BANKING FRAUD - ITS DETECTION, PREVENTION AND REPORTING*

Introduction

The Indian banking sector has experienced significant growth and changes since liberalization of economy in 1991. Though the banking industry is generally well regulated and supervised, the sector suffers from its own set of challenges when it comes to ethical practices, financial distress and corporate governance. In recent years, instances of financial frauds have regularly been reported in India. Although banking frauds in India have often been treated as cost of doing business, post liberalization the frequency, complexity and cost of banking frauds have increased manifold resulting in a very serious cause of concern for regulators, such as the Reserve Bank of India (RBI).

Fraud vitiates every solemn proceeding and no right can be claimed by a fraudster on the ground of technicalities. The definition of fraud as defined in the Black's Law Dictionary, which is as under:

"Fraud means:

(1) A knowing misrepresentation of the truth or concealment of a material fact to induce another to act to his or her detriment.

Fraud is usually a tort, but in some cases (especially when the conduct is wilful) it may be a crime.

(2) A misrepresentation made recklessly without belief in its truth to induce another person to act.

(3) A tort arising from a knowing misrepresentation, concealment of material fact, or reckless misrepresentation made to induce another to act to his or her detriment.

(4) Unconscionable dealing; esp., in contract law, the unconscientious use of the power arising out of the parties' relative positions and resulting in an unconscionable bargain."

Colloquially, the terms "fraud" and "scam" are used interchangeably to refer to any kind of financial wrongdoing. Legally speaking, fraud usually refers to a broader and more serious crime, with scams representing one type of fraud.

A scam is a fraudulent scheme generally involving money and some sort of business transaction. Scams come in various forms. Maybe you have experienced someone telling you would win a prize if you revealed your credit card details or asking you to donate money to a charity that did not exist. Scams reach us in various ways, via telephone, email, or even in person.

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Fraud implies a deception. It is a breach of confidence or trust. Fraud is a serious crime and a violation of civil law. The motivations for fraud can be many. These include monetary gain, discrediting an opponent or adversary. It can be to gain prestige as well as a financial advantage.

Fraud as Defined In Section 17 of Indian Contract Act, 1872

"Fraud" means and includes any of the following acts committed by a party to a contract, or with his connivance, or by his agent, with intent to deceive another party thereto or his agent, or to induce him to enter into the contract:

1. the suggestion, as a fact, of that which is not true, by one who does not believe it to be true;
2. the active concealment of a fact by one having knowledge or belief of the fact;
3. a promise made without any intention of performing it;
4. any other act fitted to deceive;
5. any such act or omission as the law specially declares to be fraudulent.

In order to amount to Fraud, an act must be confined to acts committed by a party to contract with an intention to deceive another party or his agent or to induce him to enter into a contact.

Fraud, which vitiates the contract, must have a nexus with the acts of the parties entering into the contract.

This definition highlights the precondition to prove the intention of the person who has committed Fraud. If that person has willingly committed a Fraud, then he will be punished. Here the person means himself or his agent. The acts which include fraud are wrong suggestions or concealment of facts or false promises or any fraudulent act to deceive others.

Fraud under the Companies Act, 2013

The Companies Act, 2013 focuses on the issues related to corporate Fraud, as is visible, it may continue in the future too. As per Section 447, Fraud in relation to affairs of a company or a body corporate, includes any act, omission, concealment of any fact or abuse of position committed by any person or any other person with the connivance in any manner, with intent to deceive, to gain undue advantage from, or to injure the interests of, the company or its shareholders or its creditors or any other person, whether or not there is any wrongful gain or wrongful loss;

(i) "wrongful gain" means the gain by unlawful means of property to which the person gaining is not legally entitled;

(ii) "wrongful loss" means the loss by unlawful means of property to which the person losing is legally entitled.

Classification of Frauds

In order to have uniformity in reporting, frauds have been classified as under, based mainly on the provisions of the Indian Penal Code:

- Misappropriation and criminal breach of trust.
- Fraudulent encashment through forged instruments, manipulation of books of account or through fictitious accounts and conversion of property.

