This communication was significant in containing the potential for contagion, particularly given the sensitivity of the financial sector to confidence shocks. By clarifying that the Bank's capital adequacy remained above regulatory thresholds, the RBI aimed to reassure depositors, investors, and counterparties that the institution's solvency and operational stability were not immediately threatened.

At the same time, the RBI treated the episode as a serious supervisory concern rather than an isolated incident. Recognizing that similar accounting practices could potentially exist elsewhere in the banking system, the regulator initiated an industry-wide review of derivative transactions and valuation methodologies. This move reflected a precautionary approach, acknowledging that the complexity of derivative accounting and internal hedging arrangements could give rise to comparable risks across institutions. The review signalled the RBI's intent to strengthen oversight of treasury operations, ensure consistent application of mark-to-market norms, and reduce the scope for discretionary accounting treatments that obscure underlying risk exposures.

The audit process for IndusInd Bank's financial statements for FY 2024–25 provided further insight into the nature and extent of the governance failures. The statutory auditors concluded that, following the necessary adjustments and write-offs, the financial statements presented a true and fair view of the Bank's financial position and performance. However, this conclusion was accompanied by important qualifications and emphasis-of-matter disclosures. The audit reports acknowledged that in earlier financial periods, losses linked to derivative transactions had been concealed through inappropriate accounting treatments and that internal control mechanisms had been overridden by senior management. These findings underscored that the issue was not merely technical in nature, but reflected deeper weaknesses in governance, internal controls, and the integrity of financial reporting processes.

The auditors' observations also drew attention to the role of oversight functions, including the audit committee and internal audit, in detecting and escalating such issues in a timely manner. The fact that material discrepancies persisted over multiple years suggested limitations in the effectiveness of existing assurance mechanisms. As a result, the audit disclosures became a critical element in shaping stakeholder perceptions, reinforcing the view that governance lapses, rather than one-off market movements, lay at the heart of the crisis.

Credit rating agencies responded cautiously to these developments. While acknowledging IndusInd Bank's underlying franchise strength, diversified business model, and capital buffers, rating agencies revised their outlooks and placed greater emphasis on governance and operational risks. Some agencies downgraded the Bank's standalone credit profile, citing concerns over internal controls, risk management practices, and leadership stability. Others maintained existing ratings on certain debt instruments but flagged heightened reputational and execution risks in their assessments.

This measured response reflected a nuanced judgment by rating agencies. On the one hand, the Bank's core business fundamentals and market position were seen as supportive of creditworthiness. On the other hand, the governance failures exposed by the derivative episode introduced uncertainty regarding the sustainability of earnings, the reliability of financial disclosures, and the effectiveness of management oversight. Collectively, the actions of regulators, auditors, and rating agencies underscored the centrality of governance and transparency in maintaining confidence in financial institutions and highlighted the broader implications of the IndusInd Bank episode for the banking sector.

## 9. Broader Implications for Corporate Governance

The IndusInd Bank episode bears striking similarities to earlier governance failures that have punctuated India's financial sector over the past two decades, thereby highlighting enduring vulnerabilities in oversight mechanisms, risk culture, and ethical conduct. While the specific instruments and contexts may differ across cases, a common thread runs through many such episodes: the inability of institutional safeguards to detect and address emerging risks in a timely and effective manner. In this sense, the IndusInd case is not an isolated aberration, but part of a broader pattern that warrants deeper reflection on the quality of governance within complex financial organizations.

Historically, several high-profile financial scandals in India have revealed how weaknesses in internal controls and governance frameworks can persist even in institutions that appear robust on the surface. These episodes have often involved technically complex transactions, concentrated decision-making authority, and a gradual normalization of practices that deviate from the spirit of regulatory and ethical standards. The IndusInd Bank case fits squarely within this pattern, as derivative accounting choices and internal hedging arrangements evolved over time into significant financial and reputational risks. Such developments underscore the importance of a strong risk culture, one that prioritizes transparency, early escalation of concerns, and an honest assessment of downside risks, rather than a narrow focus on short-term financial performance.

