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IMPACT OF FRAUD ON INDIAN BANKING SECTOR

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ABSTRACT

Banking frauds in India seen a rising trend over the past few years. Though the banking sector is well regulated and supervised but it suffers from its own challenges when it comes to ethical practices, financial distress and corporate governance. This paper discuss about the impact of fraud on Indian banking sector. It evaluates the magnitude of fraud cases in different banking groups and its area of operation on the basis of secondary data available from reliable sources. This paper also discusses about the classification, types and causes of bank frauds. The paper finally proposes some recommendations to reduce future occurrence of frauds in Indian banking sector.

Keywords: *Bank Frauds, RBI, Mobile Banking, ABBF, CVC.*

Introduction

The banking and financial sector, government and public administration, manufacturing industries were the most represented sectors in fraud cases. The money involved in banking frauds have increased manifold resulting in a very serious cause of concern for regulators such as RBI. In the earlier times, the frauds were done through fake currency circulation, forged cheques, advancing loans to known parties without checking their credit worthiness. With the arrival of technology in banking sector, cyber crime has become the new threat. Bankers have to deal with newer terms the passage of time.

Post Liberalization, banking frauds increased manifold which is a cause of concern for RBI. Various measures taken by RBI have declined the number of fraud cases but the amount involved in these frauds has increased tremendously. An initial investigation in these cases revealed that not only middle level employees, but senior most management are also involved in fraud cases. This raises serious concern over the effectiveness of corporate governance at top level of these banks.

Meaning of Fraud

Fraud means criminal deception to get unfair or unlawful gain, use of false representation to deprive a victim of a legal right. In other words, fraud is the concealment of facts that resulted in the financial loss of wealth or assets to any person, institution or firm. Fraud as defined by Indian Contract Act, 1872 in section 17 as fraud means and includes any of the following acts committed by a party to a contract by his agent, or to convince him to enter into the contract:

- Any suggestion, as a fact, of that which is not true by one party to another, who does not believe it to be true.
- Concealment of the fact by on having knowledge or benefit of the fact.
- Any suggestion, as a fact, of that which is not true by one party to another, who does not believe it to be true.
- Concealment of the fact by on having knowledge or benefit of the fact.
- False promise made without any intention of performing it.
- Any other act fitted to deceive the party
- Any such act or omission as declared by law to be fraudulent.

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Bank Fraud

Bank fraud is the use of illegal means with an intention to cheat or conceal or falsify or forge documents, accounts or indulge in misappropriation to obtain money, assets or other property owned or held by the banks, financial institutions or bank depositors.

Classification of Fraud

Based on the provisions of the Indian Penal Code, RBI has classified fraud as under:

- Misappropriation and criminal breach of trust.
- Fraudulent encashment through forged instruments, manipulation of books of accounts or through fictitious accounts and conversion of property.
- Unauthorized credit facilities extended for reward or for illegal gratification.
- Negligence and cash shortages
- Cheating and forgery
- Fraudulent transaction including foreign exchange.
- Another type of fraud not coming under the specific heads above.

