

# Redefining Risk : Indian Sterling Bank's Journey to Mitigate Concentration Risk

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## Abstract

**Purpose :** The present case study highlighted the impact of concentration risk on the performance of banks. This case focused on the functioning and various challenges faced by a hypothetical private sector bank, that is, Indian Sterling Bank, on account of overexposure to a specific industry. It highlighted the importance of risk assessment and continuous learning in managing risks.

**Findings :** Banks are exposed to various types of risk like credit, market, operational, liquidity, and earning risk, to name a few. Overexposure to a particular sector exposed a bank to concentration risk. Any adverse conditions like demand fluctuation, policy changes, and changes in customer preferences affect the earnings and, ultimately, the viability of an industry. This, in turn, affects the banks which have taken exposure to that industry.

**Practical Implications :** Banks are exposed to various types of risks, which could impact not only their earnings but also their survival. This case study highlighted the importance of proactive risk management and the potential consequences of excessive concentration in a specific sector. The identification of concentration risk within the technology sector for Indian Sterling Bank underscored the critical importance of proactive risk management strategies. Banks should continuously monitor industry trends, economic indicators, and regulatory developments to anticipate potential risks. Implementing stringent risk assessment practices, stress testing, and scenario analysis would enable the bank to effectively identify, assess, and manage concentration risk, ensuring sustained financial stability and safeguarding against adverse sector-related events.

**Originality :** This case study highlighted the importance of risk assessment and continuous learning in managing risks effectively and safeguarding a bank's financial stability.

**Keywords :** risk, concentration risk, risk management, profitability, portfolio analysis, non-performing assets

**JEL Classification Codes :** D81, G11, G20, G21, G32

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Mr. Harsh Gupta, General Manager and Chairman of the risk management committee, was going through the portfolio analysis report of the bank, which indicated a particular trend towards risk management. The Herfindal Hirschman Index (HHI) was above 2,500 for information technology in the bank's portfolio, indicating high concentration. Mr. Gupta's attention was drawn to the portfolio review exercise, which indicated that the portfolio was skewed toward the technology sector. The very next day, Mr. Gupta called the meeting of the risk management committee and said, "I have gone through the portfolio of

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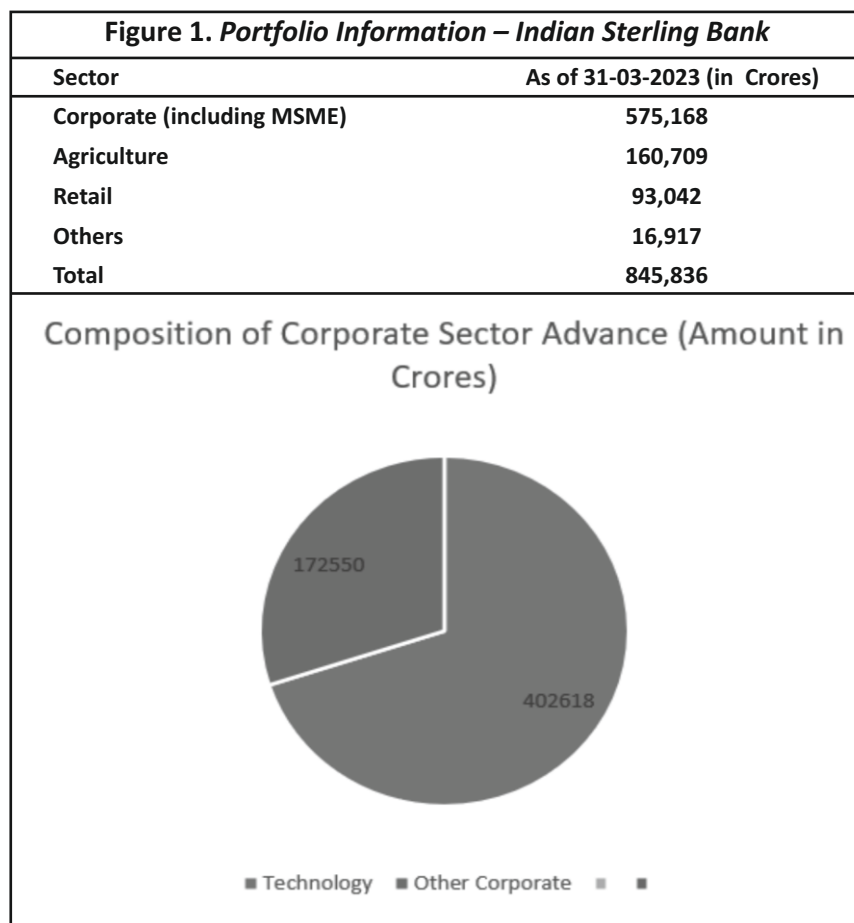
our bank, and our exposure to the technology sector is over 45%, that is 47.6% to be precise. Our dependence on one sector can prove to be catastrophic. I want to have your candid opinion on the same.” With this, he invited others to express their views on the same.

