

**WORKING PAPER NO: 505**

**Frauds in the Indian Banking Industry**

**Charan Singh**

*RBI Chair Professor*

*Economics & Social Science*

*Indian Institute of Management Bangalore*

*Bannerghatta Road, Bangalore – 5600 76*

*Ph: 080-26993818*

[charansingh@iimb.ernet.in](mailto:charansingh@iimb.ernet.in)

**Deepanshu Pattanayak**

[deepanshu.pattanayak14@iimb.ernet.in](mailto:deepanshu.pattanayak14@iimb.ernet.in)

**Divyesh Satishkumar Dixit**

[divyesh.dixit14@iimb.ernet.in](mailto:divyesh.dixit14@iimb.ernet.in)

**Kiran Antony**

[kiran.antony14@iimb.ernet.in](mailto:kiran.antony14@iimb.ernet.in)

**Mohit Agarwala**

[mohit.agarwala14@iimb.ernet.in](mailto:mohit.agarwala14@iimb.ernet.in)

**Ravi Kant**

[ravi.kanth14@iimb.ernet.in](mailto:ravi.kanth14@iimb.ernet.in)

**S Mukunda**

[s.mukunda14@iimb.ernet.in](mailto:s.mukunda14@iimb.ernet.in)

**Siddharth Nayak**

[siddharth.nayak14@iimb.ernet.in](mailto:siddharth.nayak14@iimb.ernet.in)

**Suryaansh Makked**

[suryaansh.makked14@iimb.ernet.in](mailto:suryaansh.makked14@iimb.ernet.in)

**Tamanna Singh**

[tamanna.singh14@iimb.ernet.in](mailto:tamanna.singh14@iimb.ernet.in)

**Vipul Mathur**

[vipul.mathur14@iimb.ernet.in](mailto:vipul.mathur14@iimb.ernet.in)

Year of Publication – March 2016

## Frauds in the Indian Banking Industry

### Abstract<sup>1</sup>

The Indian banking sector has experienced considerable growth and changes since liberalisation 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. This study endeavours to cover issues such as banking frauds and mounting credit card debt, with a detailed analysis using secondary data (literature review and case approach) as well as an interview-based approach, spanning across all players involved in reporting financial misconduct. The report touches upon the case of rising NPAs in the past few years across various scheduled commercial banks, especially public sector banks. The study finally proposes some recommendations to reduce future occurrence of frauds in Indian banking sector. The credibility of third parties such as auditing firms and credit rating agencies is also questioned in the study and is believed to be a significant contributor amongst other causes, such as oversight by banks and inadequate diligence.

**Keywords:** Non-performing assets, Stressed assets, Banking frauds

---

<sup>1</sup> The authors have immensely benefitted from discussions with Savit Rao, Allen C.A. Pereira and R.K. Dubey. They would also like to thank Subhash Bharadwaj Pemmaraju for his research assistance.

## Introduction and Issues

In recent years, instances of financial fraud have regularly been reported in India. Although banking frauds in India have often been treated as cost of doing business, post liberalisation 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). RBI, the regulator of banks in India, defines fraud as “*A deliberate act of omission or commission by any person, carried out in the course of a banking transaction or in the books of accounts maintained manually or under computer system in banks, resulting into wrongful gain to any person for a temporary period or otherwise, with or without any monetary loss to the bank*”.<sup>2</sup>

In the last three years, public sector banks (PSBs) in India have lost a total of Rs. 22,743 crore, on account of various banking frauds. With various measures initiated by the RBI, numbers of banking fraud cases have declined, but amount of money lost has increased in these years. Prima facie, an initial investigation in these cases has revealed involvement of not only mid-level employees, but also of the senior most management as was reflected in the case of Syndicate Bank and Indian Bank. This raises serious concern over the effectiveness of corporate governance at the highest echelons of these banks. In addition, there has been a rising trend of non-performing assets (NPAs), especially for the PSBs, thereby severely impacting their profitability. Several causes have been attributed to risky NPAs, including global and domestic slowdown, but there is some evidence of a relationship between frauds and NPAs as well.

The robustness of a country’s banking and financial system helps determine its production and consumption of goods and services. It is a direct indicator of the well-being and living standards of its citizens. Therefore, if the banking system is plagued with high levels of NPAs then it is a cause of worry, because it reflects financial distress of borrower clients, or inefficiencies in transmission mechanisms. Indian economy suffers to a great extent from these problems, and this served as the prime motivation for the authors to carry out this detailed study of frauds in the Indian banking system and examining frauds from different angles.

This study takes into consideration, different aspects of Indian banking sector. Specifically for this study, primary semi-structured interviews were conducted with bankers and industry

---

<sup>2</sup> [https://rbi.org.in/scripts/BS\\_SpeechesView.aspx?Id=826](https://rbi.org.in/scripts/BS_SpeechesView.aspx?Id=826)

veterans to better understand sector dynamics. Finally, an attempt has been made to give possible recommendations that can help mitigate these problems.

The rest of the paper is organized into three major sections. Section 2 is a review of existing literature on the global and domestic banking sector. It talks of the evolution of the regulatory landscape governing the banking system as well as a discussion of existing literature on the issues of NPAs in banks and incidence of banking fraud. Section 3 provides a detailed analysis of banking frauds in India. It broadly covers two categories of studies carried out – secondary research from literature and case studies and primary research from interviews spanning across all players involved in reporting of financial misconduct. Section 4 provides a detailed set of recommendations for prevention and early detection of frauds in banking system.