The episode also raises critical questions about the role and effectiveness of boards of directors in financial institutions. Boards are expected to act as the first line of defence in governance, providing strategic direction and oversight over management. However, in institutions where financial products and accounting treatments are highly specialized, boards may struggle to bridge the gap between formal responsibility and practical capability. The IndusInd experience suggests that board oversight can be undermined not by a lack of independence, but by limitations in technical understanding, over-reliance on management assurances, and insufficient access to independent expert advice. This challenges conventional assumptions that board composition alone is sufficient to ensure effective governance.

Auditors, both internal and statutory, occupy another critical position within the governance ecosystem. Their role extends beyond verifying compliance with accounting standards to exercising professional scepticism and identifying patterns that may indicate deeper control failures. In the IndusInd case, the persistence of accounting irregularities over multiple years raises concerns about whether audit processes were adequately designed to capture complex derivative exposures and internal transactions. The episode thus prompts reflection on the evolving expectations placed on auditors in an increasingly complex financial environment, where traditional audit approaches may need to be supplemented with more specialized expertise and forensic tools.

Regulators, too, face difficult trade-offs in supervising large and complex financial institutions. They must balance the need for regulatory flexibility and innovation with the imperative of safeguarding systemic stability and market integrity. The IndusInd Bank

episode illustrates how regulatory gaps or transitional phases can create spaces in which risks accumulate unnoticed. It raises the question of whether supervisory frameworks are sufficiently forward-looking to anticipate how institutions might respond to evolving rules and whether early intervention mechanisms are robust enough to prevent the escalation of latent risks.

Taken together, the IndusInd Bank case underscores the interconnected responsibilities of boards, auditors, and regulators in maintaining the soundness of the financial system. It highlights that effective governance is not merely a function of formal compliance, but of continuous vigilance, ethical leadership, and institutional learning. By drawing attention to persistent governance vulnerabilities, the episode serves as a reminder that preventing financial crises requires sustained commitment to transparency, accountability, and proactive risk management across all layers of oversight.

## 10. Theoretical Interpretation and Research Anchoring

### 10.1 Agency Theory Perspective

The IndusInd Bank debacle offers a significant extension to Agency Theory, particularly in the context of modern, technically complex financial institutions. Classical agency theory conceptualizes conflict as arising from information asymmetry between principals and agents, where managers exploit superior access to information to pursue self-interested objectives (Jensen & Meckling, 1976). The IndusInd case suggests that this framing, while still relevant, is no longer sufficient on its own. The core agency problem here was not simply the withholding of information, but the creation of what may be described as *comprehensibility asymmetry* i.e. a condition in which information is disclosed but remains difficult to meaningfully interpret or challenge.

Senior management possessed deep technical expertise in derivative structures and accounting treatments that were not easily accessible to boards, auditors, or external stakeholders. As a result, agency power was exercised not through secrecy, but through control over interpretation and timing of risk recognition. This has important implications for agency theory, which has traditionally assumed that improved disclosure and monitoring can mitigate conflicts. The IndusInd episode demonstrates that disclosure alone does not resolve agency problems when principals lack the cognitive or technical capacity to evaluate complex financial information.

The case also reinforces the role of incentive structures in exacerbating agency conflicts. Pressure to maintain stable earnings, protect managerial reputation, and meet market expectations may have encouraged managerial behaviour that prioritized short-term financial appearance over long-term transparency. Existing agency models often emphasize incentive alignment through compensation design; however, this case suggests that incentive effects must be examined alongside the technical domains in which discretion is exercised.

As a contribution to the literature, the IndusInd Bank debacle highlights the need to reconceptualize agency problems in financial institutions as problems of *interpretive dominance* rather than mere information imbalance. It suggests that effective agency mitigation requires not only monitoring mechanisms, but also enhanced technical literacy, independent validation, and scepticism at the governance level. This insight deepens agency theory by adapting it to the realities of contemporary banking and financial complexity.

### 10.2 Corporate Governance Failure

From the perspective of corporate governance literature, the IndusInd Bank episode underscores a critical and recurring theme: the distinction between formal governance structures and their functional effectiveness. Much of the existing literature has focused on governance form i.e. board independence, committee structures, regulatory compliance, and disclosure norms, as proxies for good governance (Shleifer & Vishny, 1997). IndusInd Bank appeared to satisfy many of these criteria, yet governance failed in practice, revealing the limitations of structure-centric approaches.