## A Brief About Indian Sterling Bank

Indian Sterling Bank is a leading private-sector bank that Mr. Nageshwar Rao, an eminent businessman in 1995, started. The bank began its operations from Bangalore (now Bengaluru) and gradually expanded to other parts of the country. The bank has a significant presence in the South and West regions of India. Having a business acumen, Mr. Rao focused primarily on non-individual segments for the credit growth of the bank. The business sector was neglected by most of the banks on account of risk perception and specialization. This niche was ingenuity captured by the Indian Sterling Bank. The officers were specially groomed for credit appraisal in corporate credit in-house as well as reputed training institutes across the banks.

Indian Sterling Bank took advantage of liberalization, privatization, and globalization (LPG) introduced in the 1990s, which pushed the demand for corporate credit. Slowly, Bengaluru began to develop into an IT hub, which was mirrored in the credit portfolio of the bank (refer to Figure 1).

There are several reasons why the exposure of the bank is skewed toward the information technology segment, which are as follows :



## ***Growth Potential***

Indian Sterling Bank identified technology as a credit growth sector early, considering the growing presence of the sector in every sphere, be it healthcare, finance, logistic customer service, to name a few. Through its exports, which add value to the GDP and create jobs, this industry is also essential to the nation's economic expansion. Other banks recognized this, but Indian Sterling Bank was the first to act, giving it an advantage. Word-of-mouth publicity by earlier clients helped the bank in garnering more clients for the bank. Apart from growth potential, the bank also identified earning opportunities in financing this sector. The commercial loans offered to this sector are more lucrative to banks as compared to the retail segment. The lack of security is, in a way, exploited through charging high-risk premiums by the bank. It is not so that the bank completely ignored security aspects; in most of the financing, it relied on the guarantee cover scheme for securing the loans. Thus, we can say that the bank exploited the growth potential of the sector and the bank's growth avenue for financing this sector. The bank targeted both profitability and growth potential while financing this segment.

## ***Clientele of Indian Sterling Bank***

As described earlier, Indian Sterling Bank primarily focused on corporate clients, which in turn dealt with many technology firms. On account of the excellent service experience by these corporates, they introduced these clients to the bank. The word-of-mouth publicity from existing clients, the client base, especially from technology segments, started growing, leading to above-market growth for the bank.

## ***Geographical Trends***

Another factor was the branch network, which has synergy for the bank. Having roots in Southern states proved to be a boon for the bank. The bank targeting good margins started financing start-ups in a big way. As the sector was in a nascent stage, most of the banks avoided the segment, fearing higher risk. Growth uncertainty, coupled with a lack of track record and collateral requirements, were other reasons leading to neglect by other private players in the industry. Public sector banks were very conservative in approach and avoided the sector. Mr. Rao, who always looked to exploit untapped and high-growth potential segments, capitalized on the opportunity offered by the segment. Indian Sterling Bank started financing start-ups in and around Bengaluru that dealt in the technology sector. The lack of collateral and track record was compensated in a way through high margins on these loans.

## ***Specialization***

Indian Sterling Bank achieved specialization in lending through specialized branches, training of staff, and specialized products. The Indian Sterling Bank identified branches for lending to technology companies, which acted as a one-stop solution for them. All accounts of over 25 crores were assigned to a particular relationship manager who created the financial and investment needs of a particular corporation. Another initiative was to train the staff to entice customers through enhancing their credit skills in general and appraising loans for the technology in particular. The biggest problem faced by the technology sector was collateral, as it lacked the infrastructure of manufacturing units. Indian Sterling Bank, through extensive market research, identified this problem as most of the banks, particularly public sector banks, turn down the application of technology firms for the lack of collateral. The underwriting process gave less weightage to collateral. Instead, it relied on other factors like the strength of IT companies, like intellectual property rights, patents, and software licenses, to name a few. The other aspects of customization are related to product offerings. Indian Sterling Bank offered various types of

offerings like venture debt for new firms, working capital, R&D loans, and equipment financing, depending upon the requirements of the corporates. This customization was offered in loan repayment also through offering flexible repayment aligned with the cash flows of the technology firms. Indian Sterling Bank developed a specialized rating model called “Tech Trailblazer” for assessing credit worthiness of technology. It utilized inputs like customer acquisition rate, customer retention, technological differentiation growth plan, etc., for assessing the creditworthiness of the corporates. This helped in identifying good corporate entities eligible for financing by the banks.