The study intends to fulfil the following two objectives – a) to understand and analyse underlying causes contributing to increasing trend in frauds committed in Indian banking sector; and b) to suggest appropriate and suitable measures that can help the system in addressing these issues. A dual approach was undertaken to accomplish the above mentioned objectives: a) Secondary sources: This was based on literature review and case study approach. It also relied heavily on trend analysis of frauds based on past data available with the RBI and various other entities. Also, it seeks to uncover the broader trends within public sector banks (PSBs) and private sector banks (PVBs) in India; b) Primary sources: A 360 degree analysis was conducted by interviewing banking officials, retired bankers, practitioners, policy makers, crime and compliance officers, and auditors.<sup>3</sup>

## **Section 2: Brief Literature Review**

The aftermath of the great depression in 1930s in the USA saw enforcement of Glass-Steagall act (GSA) with an objective to reduce risks to financial system and tackle conflict of interests that exist in banking, by separating commercial banking functions from ‘risky’ investment banking functions. However over time, a series of dilutions gradually rendered GSA ineffective which was finally repealed in 1999.

With globalization, Kohler (2002) in his speech at a conference on humanizing the global economy stressed the need to increase transparency of financial structures as well as to raise

---

<sup>3</sup> Some of the key industry officials interviewed include a former chairman and managing director of a well-known public sector bank, chief vigilance officer of another public sector bank, managing director of a credit information company, a partner of a top notch financial auditing firm, officials of the RBI, the financial crime and compliance officer of a multi-national banking corporation, officers from the CBI and the vice president of a leading credit card provider company.

the surveillance of international capital markets. In mid 1990's, World Bank laid out a well-defined strategy to combat different types of frauds and corruption, and jointly with the IMF created financial sector assessment program (FSAP), to assess, diagnose and address potential financial vulnerabilities. FSAP has undergone several transformations and wider acceptance over the years, since its inception in 1999.

Mergers of giants in the banking industry gave birth to the concept of “too big to fail”, which eventually led to highly risky financial objectives and financial crisis of 2008. In response to the 2008 crisis, Dodd-Frank wall-street reform and consumer protection act (DFA) was enacted in 2010. DFA gave birth to various new agencies to help monitor and prevent fraudulent practices. Volcker rule, a part of DFA, banned banks from engaging in proprietary trading operations for profit.

Post crisis, IMF has worked towards making risk and vulnerabilities assessment framework effective, by advocating greater transparency and information sharing, along with empowered supervisory and regulatory bodies, as well as greater international collaboration towards regulation and supervision of financial institutions. Gaps were identified under financial surveillance as well as on the frequency of such surveillance especially in economies with truly systemic financial sectors, whose failure might trigger a financial crisis. According to literature, approximately one in three banking crises followed a credit boom, which shows a correlation between relaxed credit expansion policies by banks and crises.

Another major sector distraught with fraudulent practices is the credit card market. However, given that credit card usage in India is predominantly for transactional purposes, the macroeconomic impact of fraudulent practices is less significant and is not considered further in this study.

Indian banking system has remained plagued with growth in NPAs during recent years, which resulted in a vicious cycle affecting its sustainability. Chakrabarty (2013) noted in his speech that, while most numbers of frauds have been attributed to private and foreign banks, public sector banks have made the highest contribution towards the amount involved.

Key findings in RBI (2014b) included the stress of asset quality and marginal capitalization faced by public sector banks, and various recommendations to address these issues. Rajan (2014) stressed on good governance and more autonomy to be conferred to public sector banks

to increase their competitiveness and to be able to raise money from markets easily. In response to the common perception that increasingly strict regulations will make business opportunities take a hit, Raju (2014) stated that, regulations do not seem to be a bar in functioning of banks after the crisis. Subbarao (2009) was of the opinion that without broad-based trust and presumption of honest behaviour, there wouldn't be a financial sector of the current scale and size. He called the emergence of a moral hazard problem in the banking system as privatization of profit and socialization of costs.

To maintain uniformity in fraud reporting, frauds have been classified by RBI based on their types and provisions of the Indian penal code, and reporting guidelines have been set for those according to RBI (2014a and 2015a). Towards monitoring of frauds by the board of directors, a circular was issued as per RBI (2015b) to cooperative banks to set up a committee to oversee internal inspection and auditing, and plan on appropriate preventive actions, followed by review of efficacy of those actions. Impartial policy guidelines and whistle-blower policy are vital to empower employees to handle frauds. RBI also issued a circular and introduced the concept of red flagged account (RFA), based on the presence of early warning signals (EWS), into the current framework, for early detection and prevention of frauds. Gandhi (2014) discussed the prime causes of growing NPAs and recognised the absence of robust credit appraisal system, inefficient supervision post credit disbursal, and ineffective recovery mechanism as key barriers addressing those aspects. Gandhi (2015) stressed on the basic principles that can go a long way in preventing fraud, namely the principles of knowing the customer and employees as well as partners. He also pointed out the significance of a robust appraisal mechanism and continuous monitoring.

Lokare (2014) reveals that the share of retail loan segment in total NPAs continues to stay high, of which credit card loans (2.2 percent) have the third-highest contribution after personal and housing loans. Livshits, MacGee, Tertilt (2015) empirically suggest that the rise in consumer bankruptcy can largely be accounted by the extensive margin and lower stigma associated with it. It also suggests that financial innovations have led to higher aggregate borrowings, which has resulted in higher defaults. A study by Assocham (2014) finds strong correlation between sustainable credit growth, leading to healthy asset creation, and GDP growth. It emphasizes robust credit assessment and use of early warning systems to monitor asset quality of institutions.