Types of Bank Frauds

- **Accounting Fraud:** Accounting fraud is the company's illegal alteration of books of accounts to make business more profitable on the paper than they really are. They manipulate books of accounts by overstating revenue, failing to record expenses and misstating assets and liabilities. Based on theses fraudulent financial statements bank grant loans to these businesses, but ultimately because of these fraudulent statements they can't repay the loans. Example of accounting fraud is Enron.
- **Loan Fraud:** Accounting fraud can also lead to loan fraud by presenting fraudulent information on these loan applications. When individual present fraudulent information in order to obtain loan, then it is called loan fraud. Similarly if a thief steals someone's identity and applies for a loan in their name than this is also a loan fraud.
- **Wire Transfer Fraud:** wire fraud includes all cases of fraud involving internet or wire transfer. Fraudsters steal the username and password of a banking customer, and by login through their username they transfer money to themselves.
- **Phishing Fraud:** Phishing is when fraudster obtain victims banking details by using email, text, phone calls, fraudsters often uses phishing mails to get bank account details from their victims so they can commit wire transfer fraud.
- **Rouge Trader:** A trader who acts independently, usually to the detriment of the institutions such as investment banks that employs the traders. Rouge trader plays with high risk investments that can produce huge losses or gains. If their trade is enormously profitable, no one calls them 'rouge', in fact they are more likely to receive huge bonus but if they lose risky bets then they are called rouge and can cost the banks huge losses.
- **Demand Draft Fraud:** Demand Draft fraud happens internally. It is done by one or more dishonest bank employees. They remove few demand draft leaves or demand draft books from stock and write them like a regular demand draft. Since, they are insiders they know the coding, punching of demand draft by using the internal information to avoid detection, they cash the demand draft and keep the funds.
- **Money Laundering:** Money is when a criminal deposit fraudulently obtains proceeds into a bank and the true ownership of those proceeds are concealed or made opaque so that the proceeds appear to come from a legal source. The motive in money laundering is to conceal the existence of the illegal source of income or illegal application of income to make it appear legitimate. Globally, financial action task force (FATF) is made to prevent these illegal activities. In India, government enacted prevention of money laundering act to prevent money laundering and to provide confiscation of property derived from money laundering.
- **Bill Discounting Fraud:** Bill discounting fraud is rare fraud as compared to others. In this type of fraud, fraudster opens a business account at the bank. Then the company convinces the bank to start collecting bills from clients. Clients are also part of the scam, so they always pay the bills. When the bank is happy with the customer, the company will ask the bank to credit the bill in advance. When the bank does that the fraudster takes all the money and runs and the bank never gets those funds back.

Magnitude of Fraud Cases in Banks

In the Annual Report 2019-20, RBI reported that total cases of frauds (involving 1 lakh and above) by banks/financial institutions increased by 28 percent by volume and 159 percent by value. However, occurrence of these frauds is spread over several previous years. Report also shows increase in fraud cases to 8,707 in the year 2019-20 as compared to 6,799 in year 2018-19 and the amount involved in the frauds worth more than Rs. 1.85 lakh crore in the year ended June 2020 as compared to Rs. 71,500 crore in the previous fiscal.

Frauds mainly occurred in the loan portfolio (advances category), both in terms of number and value. In 2018-19 number of frauds recorded in advances is 3,604 and amount involve in these frauds is Rs. 64,548 crore. While in 2018-19 number of fraud cases increases to 4,610 and amount involved is Rs. 1,82,051 crore which is huge. Bank reported advances or lending operations constitute 98 percent of all fraud cases. The top 50 credit related frauds constitute 76 percent of the total amount reported as fraud in 2019-20. There was a fall in the number of fraud cases in areas like off-balance sheet and forex transactions. Cards and internet frauds constitute very small amount to frauds total amount. It has increased to 174 percent to Rs. 195 crore in 2019-20 from Rs. 71 crore in the previous year. Deposit related fraud increased 316 percent from Rs. 148 crore in 2018-19 to Rs. 616 crore in 2019-20.

RBI said weak implementation of early warning signals (EWS) by banks, non detection of EWS during internal audits, non cooperation of borrowers during forensic audits, inconclusive audit reports and lack of decision making in joint lenders' meetings causes delay in detection of frauds. In 2019-20, the average lags between the date of occurrence of frauds and their detection by banks/financial institutions was 24 months. In large fraud cases (i.e. more than Rs. 100 crores) the average lag was 63 months as compared with the average lag of 22 months and 55 months for large value frauds in previous year i.e. 2018-19.

RBI created ABBF (Advisory Board for Banking Fraud) in consultation with Central Vigilance Commission (CVC). The function of ABBF is to examine all large value fraud cases before recommendations/ references are made to the investigating agencies by Public Sector Banks.