### ***Competitive Advantage***

Several factors like customized products, specialization of operations, and technology sector-centric approach helped the bank achieve a competitive advantage in leading to the technology sector. In many a case, the rate of interest offered by other banks was less as compared to Indian Sterling Bank. Still, it was compensated by excellent customer service and word-of-mouth publicity by the existing customers. Indian Sterling Bank became the bank of choice for technology start-ups, which were neglected by most of the banks. During the silver jubilee celebrations of the bank, Mr. Suresh Reddy, the promoter of Pioneer Technology, said :

My Company started with a room office in M.G. Street in Bengaluru, now the revenue of the company is over INR 800 crores. We could not have achieved this scale without the assistance from Indian Sterling Bank. The bank offered us a loan at the incubation stage when we had nothing to offer as collateral. The bank relied on our business plan and the potential offered by the sector. Four leading banks rejected our loan application; I would not disclose their name as it is a thing of the past.

Recently, one of the top executives of a bank approached me for the takeover of this loan. I told him that Indian Sterling Bank had helped me when your bank was not even ready to listen to me. So, how can you expect me to come to your bank? Our company is moving to the next orbit, and the bank will provide me with the necessary funds for it (referring to the current loan requirement of rupees 350 crores for enhancement). The bank captured this niche segment when no other bank could sense this burgeoning sector.

### ***Risk Committee Meeting***

Mr. Rajesh Iyer, General Manager of the Recovery Department at Indian Sterling Bank, was the first to speak after Mr. Gupta invited everyone to express their opinion in the wake of a recent portfolio analysis of the bank. Mr. Iyer said :

Since you have told us to be candid, I will call a spade a spade, as it concerns the future of our bank. There are many indicators, such as rising stress in a portfolio, industry-specific default, and rising Special Mention Accounts (SMA), which lead to heightened risk in our portfolio. Our gross non-performing assets (NPA) have increased by nearly 250 basis points on a year-on-year (YOY) basis. Yesterday, only our department carried out a thorough analysis of the NPA portfolio of our bank and identified a course of action for the same. Since we are here to discuss the portfolio analysis, I would focus on the same. Yes, there is a high concentration risk, as pointed out in the report. As a result of this risk, our NPAs are also rising in the technology sector, particularly in the

start-up segment. Start-up financing is contributing to nearly 50% of NPAs in the technology segment. Our exposure is skewed toward the technology sector, which is experiencing a downturn leading to impairment of asset quality. This is reflected not only through rising NPAs, but in overdue positions also.

With this, Mr. Iyer concluded his remarks.

Mr. Gupta said, “I fully agree with what Mr. Iyer said, as over-dependence on a particular sector may lead to a severe impact on the portfolio of our bank.” Apart from the downturn that is prevalent now, technological disruption or, for that matter, a shift in consumer tastes or behavior can impact the performance of this sector.

Next to express his opinion was Mr. Sudeep Shetty, Chief Finance Officer (CFO) of the bank :

The share price of our bank has been under pressure for a couple of months as the market perceives us to be more risky and less stable than our peers. If we go into detail, the risk is further aggravated on account of our large exposure to few corporates in the technology sector. Apart from the risk, our margins are also being impacted on account of competitive pricing in the sector. We had an earlier mover advantage, resulting in a handsome net interest income (NII) for the bank. But other players have captured this segment, leading to high competition. An increase in other income is masking our decline in margin, but this situation may not last for long, and we need to make appropriate strategies for the same.

After listening to Mr. Shetty, Mr. Gupta said to Mr. Abhijit Chatterjee, Chief Risk Officer of the bank, “We have heard the recovery department's and finance department's perspective; your assessment of this risk is critical as you deal with it directly.”

Then, Mr. Chatterjee started talking, saying :

As everyone else on the committee has correctly pointed out, we have to focus our efforts on risk management. Our department carried out stress testing of our portfolio yesterday only, the report of which is submitted to the top management. The report indicates vulnerability on two fronts, which are critical for the bank, i.e., earnings and asset quality under moderate stress conditions, which indicate that earnings and asset quality will take a hit on account of high exposure in a particular sector (referring to the IT sector). The bank took a conscious step to focus on a profitable segment, which worked well for the bank. But now, we have to take measures according to the present dynamics of the environment in which we operate. We are in the process of reviewing our risk management framework in light of present conditions for effective control and management of risks.