### **Section 3: Analysis**

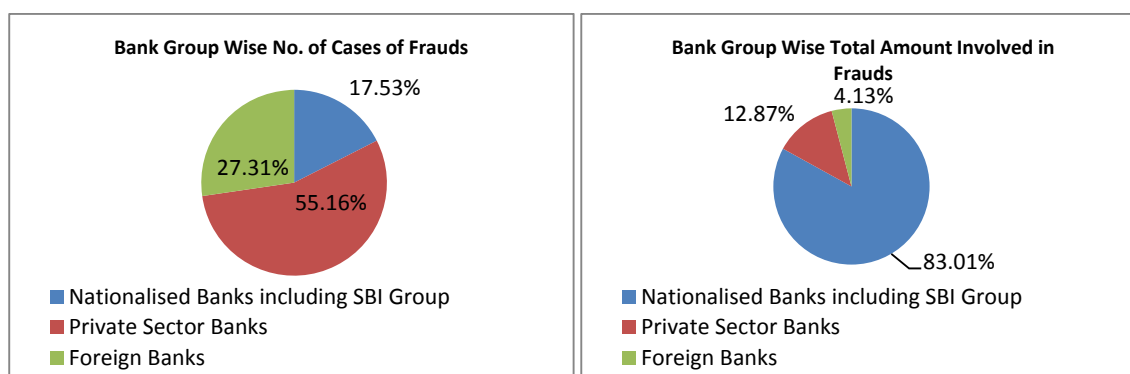
#### *Secondary Research*

As per the RBI, bank frauds can be classified into three broad categories: deposit related frauds, advances related frauds and services related frauds.

Deposit related frauds, which used to be significant in terms of numbers but not in size, have come down significantly in recent years, owing to a new system of payment, and introduction of cheque truncation system (CTS) by commercial banks, use of electronic transfer of fund, etc. Advances related fraud continue to be a major challenge in terms of amount involved (nearly 67 percent of total amount involved in frauds over last 4 years), posing a direct threat to the financial stability of banks. With ever-increasing use of technology in the banking system, cyber frauds have proliferated and are becoming even more sophisticated in terms of use of novel methods. Also, documentary credit (letter of credit) related frauds have surfaced causing a grave concern due to their implications on trade and related activities.

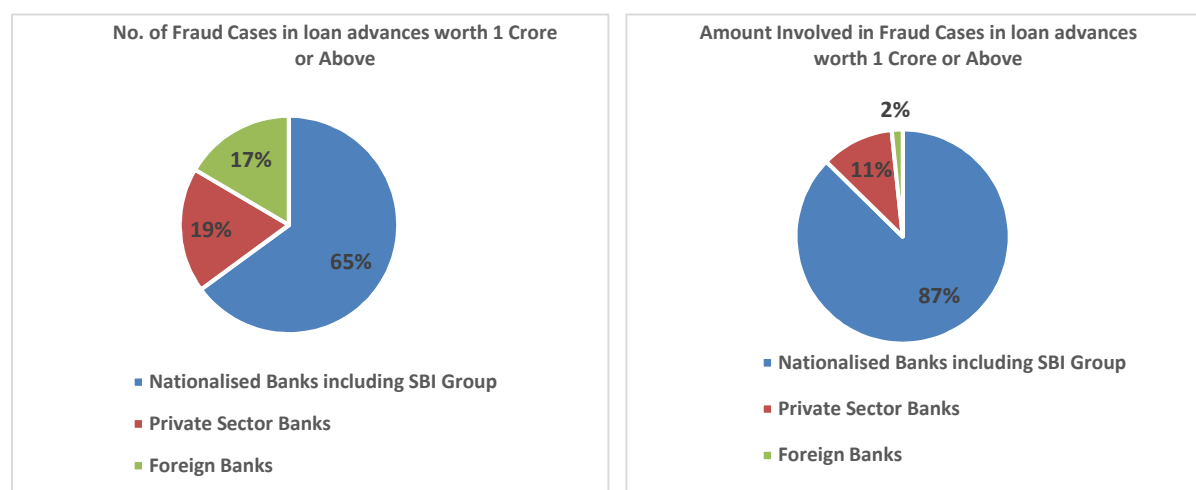
The data reveals that more than 95 percent of number of fraud cases and amount involved in fraud comes from commercial banks. Among the commercial banks, public sector banks account for just about 18 percent of total number of fraud cases, whereas in terms of the amount involved, the proportion goes as high as 83 percent. This is in stark contrast with private sector banks, with around 55 percent of number of fraud cases, but just about 13 percent of the total amount involved in such cases (Figure 1). The PSBs are more vulnerable in case of big-ticket advance related frauds (1 crore or above) in terms of both number of fraud cases reported and total amount involved (Figure 2).

The correlation between rising level of NPAs of public sector banks and frauds probably indicates lack of requisite standards of corporate governance leading to more instances of high value bank loan default and possible collusion between corporate entities and high echelon bank officials. Also, in case of private banks, high number of fraud cases with relatively low cost of fraud indicates very nature of fraud - online/cyber/technology related frauds with a high frequency of occurrence and relatively low associated cost.

**Figure 1: Group wise summary of bank fraud cases**

Note: Data pertains to the period from March 31, 2010 to March 31, 2013.

Source: Chakrabarty (2013).

**Figure 2: Group wise summary of advance related fraud cases**

Note: Data pertains to the period from March 31, 2010 to March 31, 2013.

Source: Chakrabarty (2013).

According to findings of Deloitte (2015), number and sophistication of frauds in banking sector have increased over the last two years. Around 93 percent of respondents suggested an increase in fraud incidents and more than half said that they had witnessed it in their own organizations. Retail banking was identified as the major contributor to fraud incidents, with many respondents saying that they had experienced close to 50 fraudulent incidents in the last 24 months and had lost, on an average of Rupees ten lakhs per fraud. In contrast, survey respondents indicated that the non-retail segment saw an average of 10 fraud incidents with an approximate loss of Rupees two crore per incident. Many respondents could not recover more than 25 percent of the loss.