- ➢ Unauthorised credit facilities extended for reward or for illegal gratification.
- ➢ Cash shortages.
- ➢ Cheating and forgery.
- ➢ Fraudulent transactions involving foreign exchange
- ➢ Any other type of fraud not coming under the specific heads as above.

Recently Pratip Chaudhuri, former State Bank of India chairman was arrested by Rajasthan Police in Delhi in connection with an alleged loan scam. The arrest was made on the basis of a protest petition filed by former directors of Hotel Gaudavan before the Chief Judicial Magistrate (CJM) Jaisalmer. A hotel project, 'Garh Rajwada', was financed by SBI in 2007. The case is related to properties owned by Godawan Group, which took a Rs. 24-crore loan from SBI in 2008 to construct a hotel. In 2010, the key promoter passed away, following which the project turned into a non-performing asset (NPA). The charges against Chaudhuri include properties worth Rs. 200 crore being sold for Rs. 25 crores after the bank seized them for defaulting on the loan.

Flow of Events

In 2008, Rajasthan-based Hotel Gaudavan Pvt. Ltd. took loan for Rs. 23.5 crore.

→ In 2010, the term loan declared as NPA.

→ In July 2013, SBI had invoked the SARFESI Act under the Debt Recovery Tribunal.

→ In 2013 Mr. Chaudhuri retired and took over the directorship of Delhi headquartered Alchemist ARC.

→ In March 2014, SBI sold the loan to the Alchemist ARC.

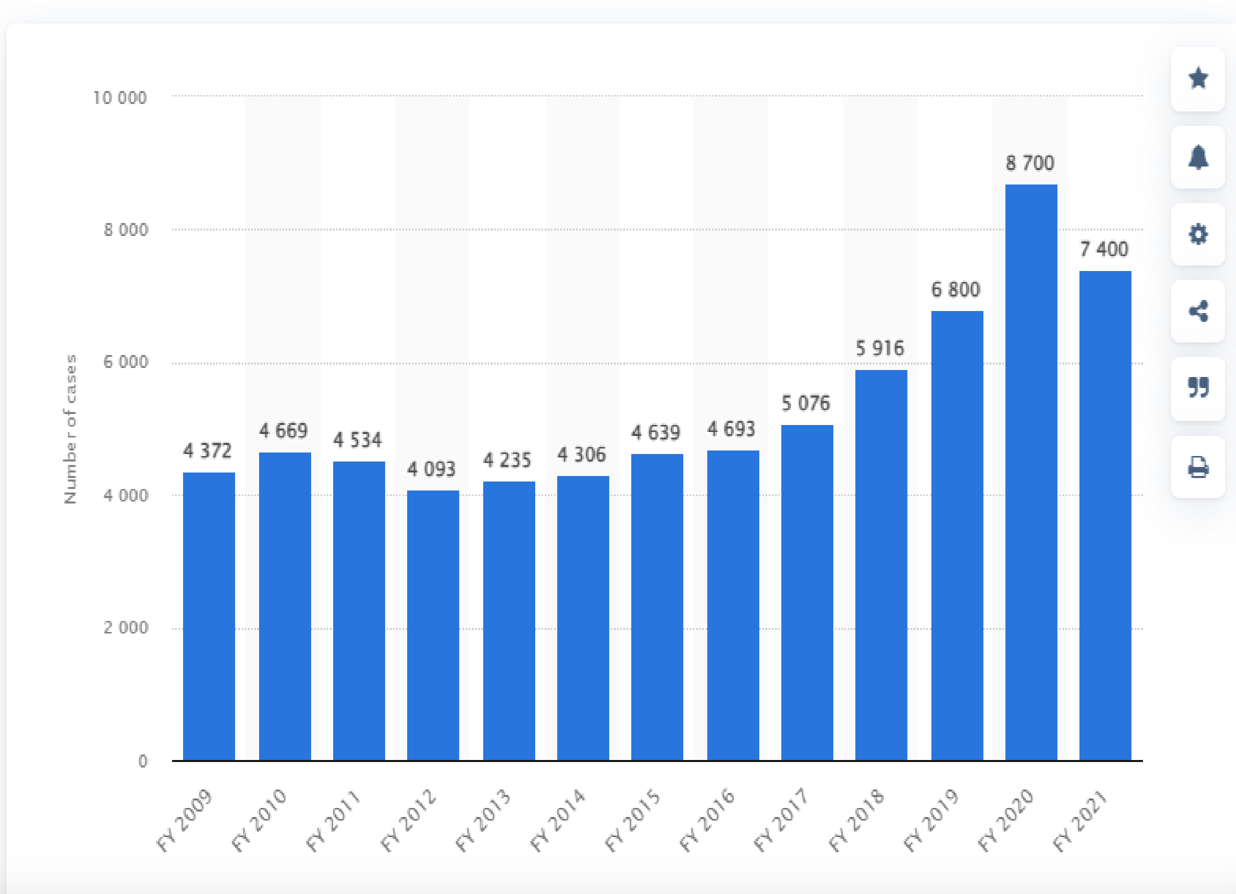
→ In March 2017, Alchemist, approached the National Company Law Tribunal (NCLT) for resolution under a court-driven process.

