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Bank Frauds and Regulators

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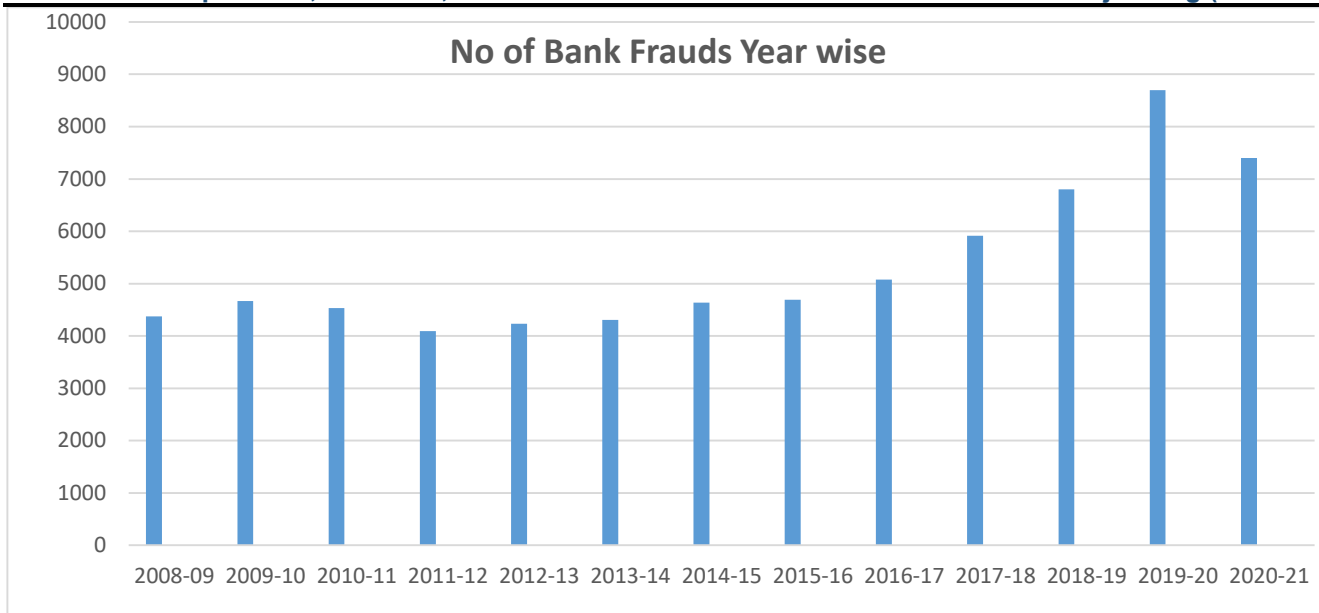
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The role of Banks is significantly and systematically crucial in the financial system and the economy of a country. Despite adherence to the best Banking practices, guidelines, rules and laws under the ambit of a number of statutory regulators, frauds i.e an act of using illegal means to obtain money or assets of Banks, appear constant and recurrent. Banks and other Financial Institutions (F.I) have reported frauds worth Rs 1.38 trillion numbering 7400 plus in the financial year (FY) 2020-21. This figure is down by 25% compared to previous year as per RBI annual report released on 28-05-2021. A great many factors contribute for occurrence of frauds in the financial system and subsequent failure towards mitigation and containing occurrence and recurrence of frauds.

The Banking system is regulated by Reserve Bank of India under the provisions of Banking Regulation Act, 1949 and Reserve Bank of India Act 1934. R B I is the Bankers Bank and Central Bank of India. All the countries of the world have such Regulatory Authorities which supervise, regulate, control, advise, guide, issue instructions and guidelines from time to time under Financial Acts. The Regulator of a country has the responsibility for monetary policy, regulation and development of financial sector institutions and financial system with the objective to guarantee fair and efficient markets and financial stability in a country.

Given below are the number of Bank frauds year wise: 4372 (2008-09), 4669 (2009-10), 4534 (2010-11), 4093 (2011-12), 4235 (2012-13), 4306 (2013-14), 4639 (2014-15), 4693 (2015-16), 5076 (2016-17), 5916(2017-18), 6800 (2018-19), 8700 (2019-20) and 7400 (2020-21).

SBI reported the highest amount of loans fraud of Rs 78072 crore value as on March 2021, followed by Punjab National Bank Rs 39733 crore and Bank of India Rs 32224 crore. The biggest frauds that shook the nation are of Vijay Mallya's in 2016 and Nirav Modi's PNB Bank fraud in 2018 of Rs 9000 and Rs 11400 crore respectively.