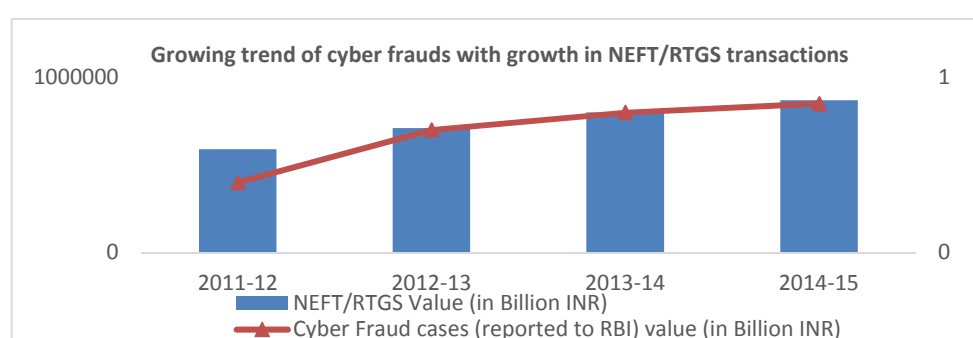
The risks undertaken by banks are still a cause of worry although it has moderated a bit. This is indicated by the bank stability indicator. Similarly, banks were worried by poor asset quality. System level credit risk is determined by gross NPA ratio which is expected to be around 5.4 percent by September 2016 and 5.2 percent in March 2017 as per RBI (2015c). Further, the ratio of stressed assets has increased significantly in the last few years. As of September 2015, stressed and written off assets (SWA)<sup>4</sup> are at 14.1 percent. The trends however are divergent, with public sector banks having an SWA of 17 percent and private sector banks having an SWA of 6.7 percent according to Mundra (2016).

As far as credit risk is concerned, 16 out of 60 banks (26.5 percent market share) were not able to cover their expected losses from their current framework.

RBI states that NPAs from retail banking are just 2 percent, whereas NPAs from corporate banking are 36 percent. Given the size of transactions in corporate banking, it is important that banks implement a robust monitoring mechanism post sanction and disbursement of facilities, and be vigilant to early signs of stress in the borrower accounts.<sup>5</sup>

India has witnessed a massive surge in cybercrime incidents in the last ten years - from just 23 in 2004 to 72,000 in 2014-15 (Figures 3 and 4). As per the government's cyber security arm, computer emergency response team-India (CERT-In), 62,189 cyber security incidents were reported in just the first five months of 2015-16.

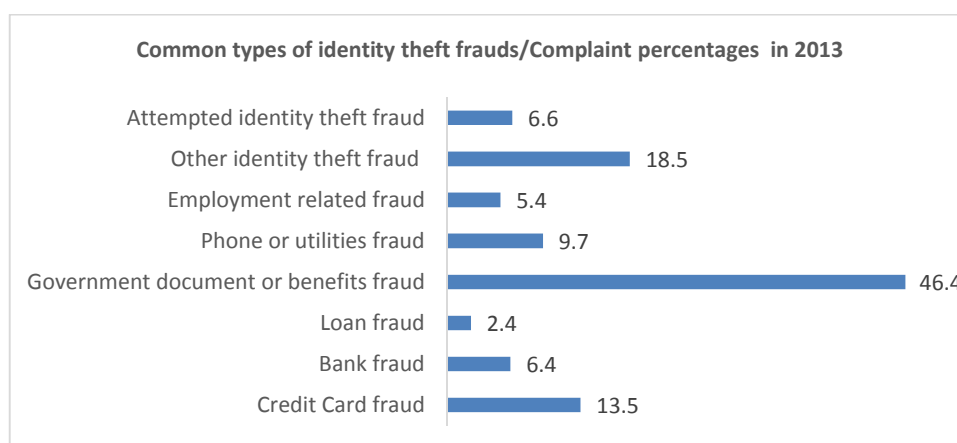
**Figure 3: Cyber Frauds**



Source: PWC India and ASSOCHAM (2014).

<sup>4</sup> Stressed and written off assets (SWA) = Gross NPA + restructured assets + assets written off

<sup>5</sup> It is not necessary that NPAs are frauds. However, it is clear that all frauds become NPAs.

**Figure 4: Identity Theft Fraud**

Source: PWC India and ASSOCHAM (2014).

### *Interview Based*

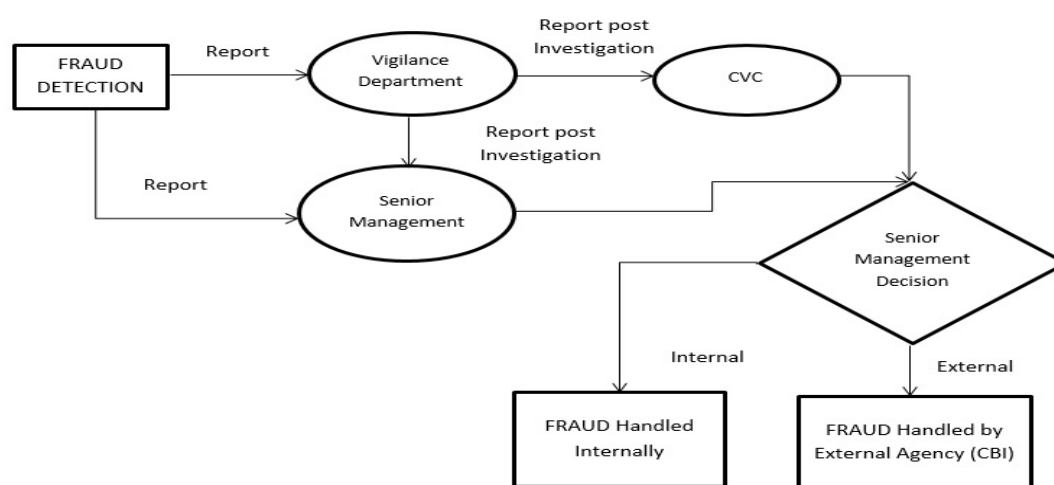
A semi-structured interview was conducted by the authors with various officials of the banking industry and investigating agencies. Detailed projects can be made available on request. Thus, from the study, the authors were able to come up with the following insights and key findings:-