→ The NCLT finally disposed of the case in December 2017 & ARC sold hotel to JFC Finance.

The State Bank of India (SBI) sold over 15 loan accounts of defaulters at a discount of 65-67 per cent under the chairmanship of Pratip Chaudhuri, who is currently under arrest in a Rs. 23.5-crore loan case. The 68-year-old Chaudhuri is charged in connection with one such non-performing asset (NPA) sale to an asset reconstruction company (ARC), which happened after his retirement.

Bank frauds in India

Number of bank fraud cases across India between from financial year 2009 to 2021



Source: https://www.statista.com/statistics/1012729/india-number-of-bank-fraud-cases/

In the last decade, Public Sector Banks (PSBs) in India have lost thousand crores on account of various banking frauds. Indian banking system has remained plagued with growth in NPAs during recent years, which resulted in a vicious cycle affecting its sustainability. In May, 2021 the RBI has published its annual report 2020-21 which disclosed that in the last three years 22,864 banking frauds have been reported involving a gargantuan amount of over INR 3.95 trillion. Some of the frauds in last three years are ICICI Bank-Videocon bribery for loan scam in 2020, Punjab and Maharashtra Co-operative Bank crisis in 2019 or Nirav Modi and Gitanjali Gems-Punjab National Bank scam in 2018. After investigations it is revealed the involvement of not only mid-level employees, but also of the senior most management of the banks.

Fraud Cases - Bank Group-wise

(Amount in ₹ crore)

Bank Group/Institution	2018-19		2019-20		2020-21	
	Number of Frauds	Amount Involved	Number of Frauds	Amount Involved	Number of Frauds	Amount Involved
1	2	3	4	5	6	7
Public Sector Banks	3,704 *(54.5)*	64,207 *(89.8)*	4,410 *(50.7)*	1,48,224 *(79.9)*	2,903 *(39.4)*	81,901 *(59.2)*
Private Sector Banks	2,149 *(31.6)*	5,809 *(8.1)*	3,065 *(35.2)*	34,211 *(18.4)*	3,710 *(50.4)*	46,335 *(33.5)*
Foreign Banks	762 *(11.2)*	955 *(1.3)*	1026 *(11.8)*	972 *(0.5)*	521 *(7.1)*	3,315 *(2.4)*
Financial Institutions	28 *(0.4)*	553 *(0.8)*	15 *(0.2)*	2,048 *(1.1)*	25 *(0.3)*	6,839 *(4.9)*
Small Finance Banks	115 *(1.7)*	8 *(0.0)*	147 *(1.7)*	11 *(0.0)*	114 *(1.6)*	30 *(0.0)*
Payments Banks	39 *(0.6)*	2 *(0.0)*	38 *(0.4)*	2 *(0.0)*	88 *(1.2)*	2 *(0.0)*
Local Area Banks	1 *(0.0)*	0.02 *(0.0)*	2 *(0.0)*	0.43 *(0.0)*	2 *(0.0)*	0 *(0.0)*
Total	**6,798** ***(100.0)***	**71,534** ***(100.0)***	**8,703** ***(100.0)***	**1,85,468** ***(100.0)***	**7,363** ***(100.0)***	**138,422** ***(100.0)***

Note: 1. Figures in parentheses represent shares in total (in per cent).