Regulators

Banking is a heavily regulated industry, being regulated by multiple Regulators unlike other nations.

Apart from RBI, other Regulatory authorities include:

- Securities Exchange Board of India (SEBI)
- Banks Bureau of Standard (BBS)
- Insurance Development Regulatory Authority of India (IRDA)
- Pension Fund Regulatory Development Authority of India (PFRDA)
- Indian Banks Association (IBA)
- Banking Codes and Standard Board of India (BCSBI) (since dissolved and a new single nodal point is created which is Consumer Education and Protection Department (CPED))
- Banking Ombudsman
- Ministry of Finance (MOF), Government of India.
- Competitive Commission of India
- Forward Markets Commission

Increased powers have been provided and the regulators have been strengthened in the aftermath of the Securities scam of 1992.

Further, the following Quasi Regulatory Institutions are government regulatory organizations that carry out regulatory functions directly or indirectly in the banking system in their respective areas of the economy in the country:

NABARD (National Bank for Agriculture and Rural Development)

SIDBI (Small Industries Development Bank of India)

EXIM (Export & Import Bank of India)

NHB (National Housing Bank)

Apart from the Regulators / quasi regulatory bodies, the Banks and Financial Institutions come under the ambit of the following important Acts:

- ✚ Banking Regulation Act of 1949
- ✚ Reserve Bank of India Act 1934
- ✚ Negotiable Instrument Act 1881
- ✚ State Bank of India Act 1955, (Repeal & Amendment 2018)
- ✚ The Banking Companies (Acquisition and Transfer of undertakings) Act 1980
- ✚ Payments & Settlement Systems (Amendment) Act 2015
- ✚ SARFAESI Act 2002 (Securitization and Reconstruction of Financial Assets and Enforcement of Securities Interest Act 2002)
- ✚ Foreign Exchange Management Act 1999
- ✚ Consumer Protection Act 1886

- ✦ The Limitation Act 1963.
- ✦ The Bankers' Books of Evidence Act 1891
- ✦ DICGC (Deposit Insurance & Credit Guarantee Corporation) Act 1961

Other quasi judiciary bodies and law enforcement agencies come into purview as soon as frauds occur in Banks for the investigation process and initiation of legal action. Bodies are Central Bureau of Investigation, Enforcement Directorate under Ministry of Finance that investigate fraudulent transactions under Prevention of Money Laundering Act 2002 (PMLA), State Police's CID / Economic Offences Wing of Police. Further, they require necessary certificates and documents from the Bank under section 65 B of the Indian Evidence Act, 1860 and u/s 2A(a) & 2A(b) of the Banker's Books Evidences Act 1891 for the purpose of a meaningful investigation. However for frauds exceeding Rs 50 crores, the Chief Vigilance Officer of the concerned Bank, appointed by the Government of India from among top executives other than the same Bank, is responsible for vetting with CBI.

Cases where the Bank staff has committed the fraud and the amount has been recovered or made good by the staff concerned are also to be reported to the concerned authorities for investigation. Appropriate action is taken in order to send a strong message to the employees for not indulging in fraudulent activities, detrimental to the interest and image of the Bank. Delay in reporting of fraud results in escaping disciplinary action and punishment against the staff involved in frauds.

Sources of information on fraud:

- ✓ Allegation / news items appearing in the Press or other media
- ✓ Received directly by the Bank Branches
- ✓ Forged by other departments of the Bank.
- ✓ Received from individual staff members / union/public
- ✓ Departmental Audit Report / Stock verification report
- ✓ Statement of annual assets liabilities, financials of units / companies
- ✓ Suo motu investigation conducted by Bank
- ✓ Audit Reports on Government accounts, PSUs, corporate bodies
- ✓ Anonymous / pseudonymous complaints received
- ✓ Intelligence gathered by agencies like CBI, NIA, ED, DRI etc.
- ✓ Compliant received under Government of India Resolution on Public Interest Disclosure and Protection of Informers PIDPI / Whistle Blower's Scheme

Frauds can be classified into three broad categories:

- Deposit related frauds
- Advance related fraud
- Service related fraud

Types of Bank fraud:

- ✓ Fraudulent Loans
- ✓ Phishing fraud (sending fraudulent message to steal confidential information about login credentials, password, credit cards etc)
- ✓ Card skimming (a device that reads credit and debit card's magnetic strip and used subsequently to defraud)
- ✓ Accounting data fraud (Enron Power)
- ✓ Account opening fraud,
- ✓ Cheque kiting fraud,
- ✓ Cheque fraud
- ✓ Counterfeit securities fraud (Harshad Mehta Scam),
- ✓ Bank hacking fraud,
- ✓ Money laundering fraud
- ✓ Letter of credit fraud
- ✓ Online banking fraud (by using customers' PIN, Password fraudster withdraw through Debit

card, Credit card, ATM and they get a new mobile SIM through OVD (officially valid documents)

Banks frauds occurs basically for the following reasons;

- ❖ Non adherence to system & procedure of the Bank / RBI / other Regulators,
- ❖ Lack of knowledge and negligence on the part of officials help the outsiders to defraud the Bank
- ❖ Mala fide Intention of insiders / outsiders to commit fraud.
- ❖ Fraudster taking advantage of lapses / lacunae in the guidelines, instructions, systems and procedures of the Banking system and utilizing it intelligently for fraudulent transactions. In the current scenario, Payments Banks cannot accept deposits from a single customer for more than Rs one lakh. However, these Banks are accepting deposits for more than one lakh. Amount in excess of Rs 1 lakh gets transferred through auto sweep to other big brother Banks. Again on account of mandate from the customer for withdrawal of amount, the money is auto swept from Big Banks to Customers account of Payment Bank through Payment Bank. In another example of Harshad Mehta Securities Scam 1992, the seller Bank issued Bank Receipt (BR) to the buyer of the securities, till such time the shares were physically handed over. Once the buyer got delivery of the securities, the BR would no longer be valid. Stock brokers always wanted to borrow funds to deploy in stock market. Brokers and Banks got help from PSUs which were looking into avenues to deploy temporary surpluses. In violation of rules, PSUs started taking positions in the securities market through the portfolio management services (PMS) schemes run by Banks. The Banks had funds and despite stringent RBI regulations against borrowing funds from Banks, the Broker found a workaround built on trading in Government Securities, colluding with Banks, circumventing RBI rules, getting their hands on bank funds and diverting it to stock market.

BRs could not be issued for Government securities, but could only be issued only when PSU bonds or mutual funds unit are traded. The record of Government securities held by Banks is maintained by RBI's Public Debt Office through SGL (Securities General Ledger). When a Bank wanted to sell Government securities, it only had to give a SGL transfer form to the PDO, which would then credit the securities to the buyer's account and debit the seller's Bank's securities account.. BRs were valid up to 90 days. Interestingly, a Bank would be holding a BR yet to receive delivery of the securities would trade in those securities with a third Bank, and issues another BR. In fact, BRs were issued with BRs as the underlying, instead of securities. As per RBI inspection report in October 1986, Andhra Bank and Syndicate Bank had issued BRs without having underlying securities.

- ❖ Frauds are committed in connivance with or without outsourced agencies and professionals by the borrowers and or Bank officials / employees. During processing of loan, Banks require a number of reports from them i.e. Title Investigation Reports from Advocates, valuation reports from Agencies, KYC verification reports from approved agencies, financials prepared by Chartered Accountants etc. The Regulators and Banks have properly put in place for adherence with the required and mandatory guidelines to obtain these reports, but in the absence of proper scrutiny, chances of frauds cannot be ruled out and the instances of occurrence of frauds are many.
- ❖ Fraud, at times, is perpetrated in the KYC non-compliant accounts without direct involvement of Bank Officials through net banking called PFMS (Public Financial Management System). Fraudsters take advantage of lapses in the system and procedure of the Bank. The funds are transferred by them from the corporate customer's account of Bank "X" to the customer account of Bank "Y" through net banking under PFMS misusing the user ID and Password of the corporate account holder of "X" bank. However during the entire investigation process KYC of Bank "Y" is verified. The Bank gets penalized for any negligence for opening fraudulent account without adhering to the guidelines for opening accounts.

Areas of supervision and control by Regulators

Fraud detection is described in the earlier paras. Frauds have been classified on the provisions of Indian Penal Code. This ensures uniformity in reporting of frauds to RBI/ other Bodies.

- Misappropriation and criminal breach of trust
- Fraudulent encashment of instruments
- Unauthorized credit facilities extended for illegal gratification
- Cash shortages
- Cheating and forgery
- Fraudulent transactions involving forex
- Any other transaction not coming under as above

Banks need to furnish Fraud Monitoring Return in individual fraud cases irrespective of the amount involved within 3 weeks of detection. Banks are also required to furnish flash Report on fraud involving amounts of Rs 50 million within a week of detection coming to the notice of Bank's Head Office & RBI electronically. A Central Fraud Registry based on Fraud monitoring returns filed by Banks and FIs including updates are available for which Banks have been provided with ID and password for access. Central Fraud Monitoring Cell, Department of Banking Supervision Bangalore will have records of all officers responsible for Banks for reporting of fraud. For delay reporting of fraud, staff accountability is fixed on Bank officials.