## **Conclusion**

Other members of the committee also expressed similar concerns, as mentioned by the Heads of three departments. They also highlighted potential volatility in earnings, the competitive environment both for the technology sector and the bank, as well as dwindling investor confidence. Mr. Sanjeev Nair, the Compliance Officer of the Bank, raised another important aspect: economic recession impacts IT spending by the corporates, which will impact the earning and asset quality of the bank.

The meeting ended with the final address of Mr. Gupta, who concluded by saying :

I am thankful to all who expressed their frank opinion on the report. The good thing is that we have identified the disease at the right time, and it could be treated accordingly. Our bank has experienced testing time earlier also, and it had come out even stronger.

The meeting ended with a decision to develop strategies for finding solutions to the problems confronting the Indian Sterling Bank. This entailed the submission of a report by the major functional departments on the impact and strategies to overcome the key risk attributes on account of overexposure to the technology sector. A deadline of 15 days was set for the submission of the final report by the key departments.

## **Managerial Implications**

Banks are exposed to various types of risks, which can impact not only their earnings but also their survival. This case study highlights the importance of proactive risk management and the potential consequences of excessive concentration in a specific sector.

The identification of concentration risk within the technology sector for Indian Sterling Bank underscores the critical importance of proactive risk management strategies. This scenario highlights the potential vulnerabilities that can arise from overexposure to a specific industry, such as technology, due to its inherent volatility and susceptibility to rapid changes. In response, the bank should diversify its portfolio across various sectors to mitigate the impact of sector-specific downturns. Moreover, the bank should continuously monitor industry trends, economic indicators, and regulatory developments to anticipate potential risks. Implementing stringent risk assessment practices, stress testing, and scenario analysis will enable the bank to effectively identify, assess, and manage concentration risk, ensuring sustained financial stability and safeguarding against adverse sector-related events.

## **Teaching Notes**

### ***Teaching Objectives***

This case focuses on the functioning and various challenges faced by a hypothetical private sector bank, that is, Indian Sterling Bank, on account of overexposure to a specific industry. It highlights the importance of risk assessment and continuous learning in managing risks effectively and safeguarding a bank's financial stability. At the end of the case exercise, participants should have an understanding of the following issues:

- ✍ Risk management process in banks.
- ✍ Importance of portfolio diversification in banks.
- ✍ Strategic decision making.
- ✍ Various types of risks in banks.
- ✍ Risk reward balance.



## **Potential Audience**

Graduate and post-graduate students, finance executives, and finance and risk management professionals are the potential audience.

Relevant programs – Graduates and post-graduates of management, commerce, banking, and finance.

✦ **Number of Teaching Sessions Needed:** Three lectures of 50 minutes.

## **Authors' Analysis of Each Question Raised**

### **(1) According to you, what are the challenges faced by Indian Sterling Bank?**

The significant challenges faced by Indian Sterling Bank are as follows :

✦ **Concentration Risk.** The biggest challenge before the Indian Sterling Bank was concentration risk due to its high exposure to the technology sector. The technology sector is known for its cyclicality. Indian Sterling Bank's exposure left it vulnerable to sector-specific downturns. A broader economic slowdown could lead to reduced technology spending and delayed projects, increasing non-performing loans. A disruptive technology or change in customer preferences can render some of the technology companies in Indian Sterling Bank's portfolio obsolete, leading to a risk of defaulting.

✦ **Deteriorating Credit Quality.** As technology companies struggle to meet their financial obligations, Indian Sterling Bank faces an increase in non-performing loans from its technology sector borrowers. This surge in defaults places considerable stress on the bank's asset quality and overall financial health, potentially leading to a deterioration of its credit rating and increased regulatory scrutiny.

✦ **Credit Risk Management.** Managing credit risk in a concentrated sector requires advanced risk assessment and due diligence. Indian Sterling Bank needs to understand the nuanced risks within the technology companies it lent to, including their business models, competitive positions, and potential vulnerabilities.

✦ **Investor Confidence.** If Indian Sterling Bank's exposure to the technology sector is perceived as high, especially in a volatile market, investors might become cautious. This could lead to increased scrutiny from analysts, rating agencies, and shareholders. The bank may face questions about its risk management practices, capital adequacy, and contingency plans in case of sector-specific challenges.

✦ **Reputation Impact.** The bank's reputation might be affected if it's seen as being slow to respond or lacking a robust risk management strategy. Negative perceptions could impact customer confidence, potentially leading to customer attrition and difficulty in attracting new clients.

### **(2) According to you, what are the possible steps for overcoming the challenges faced by Indian Sterling Bank?**

✦ **Stress Testing for Economic Scenarios.** The Indian Sterling Bank conducted in-depth stress tests, simulating various economic scenarios specific to the technology sector. These tests helped the bank assess its resilience and identify potential weaknesses in its portfolio, allowing for timely adjustments.