2. Figures reported by banks & FIs are subject to change based on revisions filed by them.
3. Amounts involved reported do not reflect the amount of loss incurred. Depending on recoveries, the loss incurred gets reduced. Further, the entire amount involved is not necessarily diverted.
4. The dates of occurrence of these frauds are spread over several previous years.
5. The above data is in respect of frauds of ₹1 lakh and above reported during the period.

Source: RBI Supervisory Returns.

The root cause of weak corporate governance at highest level is directly linked to the very process of appointment of highest level of officials and poor compensation structure of highest level functionaries. There is a serious issue in terms of pay structure in higher echelons of PSBs, which is markedly lower than their counterparts in PVBs. The only good factor in PSBs is prestige of a post that a person holds. The inability to hire competent professionals and expertise from market (lateral hiring) due to existing recruitment policy, flight of officials to greener pastures and private or foreign banks, poor compensation structure, unionization challenges as well as lack of adequate training in contemporary fraud prevention techniques are key HR issues, which indirectly contribute to bank frauds.

At times, senior management themselves may like to cover-up some cases to meet their short term targets and goals, and create a good picture for the shareholders. In fraud cases, within the banks, with suspected involvement of senior management, there is significant resistance while prosecuting officers in level 4 or above. Most of the officers retire before they can be booked for a fraud. Once retired, pension regulations apply to them making them immune to any financial penalty.

The Basel III

The context of the disclosures by Banks are required under Annex 18 – Pillar 3 disclosure requirements of the Reserve Bank of India ('the RBI') Master Circular – Basel III Capital Regulations dated 1st July 2015. The Bank has implemented the requirements laid down by RBI for Pillar 3 disclosure, covering both the qualitative and quantitative items. The information provided has been reviewed by senior management and is in accordance with the guidelines prescribed by the RBI.

Basel III is an internationally agreed set of measures developed by the Basel Committee on Banking Supervision in response to the financial crisis of 2007-09. The measures aim to strengthen the regulation, supervision and risk management of banks.

Central Fraud Registry (CFR)

A Central Fraud Registry (CFR) based on the Fraud Monitoring Returns, filed by the banks and the select FIs, including the updates thereof, has been made available, for which banks have been given access through user-ids and password. CFR is a web-based and searchable database. The practice of issuing paper based Caution Advice (CA) has since been discontinued. However CAs on frauds including attempted frauds having systemic implication will be issued as and when required. Banks are advised to make full use of the CAs/CFR for timely identification, control, reporting and mitigation of fraud risk. Banks are also advised to put in place proper systems and procedure to ensure that the information available in CA/CFR is made use as a part of the credit risk governance and fraud risk management.

Reporting of frauds to Reserve Bank of India

Banks need to furnish Fraud Monitoring Return (FMR) in individual fraud cases, irrespective of the amount involved, to RBI electronically using FMR Application in XBRL System supplied to them within three weeks from the date of detection.

A monthly certificate, (mentioning that soft copy of all the FMRs have been submitted to RBI) is to be submitted by the bank to CFMC, Bengaluru with a copy to the respective SSM of the bank, within seven days from the end of the month.

Fraud reports should also be submitted in cases where central investigating agencies have initiated criminal proceedings suo moto and/or where the Reserve Bank has directed that such cases be reported as frauds.