RBI imposes monetary penalty on Banks for contravention of or non-compliance with certain provisions of directions contained in RBI fraud classification and reporting by commercial banks.

Apart from reporting frauds to Controllers at different level of banks and RBI, frauds also need to be reported to different law enforcing agencies as per following:

- ✓ Frauds less than Rs 3.00 crore to be reported to state CID/EOW of the state
- ✓ Rs 3.00 crore and above to be reported to various wings of Central Bureau of Investigation
 - Anti-Corruption Branch (ACB)
 - Economic Offences Wing (EOW)
 - Banking Security & Fraud Cell (BSFC)
 - Joint Director (Policy), CBI HQ, New Delhi

ABBFF: Advisory Board for Banking and Financial Supervision:

Central Vigilance Commission in consultation with RBI reconstituted the Board with 3 members and Dr TM Bhasin as Chairman. ABBFF will examine the role of officials/ whole time Directors in PSB and Public Financial Institutions in case of frauds amounting to Rs 3 crore and up to Rs 50 crores. All PSB will refer to Board for advice before initiating criminal investigation. The Board may also periodically carry out fraud analysis in the financial system and give inputs, if, any for policy formulation related to frauds to RBI and CVC. CBI also may refer any case / matter to the Board where it has any issue or difficulty.

The Regulators have framework for timely detection, reporting and investigation related to large value bank frauds. Central Fraud Registry, based on fraud monitoring returns filed by banks and select FIs, has been set up by RBI as a searchable online central data base for use by Banks to control occurrence of further frauds.

Public Sector Banks report particulars of frauds to the RBI. RBI nominee will be present in the Central Board of PSBs. RBI controls the Bank and undertake strict measures for adhering to different measures circulated to Banks from time to time by it. RBI categorized SBI, ICICI and HDFC Banks, that are too big to fail, as Domestic Systematically Important Banks in 2019 on the ground that these FIs are so large and so interconnected that their failure would be disastrous to the economic system if their risk management measures are not effectively maintained. Under regulation by RBI, deficiency in supervisory control cause financial crises for Banks. Operational and Financial Risk are higher in Banks having high occurrence of frauds and affects international image of the Bank. Therefore, the regulators

must ensure adherence and meticulous compliance of circular instructions / guidelines by the Banks & Financial Institutions, issued from time to time by Regulators.

Effect of frauds on Banks: Fraud erodes public confidence in the Banking system, reduces profitability of Banks, crashes stock market, and weakens the market and economy, often leading to slowdown in the economic growth and disappearance of foreign investment.

Suggestions / Recommendations

Awareness among the general public.

Publishing photographs and details of willful defaulters in the newspapers.

Role / efforts of Regulators to minimize, control and monitor the probability or impact of unfortunate events on account of prevention, detection and reduction of frauds.

Early Warning Signals of accounts and Red flag accounts in the Banks.

Monitoring of High value transactions by Bank & RBI should be meaningful.

Job rotation & Transfer policy for staff in the Banks must be operationalized.

Punitive measures for staff, partners, outsourced agencies, third parties, Chartered Accountants, Advocates, Auditors, Rating agencies

Stringent laws against the borrowers and stake holders having malafide intention to defraud the Banks.

Whistle blower policy / Complaint mechanism under PIDPI (Public Information Disclosure and Protection of Informers) to be strengthened as well as rationalized coding punishment to complainant for false allegations.

Concurrent Auditor must be posted at high valued advance Branches of Banks.

Financial literacy among the public.

Sanction of medium and large loans through Committee approach. The loans should be sanctioned by a committee of members rather than an individual officer.

Reading, analysis and interpreting third party reports by the Bank officials during processing high value loan proposals.

Logical and meaningful Branch visits, audit and investigation by Bank Officials.

Supervision / Regulatory work in true letter and spirit

External Auditors to be ethical and honest.

Verification of original title deeds and documents by Banks in the process of loan sanction in the respective Government Departments and internet sites.

Due diligence in respect of KYC of seller / builder/ promoter to be done meticulously.

Scrutiny of staff accounts and keeping close watch on the lifestyle of staff of the Bank.

Incentive for early fraud reporting.

Incentive for preventive actions by staff for non-occurrence of fraud.