The case contributes to governance scholarship by demonstrating that governance breakdowns can occur even in the presence of apparently robust institutional architecture. Independent directors, audit committees, and risk management frameworks did not prevent prolonged accounting distortions or the override of internal controls. This suggests that governance failures are often behavioural and cultural rather than purely structural. Deference to managerial expertise, limited challenge in technically complex domains, and reliance on assurances rather than independent scrutiny can weaken oversight even when formal mechanisms are in place.

The IndusInd episode also reinforces emerging arguments in the literature that board capability matters as much as board independence. Governance effectiveness depends on whether directors possess the expertise, confidence, and informational support necessary to interrogate management decisions, particularly in areas such as derivatives, valuation, and treasury operations. Where boards lack such capacity, oversight risks becoming procedural rather than substantive.

In addition, the case raises questions about the role of audit committees and internal assurance functions when senior management can override controls. It highlights the importance of escalation mechanisms, ethical leadership, and a culture that encourages dissent and transparency.

As a contribution to the corporate governance literature, the IndusInd Bank debacle strengthens the argument that effective governance cannot be reduced to compliance checklists. Instead, it must be understood as a dynamic process shaped by expertise, behaviour, culture, and ethical norms. This insight is particularly relevant for governance research in banking and other high-complexity sectors.

### 10.3 Regulatory Arbitrage and Institutional Gaps

The IndusInd Bank case provides a valuable contribution to the literature on regulatory arbitrage and institutional gaps, especially in the context of evolving regulatory regimes. Regulatory arbitrage is often associated with deliberate exploitation of loopholes to evade regulatory intent. The IndusInd episode illustrates a subtler and increasingly relevant form of arbitrage i.e. one rooted in interpretive discretion and regulatory transition rather than explicit non-compliance.

Prior to the Reserve Bank of India's mandate requiring uniform mark-to-market valuation of all derivative transactions, banks had discretion in accounting for internal hedges. IndusInd Bank's asymmetric treatment of internal and external derivatives exploited this discretionary space, allowing economic losses to be deferred over multiple years. While such practices may not have violated the letter of existing rules at the time, they departed from the broader regulatory objective of transparent and timely risk recognition. This underscores how regulatory arbitrage can arise from *institutional ambiguity* rather than violation of intentional rules.

The case contributes to the literature by highlighting the role of regulatory lag and fragmented oversight. Accounting standards, banking supervision, and securities regulation operate within distinct institutional silos, which may not always be fully aligned. The IndusInd episode shows how risks can accumulate when these domains fail to intersect effectively, particularly in areas involving complex financial instruments.

Furthermore, the case raises important questions about principle-based regulation. While such frameworks provide flexibility and adaptability, they also increase reliance on managerial judgment. Without proactive supervision and anticipatory enforcement, principle-based regimes may inadvertently expand the scope for arbitrage.

As a contribution to regulatory theory, the IndusInd Bank debacle reinforces the need to examine not only regulatory design, but also regulatory timing, coordination, and behavioural responses. It highlights that closing institutional gaps requires continuous engagement, cross-regulatory coordination, and an appreciation of how firms adapt to evolving rules. In doing so, the case enriches the literature on regulatory arbitrage by situating it within the realities of modern financial governance.

## 11. Scope of Future Studies

The IndusInd Bank debacle opens several promising avenues for future research that can meaningfully extend the existing literature on corporate governance, particularly in the context of complex financial institutions operating in emerging markets. While prior studies have extensively examined governance structures, board independence, and regulatory compliance, this episode highlights deeper, less explored dimensions of governance that merit systematic academic inquiry.

One important direction for future studies lies in examining board capability and cognitive competence rather than focusing solely on-board composition. Much of the governance literature treats independence and diversity as proxies for effective oversight. The IndusInd case suggests that such proxies may be insufficient when boards are required to oversee technically complex domains such as derivatives, valuation models, and treasury risk management. Future research could explore how directors' financial literacy, prior professional experience, and access to independent technical advisors influence their ability to challenge management decisions. Comparative studies across banks could assess whether boards with deeper technical expertise are better positioned to detect early warning signals and prevent governance failures.