Banks may also report frauds perpetrated in their subsidiaries and affiliates/joint ventures in FMR format in hard copy only. In case the subsidiary/ affiliate/joint venture of the bank is an entity which is regulated by Reserve Bank of India and is independently required to report the cases of fraud to RBI in terms of guidelines applicable to that subsidiary/affiliate/joint venture, the parent bank need not furnish the hard copy of the FMR statement in respect of fraud cases detected at such subsidiary/affiliate/joint venture.

Banks (other than foreign banks) having overseas branches/offices should report all frauds perpetrated at such branches/offices also to RBI.

In addition to the FMR, banks are required to furnish a Flash Report (FR) for frauds involving amounts of ₹50 million and above within a week of such frauds coming to the notice of the bank's head office. The FR is to be furnished in the form of a DO letter addressed to the PCGM / CGM-in-Charge, DBS, RBI, Central Office, Mumbai with a copy to CFMC, Bengaluru. The FR, inter alia, should include amount involved, nature of fraud, modus operandi in brief, name of the branch/ office, names of parties involved, their constitution, names of proprietors / partners and directors, names of officials involved and lodging of complaint with police/CBI.

Further, banks are also required to furnish developments in the fraud case through the FMR Update Application supplied to them in XBRL system.

It is observed while scrutinizing FMR returns from the banks, that certain vital fields in the returns are left blank. As the complete particulars on frauds perpetrated in the banks are vital for monitoring and supervisory purposes and dissemination of information through Caution Advice / Central Fraud Registry (CFR), banks should ensure that the data furnished are complete/accurate and up-to-date. Incidentally, if no data is to be provided in respect of any of the items, or if details of any of the items are not available at the time of reporting of FMR return, the bank may indicate as “no particulars to be reported” or “details not available at present” etc. In such a situation, the banks have to collect the data and report the details invariably through FMR Update Application.

Central Fraud Monitoring Cell (CFMC), Department of Banking Supervision, Central Office located at Bengaluru will have a Record of officers of all banks/Financial Institutions (FI) responsible for reporting of Frauds etc. All banks/Financial Institutions should furnish to Department of Banking Supervision, Central Fraud Monitoring Cell, Bengaluru any changes in the names of officials that will be necessary for inclusion in the Record.

Early Detection and Reporting

At present the detection of frauds takes an unusually long time. Banks tend to report an account as fraud only when they exhaust the chances of further recovery. Among other things, delays in reporting of frauds also delays the alerting of other banks about the modus operandi through Caution Advice / CFR by RBI that may result in similar frauds being perpetrated elsewhere. More importantly, it delays action against the unscrupulous borrowers by the law enforcement agencies which impact the recoverability aspects to a great degree and also increases the loss arising out of the fraud.

The most effective way of preventing frauds in loan accounts is for banks to have a robust appraisal and an effective credit monitoring mechanism during the entire life-cycle of the loan account. Any weakness that may have escaped attention at the appraisal stage can often be mitigated in case the post disbursement monitoring remains effective. In order to strengthen the monitoring processes, based on an analysis of the collective experience of the banks, inclusion of the following checks / investigations during the different stages of the loan life-cycle should be carried out:

Pre-sanction: As part of the credit process, the checks being applied during the stage of pre-sanction may consist of the Risk Management Group (RMG) or any other appropriate group of the bank collecting independent information and market intelligence on the potential borrowers from the public domain on their track record, involvement in legal disputes, raids conducted on their businesses, if any, strictures passed against them by Government agencies, validation of submitted information/data from other sources like the ROC, gleaning from the defaulters list of RBI/other Government agencies, etc., which could be used as an input by the sanctioning authority. Banks shall keep the record of such pre-sanction checks as part of the sanction documentation.

Disbursement: Checks by RMG during the disbursement stage, shall among others, focus on the adherence to the terms and conditions of sanction, rationale for allowing dilution of these terms and conditions, level at which such dilutions were allowed, etc. The dilutions should strictly conform to the broad framework laid down by the Board in this regard. As a matter of good practice, the sanctioning authority may specify certain terms and conditions as 'core' which should not be diluted. The RMG may immediately flag the non-adherence of core stipulations to the sanctioning authority.