1. Fraud detection procedure in public sector banks: The authors analyzed the process of fraud detection and reporting in a public sector bank and who are the various players involved in this process. Following is a step by step illustration of the same (Figure 5).
  - a) First, a fraud is internally reported to senior management of a bank. These may include chief general managers, executive directors, chairman and managing director. They may also be reported to vigilance department of the bank.
  - b) If reported to the vigilance department of the bank, it investigates the fraud and then reports it to both senior management as well as the central vigilance commission (CVC) to whom they are required to report monthly.
  - c) Although CVC can report fraud directly to investigating agencies like CBI, usually final decision to either report fraud to an external agency or to deal with it internally is made by senior management of the bank. Depending upon size of the bank, amount of money involved in fraudulent activity and number of third parties involved, senior management may choose to deal with the fraud internally or file an FIR and report it to either local police or CBI.
  - d) A committee of the RBI also independently monitors fraudulent behaviour in banks and reports its observations on quarterly basis to central board of the RBI. The board may

then report the matter to either central vigilance commission or ministry of finance (MoF).

- e) Auditors, during the course of their audit, may come across instances where transactions in accounts or documents point to possibility of fraudulent transactions in accounts. In such a situation, auditor may immediately bring it to the notice of top management and if necessary to audit committee of board (ACB) for appropriate action.
- f) Employees can also report fraudulent activity in an account, along with the reasons in support of their views, to the appropriately constituted authority (Table 1), under the whistle blower policy of the bank, who may institute a scrutiny through the fraud monitoring group (FMG). The FMG may ‘hear’ the concerned employee in order to obtain necessary clarifications. Protection should be available to such employees under the whistle blower policy of the bank so that fear of victimization does not act as a deterrent.

**Figure 5: Flow Chart depicting procedures post Fraud Detection and Reporting in PSBs**



Source: Author's line-chart.

**Table 1: Current Structure for filing Police/CBI complaints<sup>6</sup>**

Category of bank	Amount involved in the fraud	Agency to whom complaint should be lodged	Other Information
Private Sector/ Foreign Banks	Rs.1 lakh and above	State police	
	Rs.10000 and above if committed by staff	State police	
	Rs.1 crore and above	Serious fraud investigation office (Ministry of Corporate Affairs)	In addition to state police
Public Sector Banks	Below Rs. 3 crore	State police	
	Rs.3 crore and above and up to Rs.25 crore	CBI	Anti-corruption branch of CBI (where staff involvement is prima facie evident)  Economic offences wing of CBI (where staff involvement is prima facie not evident)
	More than Rs.25 crore	CBI	Banking Security and Fraud Cell (BSFC) of CBI (irrespective of the involvement of a public servant)

Source: Reserve Bank of India.

<sup>6</sup> Source : RBI Website, <https://rbi.org.in/scripts/NotificationUser.aspx?Id=9713&Mode=0>

2. Reason for higher advance related frauds in public sector banks and rising NPAs: Higher advance related frauds of above Rs. one crore loans (87 percent of total amount involved in loan worth Rs. one crore or above in value) (Figure 2) in public sector banks as compared to private sector banks (11 percent of total amount involved) could be due to the proportion of the loan advanced by both PSBs (~ 70 percent) and private sector banks (~ 30 percent) especially in large and long gestation projects like infrastructure, power or mining sectors. Also, the higher number of fraud cases reported by PSBs (65 percent of total) as compared to PVBs (19 percent of total) may be attributed to stringent oversight of CVC in PSBs. It may also be due to a possible underreporting/evergreening of loans on the part of the PVBs, evidenced by RBI's measures to curb such practices in recent times.<sup>7</sup>

The reason for large NPA's of PSBs could be attributed to greater amount of lending/exposure to mining, infrastructure and power sector projects, whose performance and associated cash flows closely follow the economic cycle of boom and recession. Also, in India, post - 2008 global crisis, a number of governance and other external issues such as policy paralysis, inordinate delay on account of stringent environmental laws/regulation, Supreme Court decision on coal mines as well as weak demand crippled these sectors and resulted into weaker cash flows. These developments severely affected the ability of such firms to service their loans leading to higher NPAs.

There is an ongoing debate on the nexus between rising NPAs in the banking system and the increasing incidence of fraud. A former CBI director, in 2013, had raised the point that, amount involved in bank frauds had increased almost 324 percent in last three years while large ticket fraud cases involving amounts of Rs. 50 crore and above had increased tenfold. He also pointed to reluctance on part of banks to declare bad accounts as frauds despite there being clear-cut manifestation of malfeasance CBI (2014).

---

<sup>7</sup> Evergreening involves replacing the original loans by sanctioning inflated loans to the counterparty year on year.

There are some limitations that emerged in the discussion. One limitation is that bankers take the project at their face value during inspection. Even today due diligence across several public sector banks is weak. The banks keep the outstanding amount as current assets and hence the original costing basis of asset valuation shows no loss of money. Shareholders are hence not aware for a long time. The classification of bad debts is also delayed considerably for a long time across all banks in India. Also, due diligence involves whether the project has got all necessary approvals, illustratively, a selling agreement as power-purchase agreement with the state government electricity board. Receivables from the government are taken for granted by the bankers but when the project goes sick these cash-flows are not realizable.