✚ **Diversification into Resilient Industries.** To reduce the concentration risk, Indian Sterling Bank should actively diversify its portfolio by allocating resources to industries with proven resilience, such as healthcare, infrastructure, and established consumer goods companies. This diversification approach can provide a buffer against technology sector downturns.

✚ **Strengthened Due Diligence.** The bank bolstered its credit risk assessment processes, focusing on technology sector borrowers' financial health and market competitiveness. It adopted a more cautious approach when extending credit to start-ups, ensuring a thorough evaluation of their business models and sustainability.

✚ **Active Monitoring and Regular Reporting.** Indian Sterling Bank established a dedicated risk monitoring team that closely tracked developments within the technology sector. The team provided regular reports to the bank's management, allowing them to make informed decisions based on real-time data.

✚ **Risk Management Policies.** The bank should revise its risk management policies to include sector concentration limits and guidelines. Setting prudent exposure limits to specific sectors can prevent excessive concentration and minimize the impact of sector-specific shocks.

✚ **Continuous Monitoring.** The Indian Sterling Bank must establish a robust monitoring system that tracks early warning indicators specific to the technology sector. Regularly evaluating factors such as market trends, regulatory changes, and competitive dynamics can provide valuable insights into potential risks and opportunities.

✚ **Strategic Rebalancing.** To address the concentration risk, Indian Sterling Bank needs to rebalance its portfolio strategically. This involves reallocating credit away from the technology sector, which requires careful planning and execution to maintain profitability.

✚ **Dynamic Risk Assessment.** The Bank needs to implement dynamic risk assessment methodologies that consider both internal and external factors affecting the technology sector. This approach allows the bank to adjust its risk management strategies based on changing market dynamics.

✚ **Investor Communication.** In the event of sector-specific challenges or adverse developments, Indian Sterling Bank should communicate transparently with its investors and stakeholders. Open and timely communication can help manage expectations and maintain investor confidence.

✚ **Long-Term Strategy.** Indian Sterling Bank should adopt a long-term perspective when evaluating sector exposure. While short-term gains might be tempting, a well-considered, sustainable strategy should prioritize risk mitigation and long-term stability.

### **(3) What problems will the Indian Sterling Bank face in maintaining the status quo?**

The following obstacles will have to be overcome by Indian Sterling Bank in order to keep things as they are:

✚ **Heavy Dependence on the Technology Sector.** Indian Sterling Bank had significant exposure to the technology sector, driven by the sector's potential for substantial returns. However, this overreliance made the bank vulnerable to sudden downturns, leading to high defaults. As market saturation increased and competition intensified, the credit quality of companies in these sub-sectors deteriorated, putting the bank at risk of potential loan defaults.



↳ **High Exposure to Start-ups and Unproven Ventures.** To capture the disruptive potential of the technology sector, Indian Sterling Bank provided substantial funding to start-ups and ventures. While these investments held promise for significant returns, they also carried high risk due to the inherent uncertainty and failure rates associated with early-stage companies.

↳ **Deteriorating Credit Quality in Tech Sub-Sectors.** As technology companies struggle to meet their financial obligations, Indian Sterling Bank faces an increase in non-performing loans from its technology sector borrowers. This surge in defaults places considerable stress on the bank's asset quality and overall financial health, potentially leading to a deterioration of its credit rating and increased regulatory scrutiny.

↳ **Reputation Impact.** The bank's reputation might be affected if it's seen as being slow to respond or lacking a robust risk management strategy. Negative perceptions could impact customer confidence, potentially leading to customer attrition and difficulty in attracting new clients. Some technology companies in Indian Sterling Bank's portfolio are prone to legal and regulatory challenges, resulting in reputational damage to the bank.

## Authors' Contribution

Mr. Girish Mainrai conceived the idea and wrote the case study considering different aspects of the case. Dr. Sarvesh Mohania reframed the case and wrote the teaching notes in the case. Both authors reviewed the final manuscript.

## Conflict of Interest

The first author, Mr. Girish Mainrai, is associated with a bank, but the present case study is written from the banking industry perspective and not any individual bank. Furthermore, the case study is fictitious, written only for aid management teaching. The second author, Dr. Sarvesh Mohania, certifies that he has no affiliations with or involvement in any organization or entity with any financial interest or non-financial interest in the subject matter or materials discussed in this manuscript.

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## Disclaimer

The authors prepared this case for the sole purpose of aiding classroom discussion. Cases are not intended to serve as endorsements, sources of data, or illustrations of effective or ineffective management.

## Suggestions for Further Reading

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