(Amount in Rs. Crore)

Bank Group/ Institutions	2018-19		2019-20	
	No. of Frauds	Amount Involved	No. of Frauds	Amount involved
Public Sector Banks	3,568	63,283	4,413	1,48,400
Private Sector Banks	2,286	6,742	3,066	34,211
Foreign Banks	762	955	1,026	972
Financial Institutions	28	553	15	2,048
Small Finance Banks	115	8	147	11
Payment Banks	39	2	38	2
Local Area Banks	1	0.02	2	0.43
Total	**6,799**	**71,543**	**8,707**	**1,85,644**

Source: RBI Annual Report 2019-20

Fraud Cases- Area of Operations

(Amount in Rs. Crore)

Area of Operations	2018-19		2019-20	
	No. of Fraud	Amount involved	No. of Fraud	Amount involved
Advances	3,604	64,548	4,610	1,82051
Off-Balance Sheet	33	5,538	34	2,445
Forex transactions	13	695	8	54
Card/Internet	1,866	71	2,678	195
Deposits	593	148	530	616
Inter-Branch Account	3	0	2	0
Cash	274	56	371	63
Cheques/DDs, etc	189	34	202	39
Clearing A/c, etc	24	209	22	7
Others	200	244	250	174
Total	**6,799**	**71,543**	**8,707**	**1,85,644**

Source: RBI Annual Report 2019-20

Causes of Bank Frauds

- Lack of supervision by concerned officers on deviation management with existing systems and procedures; it is the duty of the senior management to allow specific deviations. Lack of knowledge regarding the same may lead to fraud.
- Many banks compromise KYC requirements in the haste of increasing CASA. RBI also fined banks for non-adherence to KYC norms. The concurrent auditor points out those KYC guidelines which are not followed by the banks and ask them to obtain proof. This takes another month or so. During this period, fraudsters open deposit account and deposit forged stolen cheques and withdraws the amount.
- Management passes their targets such as margins, profitability and shareholders expectations to the middle management who in turn has transmitted the same to the line staff. Staff may use unethical methods to achieve those targets.
- There is a lack of tools to identify red flags despite of having correct, agile and educated managers; there may be absence of suitable system.
- Poor internal control system also increases the chances of fraud. Such as poor control environment, lack of segregation of duties, lack of independent checks, lack of proper authorizations, lack of proper documents and records, overriding of existing controls and an inadequate accounting system.
- Changes in technology makes banks vulnerable to various risks such as phishing, identity theft, card skimming, viruses, Trojans, spyware, adware, social engineering and cyber stalking. Banking transactions have done thru electronic channels like ATMs, RTGS/NEFT, ECS/NECS, internet banking and mobile banking.
- Insider fraud considered to be one of the most serious fraud threats faced by banks in India which arises from collusion, coercion, etc.
- Employees with little or no experience or exposure to loans/ advances are posted to branches which have large advances portfolio and are compelled to process loan proposals.

Conclusion and Recommendations

It is observed that public sector banks had more cases than private sector banks as well as the total amount involved in PSBs is much higher than the PVBs. Least fraud cases arrived from Local Area Banks. Report shows that there is increase in fraud cases by 28 percent by volume and 159 percent by value as compared to previous year. Advance related fraud has the maximum impact in all banking frauds in India because of high value involved.

The frauds may be due to weak implementation of early warning signals (EWS) by banks, non-detection of the same during internal audits, non-cooperation of borrowers during forensic audit.

The banks should reduce the lag between date of occurrence of frauds and their detection by banks/ financial institutions. The mindset of bank employees cannot be read during recruitment. Some employees intentionally defraud the organization. Organization need to establish and recheck system which shall raise the timely alert on deviations. Banks should constantly monitor the typology of fraudulent activities in online banking transaction regularly review and update the existing security features to prevent easy manipulation by hackers, skimmers, phishes, etc. early detection of emerging threats through implementation of requisite programs/ software's / system can be essential step towards containing and mitigating losses. Banks should monitor 24/7 for efficient handling and remediation processes.

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