3. Third party agencies involved: Big loan advance frauds are not so easy to commit and it often results because bank officials collude with borrowers and sometimes even with officials of third parties such as advocates or chartered accountants (CAs). In such cases, the third parties such as the CAs or the advocates often get away as it is nearly impossible for the banks to prove criminal intent on the part of such persons due to various reasons such as lack of clear understanding of legal matters to bankers, and lack of expertise and legal advice on this subject, and unwillingness to reveal some sensitive data to courts/public domain. Also, self-regulatory bodies of advocates, auditors or accountants like bar council and the institute of chartered accountants of India do not generally bar their errant members. Also, in this context, cost of pursuing such individuals and delay caused by courts often deter the PSBs.

The role of auditors was further analysed in order to identify gaps and loopholes that exist in the current system. Auditors can be classified into three main types:

- a) Bank auditors – There are two main types of auditors that work for a bank to look into financial statements of its borrowers. They work in different capacities in terms of their scope and knowledge. They can be held responsible for any misreporting under common legal framework due to faith placed on them by banks. The two types of auditors are:
  - i. *Statutory auditor* – These look into financial statements of all borrowers that borrow from a bank. These are external auditors.

- ii. *Concurrent auditor* – These help supplement the functioning of bank in terms of internal checks and check on financial statements of its borrowers. These may be external/internal auditors
- b) Statutory auditors of the borrower – These auditors work for the borrower firm and help in reporting their financial statements.
- c) Special auditors – These auditors work on a case by case basis independently and are not associated with any firm or bank. They help provide an external view on statements reported by the borrower to the bank.

In our discussions, one factor that emerged was that there is a lack of competent auditors in India. The reasons were:

- a) *Staffing of auditors in banks:* The staffing of auditors is generally very competitive and price driven. It is a relatively low paying job which means only so much effort is put in by auditors to do their work. Also, the skill-set of many young auditors is low. This coupled with low standards of training meted out to them leaves them at a disadvantage in terms of the benefit of observation and experience. In addition, the auditors have clerks/articleship students working with them, who can be easily manipulated.
- b) *Training given to auditors:* The standards of training imparted to bank auditors are very low. Unlike as in the case of forensic auditing, they are not generally questioned regarding the veracity of documents they produce and no one challenges the financial information that they generate. In some cases, they are not equipped with the working knowledge of different instruments used by banks and are technically handicapped.
- c) *Attention to early warning signals:* As a consequence of low pay benefits and training standards, it has been observed that auditors do not generally pay attention to the various early warning signs that can help an organization recognize potential fraudulent malpractices in existence.
- d) *Weaker enforcement of laws in our country:* Law enforcement agencies in India are burdened with excessive work pressure and therefore have to choose between different assignments. This is due to insufficient resources and manpower available at their disposal. In such situations, auditors happen to be most dependent for law enforcement agencies

Moreover, according to discussions, many officials in law enforcement agencies lack necessary skill-sets and financial expertise to identify and deal with fast moving financial frauds.<sup>8</sup>

4. Poor appraisal system and monitoring mechanism in PSBs: The initial project appraisal process in PSBs is as good as that of PVBs. But monitoring post sanction of loan is weaker in PSBs compared to the PVBs on account of diverse loan portfolio, lack of expertise and modern technological resources, and lack of manpower and motivated employees, who are not appropriately incentivized to detect early frauds or prevent them.
5. Corporate governance and other HR issues: 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. The weakness in selection process for top level management as documented in RBI (2014b) results into weak governance at the highest level. Also, 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.

6. Senior management and board of directors: 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.

---

<sup>8</sup> CBI and other investigating agencies may not be well equipped and may lack professional understanding of banking transactions and therefore, ultimately depend on bank employees.



If the case is finally taken up in the court of law, a public prosecutor represents the bank. The public prosecutor is usually overburdened with pending cases. Additionally, from the bank's perspective, having already lost substantial amount in fraud, they allocate limited budget for prosecutions, making it easier for the guilty to escape.

7. Bank employees: Incentive structure for employees needs a re-evaluation and gives too much importance to short term targets. This incentivizes the employees to give preference to short term targets only and not exercise proper due diligence. Hence, they take more risk than is usually the norm or resort to unethical means. There have been instances of frauds involving collusion of staff with third party agents like auditors to indulge in fraudulent activities on customers. Detection of such frauds takes a long time, and is only discovered when there are customer complaints of fraudulent cases. The customers who are victim of fraudulent activities by the bank, due to identity theft etc., could have avoided so, by following appropriate preventive measures and customer awareness guidelines. Political reasons may also be responsible for indulgence in loans proceed which has substantial risk of being defaulted or defrauded, especially when a red flag is raised on the loan. As legal opinion is not the strength of a banker, advocate's directions in that matter assume importance.

Frauds also result from lack of awareness of staff towards appropriate procedures in place and red flags they should be aware of. Technology related frauds are primarily due to non-adherence to standard procedures and systems in place, by the employees. Even when any employee detects some fraudulent activities in existence involving people in power, whistle blower protection policy does not guarantee adequate safety.

PSBs in India had prepared a five point action plan to make them more competitive, which included suggestions like introduction of performance management systems and incentives in banks. Smaller banks should focus on the areas of their strength (to optimize capital utilization) among other reform plans. The banks demanded creation of bank board bureau and bank investment committee and empowerment of banks on certain decision making capabilities, in line with RBI (2014b). Additionally, they demanded simplification of credit insurance process and strengthening of legal framework for debt recovery, apart from more usage of technology.