Annual Review: While the continuous monitoring of an account through the tracking of Early Warning Signals is important, banks also need to be vigilant from the fraud perspective at the time of annual review of accounts. Among other things, the aspects of diversion of funds in an account, adequacy of stock *vis-a-vis* stock statements, stress in group accounts, etc., must also be commented upon at the time of review. Besides, the RMG should have capability to track market developments relating to the major clients of the bank and provide inputs to the credit officers. This would involve collecting information from the grapevine, following up stock market movements, subscribing to a press clipping service, monitoring databases on a continuous basis and not confining the exercise only to the borrowing entity but to the group as a whole.

Early Warning Signals (EWS)

Some Early Warning Signals (EWS) which should alert the bank officials about some wrongdoings in the loan accounts which may turn out to be fraudulent are as under:

- Undisputed payment to the statutory bodies as declared in the Annual report.
- Bouncing of high value cheques
- Frequent change in the scope of the project to be undertaken by the borrower
- Foreign bills remaining outstanding with the bank for a long time and tendency for bills to remain overdue.
- Delay observed in payment of outstanding dues.
- Frequent invocation of BGs and devolvement of LCs.
- Under insured or over insured inventory.
- Invoices devoid of TAN and other details.
- Dispute on title of collateral securities.
- Funds coming from other banks to liquidate the outstanding loan amount unless in normal course.
- In merchanting trade, import leg not revealed to the bank.
- Request received from the borrower to postpone the inspection of the godown for flimsy reasons.
- Funding of the interest by sanctioning additional facilities.
- Exclusive collateral charged to a number of lenders without NOC of existing charge holders.
- Concealment of certain vital documents like master agreement, insurance coverage.

- Floating front / associate companies by investing borrowed money
- Critical issues highlighted in the stock audit report.
- Liabilities appearing in ROC search report, not reported by the borrower in its annual report
- Frequent request for general purpose loans.
- Frequent ad hoc sanctions.
- Not routing of sales proceeds through consortium I member bank/ lenders to the company.
- LCs issued for local trade I related party transactions without underlying trade transaction
- High value RTGS payment to unrelated parties.
- Heavy cash withdrawal in loan accounts.
- Non production of original bills for verification upon request.
- Significant movements in inventory, disproportionately differing vis-a-vis change in the turnover.
- Significant movements in receivables, disproportionately differing vis-à-vis change in the turnover and/or increase in ageing of the receivables
- Disproportionate change in other current assets
- Significant increase in working capital borrowing as percentage of turnover
- Increase in Fixed Assets, without corresponding increase in long term sources (when project is implemented).
- Increase in borrowings, despite huge cash and cash equivalents in the borrower's balance sheet
- Frequent change in accounting period and/or accounting policies
- Costing of the project which is in wide variance with standard cost of installation of the project
- Claims not acknowledged as debt high
- Substantial increase in unbilled revenue year after year.
- Large number of transactions with inter-connected companies and large outstanding from such companies
- Substantial related party transactions
- Material discrepancies in the annual report
- Significant inconsistencies within the annual report (between various sections)
- Poor disclosure of materially adverse information and no qualification by the statutory auditors
- Raid by Income tax /sales tax/ central excise duty officials
- Significant reduction in the stake of promoter /director or increase in the encumbered shares of promoter/director.

- Resignation of the key personnel and frequent changes in the management.

Conclusion

The frauds may be primarily due to lack of adequate supervision of top management, faulty incentive mechanism in place for employees; collusion between the staff, corporate borrowers and third party agencies; weak regulatory system; lack of appropriate tools and technologies in place to detect early warning signals of a fraud; lack of awareness of bank employees and customers; and lack of coordination among different banks across India and abroad. The delays in legal procedures for reporting, and various loopholes in system have been considered some of the major reasons of frauds and NPAs. Measures such as strengthening of regulatory and supervisory framework of banks and financial institutions in line with global best practices and updated technology for efficient customer services and effective fraud detection can help in reduction of frauds in banking sector.

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