A second avenue relates to the concept of information versus comprehensibility asymmetry in governance processes. While disclosure has long been viewed as a cornerstone of good governance, the IndusInd episode raises questions about whether disclosed information is actually usable by boards, auditors, and investors. Future studies could investigate how complex financial disclosures are interpreted by different governance actors and whether simplification, visualization, or alternative reporting formats enhance oversight effectiveness. This line of inquiry would contribute to the literature by shifting attention from disclosure quantity to disclosure quality and usability.

Another promising area of research concerns the interaction between incentive structures and ethical decision-making at senior management levels. The IndusInd case highlights how performance pressures and market expectations may interact with accounting discretion to influence managerial behaviour. Future empirical work could examine whether certain compensation structures,

performance metrics, or promotion criteria are associated with a higher likelihood of aggressive accounting practices or governance lapses. Such studies would enrich governance literature by integrating insights from behavioural economics and organizational ethics.

The episode also points to the need for deeper research into audit effectiveness and the role of assurance functions in complex financial environments. Scholars could examine whether traditional audit approaches are adequate for detecting risks embedded in derivative transactions and internal hedging arrangements, or whether more specialized and continuous audit models are required. Comparative analyses across jurisdictions could provide insights into best practices in audit oversight and regulatory coordination.

Finally, future research could explore regulatory coordination and institutional design, particularly during periods of regulatory transition. The IndusInd debacle illustrates how gaps between accounting standards, banking supervision, and securities regulation can allow risks to accumulate. Studies focusing on cross-regulatory communication, supervisory timing, and enforcement responses could offer valuable lessons for strengthening governance ecosystems.

Taken together, these avenues suggest that future studies on the IndusInd Bank episode can move the literature beyond static models of governance toward a more dynamic understanding of how expertise, behaviour, ethics, and institutional design shape governance outcomes in modern financial institutions.

## 12. Conclusion

The IndusInd Bank debacle represents a significant governance episode in the Indian banking sector, illustrating how technically complex financial practices, when combined with incentive pressures and regulatory transition, can culminate in systemic governance failure. Far from being a narrow accounting anomaly, the case reveals deeper structural weaknesses in oversight, ethical judgment, and institutional accountability within a large, systemically important financial institution.

At the core of the episode lies a sustained breakdown in the alignment between managerial actions and stakeholder interests. The prolonged use of asymmetric derivative accounting practices underscores how managerial discretion, exercised within technically opaque domains, can delay the recognition of economic reality while preserving the appearance of financial stability. The subsequent exposure of accumulated losses following regulatory intervention highlights the fragility of profitability built on deferred risk recognition and reinforces the importance of transparency as a cornerstone of financial integrity.

The case further demonstrates that formal compliance with governance norms—such as board independence, committee structures, and disclosure frameworks—is insufficient in the absence of functional effectiveness. Despite an apparently robust governance architecture, failures in board oversight, audit scrutiny, and internal control enforcement allowed risks to accumulate over several years. These shortcomings point to the limits of checklist-based governance models and emphasize the need for boards to possess not only independence, but also the technical competence and institutional confidence to challenge management in complex financial areas.

Equally consequential are the ethical dimensions revealed by the episode. The insider trading allegations involving senior executives during a period of unpublished price-sensitive information have amplified concerns regarding fiduciary responsibility and leadership integrity. Such actions erode trust not only in individual institutions, but also in market fairness and regulatory credibility. The strong market reaction and subsequent leadership exits reflect how quickly confidence can dissipate when transparency and ethical conduct are perceived to be compromised.

Regulatory and audit responses to the crisis underscore both the resilience and the limitations of institutional safeguards. While the Reserve Bank of India's assurances regarding capital adequacy helped contain systemic risk, the need for an industry-wide review of derivative practices signals broader vulnerabilities within the regulatory ecosystem. Similarly, audit disclosures acknowledging prior concealment of losses raise important questions about the evolving role of auditors in increasingly complex financial environments.

In conclusion, the IndusInd Bank case serves as a cautionary narrative for banks, regulators, and governance scholars alike. It reinforces the view that sustainable financial performance rests not on regulatory arbitrage or accounting discretion, but on ethical leadership, effective oversight, and a culture of accountability. By illuminating the interaction between agency conflicts, governance failure, and institutional gaps, this case contributes meaningfully to the literature on corporate governance and offers enduring lessons for the stability and credibility of modern banking systems.

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