8. Borrowers and clients of banks: Frauds may also arise solely from the borrower's side. Companies have been found to take part in 'high sea sales' with investment from Indian banks but the funds are either routed for other purpose or are not repaid after the sale has been made and instead, routed to other channels, resulting in a NPA. Such breach of contract is another instance of fraud since the funds are not utilized for the purpose they were initially set out and based on the project evaluated by the banker.
9. Legal aspects of frauds and role of investigative agencies: Investigating and supervisory bodies like central vigilance commission (CVC) or central bureau of investigation (CBI) are already overburdened with many pending investigations and have limited resources at their disposal.

The biggest hurdle in pursuing fraudsters is proving criminal intent on their part in the court of law. Most of the bank frauds are detected very late and by that time, fraudsters get enough time to wipe out trails and it becomes very difficult to establish criminal intent due to loss of relevant documents and non-availability of witnesses.

Also, while pursuing fraudsters, banks and investigation agencies face many operational issues. Bankers are not experts in legal paperwork, and formal complaints against fraudsters drafted by them often lack incisiveness. Also, in absence of a dedicated department handling fraud matters, investigating officers (CBI/police) have to deal with multiple departments and people within the bank, which often results into poor coordination and delay in investigation. This results in very low conviction rate for fraudsters (less than 1 percent of total cases). Even after conviction in fraud cases, there is no legal recourse to recover the amount lost in the bank frauds and the country's legal system is perceived to be very soft on defaulters. Also, lack of strong whistle-blower protection law inhibits early detection in case of involvement of internal employees.

10. Judicial system: The long and elaborate judicial process is another major deterrent towards timely redressal of fraud cases. The delay in judiciary to prosecute those guilty of fraudulent practices, could lead to dilution of evidence as well as significant cost building on part of the victim bank.

Also, wilful default is still not considered as a criminal offence in India. Fraudsters, both big and small, take undue advantage of these means of evasion and commit maligned activities without risk of conviction.

11. Technological and coordination perspective: RBI has an elaborate set of early warning signals (EWS) for banks to curtail frauds. However as of now, there are inadequate tools and technologies in place to detect early warning signals and red flags pertaining to different frauds. The authors' interaction with a former chairman of a big public sector bank shockingly revealed that there is only one provider of vigilance and monitoring software for banks and price discovery is poor. Even the biggest of public sector banks cannot afford to buy that software. Also, lack of coordination among different banks on fraud related information sharing is another major roadblock.

#### **Section 4: Conclusion and Recommendations**

It is observed that PSBs fare better than PVBs in terms of total number of bank frauds. However, the total amount involved is much higher in PSBs as compared to the private sector. This can be attributed to large size of loans which PSBs offer to customers.

Credit related frauds have the maximum impact in all the banking frauds in India because of the high amount involved and the cumbersome process of fraud detection followed by CVC.

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.

Also, despite efforts, banks have not been very successful in conviction of individuals responsible for financial crimes. One of the root causes of this problem is identified as lack of specialized financial sleuths with knowledge of nuances of forensic accounting as well as a good legal understanding of frauds.

Therefore, following recommendations are suggested for an early detection of frauds.

a) Independent specialized cadre: The government could consider an independent specialized cadre of officers on the lines of all India services, who are equipped with the best financial and legal know-how to detect financial frauds and are capable of carrying out an effective and time bound investigation of such scams. In short term, the government can consider forming this cadre with a pool of commercial bankers, RBI and CBI officials through lateral recruitment.

b) Know your markets: In addition to know your vendor and know your customer, the banks should also focus on know your markets. There should be a dedicated cell within each bank to assess the company/firm to which they are lending and the macro-economic environment of the concerned industry or market where products are marketed. This recommendation even seems relevant in the context of the recent crash of the Chinese market. Several Indian manufacturing companies, which were dependent on import of machinery from China, could not start their projects and generate cash flows, and this in-turn affected the banks from which loans were raised.

c) Internal rating agency: Banks should have a strong internal rating agency, which evaluates big ticket projects before sanctioning loan. The rating agency should strictly evaluate the project on the basis of business model/plan of project without being influenced by brand name or credit worthiness of the parent company, considering current macro-economic situation and exposure of the sector to the global economy. In case ratings of internal and external agencies are not similar then an investigation must be conducted to establish the causes for such differences. Also, bank should seek services of at least 2-3 independent auditors in evaluation of such projects so as to prevent chances of any possible collusion.

d) Use of latest technology: The data collection mechanism in banks is very archaic and needs a revision. The banks should employ the best available IT systems and data analytics in order to ensure effective implementation of the red flagged account (RFA) and early warning signals (EWS) framework suggested by the RBI, which would help in a better profiling of customers

by analysing patterns of their transactions and rendering a near real time monitoring possible for banks. Also, we recommend that the Institute for Development and Research in Banking Technology (IDRBT) could consider incentivising development of relevant software for commercial banks at affordable costs. This is vital to enhance their monitoring of suspicious and fraudulent transactions within the branches of their banks.

e) Monitoring outlier movement at regional level: The RBI could consider extending its monitoring ambit and scope, and should monitor the outlier movements of transactions at regional level on the lines of SEBI's circuit breaker, which might be effective in tracking the earliest possible signs of financial frauds.

f) Strong punitive measures for third parties: The government should consider examining the role of third parties such as chartered accountants, advocates, auditors, and rating agencies that figure in accounts related to bank frauds, and put in place strict punitive measures for future deterrence. There is also a case to be made to question the certification/credentials of third parties like auditors to decide their competence in evaluating accounts containing potentially fraudulent entries.

g) Strong laws to prevent fraudulent financial reporting: There are many areas where the current laws can be made stronger to improve accountability of auditors toward their jobs.

- i. One of them could be strengthening KYC norms. A benchmark in this case can be guidelines issued by OECD to regulate trust and corporate service providers (TCSPs) that helped extend liability of fraudulent malpractices in these institutions to lawyers and auditors as well. In India, NBFCs are required to act similarly by reporting about suspicious transactional activities but this is not done effectively as these laws are very weak in their current form.
- ii. Another law that can be strengthened is that of wilful default which should be made a criminal offence. It is currently a civil offence under Indian law, whereas it is a criminal offence in other countries.

h) Ground intelligence assets: Banks should be equipped with some intelligence gathering agency, which might be deployed to track activities of borrowers and is able to help the bank in ensuring real time compliance and early detection of fraud. A special fraud monitoring agency should be setup in banks with highly skilled/trained officials. A specialised

investigating agency is also needed with expertise from agencies such as CBI, RBI, SEBI and commercial banks.

i) Dedicated department for handling fraud cases: There should be a dedicated department equipped with legal assistance in every corporate branch of a PSB, which serves as a single point of contact with investigating agencies and facilitates easy access to relevant documents.

j) Financial literacy: Many a times, staff does not know the exact definition of fraud and thus needs to be educated regarding this aspect. Therefore, learning sessions for employees and the best practices across the world in areas of early fraud detection and prevention should be imparted to staff on regular basis. There can be regular e-modules with e-certifications and updates made available.

k) Transparent hiring and adequate compensation: Banks have to ensure corporate governance at the highest levels. Top management needs to set guidelines and policies for ethical practices and standard procedures to be followed throughout and set an example on zero tolerance to negligence and fraudulent activities. Considering the roles and responsibilities of top management, emphasis should be given on appropriate hiring procedure at top management level, with appropriate preference for minimum service of at least 3 years, with accountability clause. Also, changes need to be incorporated on incentive mechanisms to have a balance between short term and long term targets.

l) Coordination between agencies: there needs to be a confidential coordination between banks and agencies such as the Central Board of Direct Taxes (CBDT) to share vital information on personal wealth of promoters. In case of any information that may raise red flag, the CVC and the RBI should jointly investigate the promoters for fraudulent activities.

## Bibliography

Carney, M. (2014), “Inclusive Capitalism: creating a sense of the systemic”, Speech given by Mark Carney, Governor of the Bank of England at the Conference on Inclusive Capitalism, London 27 May 2014.

CBI (2014), “Corporate Frauds-Risk & Prevention under Changing Paradigm”, address by Ranjit Sinha, Director, Central Bureau of Investigation on May 13, 2014.

Chakrabarty, K.C (2013), “Frauds in the banking sector: Causes, Cures and Concerns”, Inaugural address by Dr. K. C. Chakrabarty , Deputy Governor, Reserve Bank of India on July 26, 2013 during the National Conference on Financial Fraud organized by ASSOCHAM at New Delhi.

Deloitte (2014), “India Fraud Survey, Edition 1”.

Deloitte (2015), “Deloitte India Banking Fraud Survey”.

Gandhi, R. (2014), “Growing NPAs in Banks: Efficacy of Ratings Accountability & Transparency of Credit Rating Agencies”, Conference conducted by ASSOCHAM on May 31, 2014.

Gandhi, R. (2015), “Financial Frauds-Prevention: A Question of Knowing Somebody”, 2<sup>nd</sup> National Conference on Financial Frauds Risks & Preventions organized by ASSOCHAM on June 26, 2015 at New Delhi.

IMF (2014), Financial Sector Assessment Program Review: Further adaptation to the post-crisis era, IMF Policy Papers.

IMF (2014), “IMF Response to the Financial and Economic crisis”, Independent Evaluation Office, IMF.

Kohler, H. (2002), “Working for a better globalization”, Remarks by Horst Kohler at the Conference on Humanizing the Global Economy.

Laeven, L. and Valencia, F. (2012), “Systemic Banking Crises Database: An Update”, IMF Working Paper No. 12/163.

Livshits, I., MacGee, J. and Tertilt, M. (2015), “The Democratization of Credit and the Rise in Consumer Bankruptcies”, University of Mannheim and CEPR, tertilt.vwl.uni-mannheim.de

Lokare, S. M. (2014), “Re-emerging stress in the Asset Quality of Emerging Markets: Macro-Financial Linkages”, RBI Working Papers.

Mundra, S.S. (2016), “Asset Resolution & Managing NPAs – What, Why and How?”, 1<sup>st</sup> CII Banking Summit on February 11, 2016.

- PwC and Assocham (2014), “Growing NPAs in Banks: Efficacy of Credit Rating Agencies”.
- Rajan, R. G. (2014), “Competition in the Banking Sector: Opportunities and Challenges”, Annual Day Lecture of the Competition Commission of India on May 20, 2014 at New Delhi.
- Raju, Y. B. (2014), “Healthy banks under healthy Regulation”.
- Reserve Bank of India (2014a), “Master Circular on Frauds- Classification and Reporting”, RBI Circulars.
- Reserve Bank of India (2014b), “Report of the Committee to the Review Governance of Boards of Banks in India” – (Chairman P.J. Nayak).
- Reserve Bank of India (2015a), “Framework for dealing with loan frauds”, RBI Circulars.
- Reserve Bank of India (2015b), “Monitoring of large value frauds by the Board of Directors”, RBI Circulars.
- Reserve Bank of India (2015c), “Financial Stability Report – Issue XII”.
- Subbarao, D. (2009), “Ethics and the World of Finance”, Conference on ‘Ethics and the World of Finance’ organised by Sri Sathya Sai University, Prasanthi Nilayam, Andhra Pradesh on August 28, 2009.
- Tung, Ko-yung (2002) “The World Banks’ Institutional framework for combating fraud and corruption”, Seminar on Monetary and Financial Law, May 8, 2002.