Disclosure and Reporting of Bank Frauds in India

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Abstract

Bank fraud is a white-collar crime and defined as planning to obtain property or money from any financial institution. To check the malpractices and cheating of customers, a Board of Financial Supervision has been set up by the Reserve Bank of India (RBI). The Mitra Committee report submitted to the RBI had recommended a two-pronged strategy to check corruption and fraud cases in the nationalised banks, which included in-house preventive measures and legislative changes. The Committee had also suggested development of best practice code, internal check and control, application of criminal laws to financial frauds, separate investigating authority for investigating serious financial frauds and special court for trying such offences and separate act to deal with financial frauds. The RBI has issued guidelines for formulating the `Best Practices Code' (BPC) to prevent frauds in a bid to ensure uniformity in the content and coverage of BPC being developed by banks.

Frauds are perhaps as old as Finance. The financial sector reforms have converged to spur greater innovative developments in Indian banking sector. But also various new types of frauds are emerging and coming frequent visitors of the system as obstacles in the function of banks. There is a crying need to have a speedier and better-coordinated process for dealing with financial frauds as well as an effective governance structure and settlement system for efficient functioning of banks and financial institutions.

What is Fraud?

Fraud is having a wider meaning being generic and infinite in variety. Fraud as defined in legal dictionaries is "a misrepresentation or concealment with reference to some fact material to a transaction that is made with knowledge of its falsity or in reckless disregard of its truth or falsity and with the intent to deceive another and that is reasonably relied on by the other who is injured thereby."

As per Section 17 of the Indian Contract Act, 1872, fraud means and includes any of the following acts committed by a party to a contract, with his connivance, or by his agent, with an intent to deceive another party thereto or his agent, or to induce him to enter into the contract: (a) suggestion as a fact, of that which is not true, or by one who does not believe it to be true; (b) active concealment of a fact by one having knowledge or belief of that fact; (c) a promise made without any intention of performing it; (d) any other fact fitted to deceive; (e) any such act or omission as the law specially describes to be fraudulent.

As per Section 25 of the Indian Penal Code, 1860 (IPC), a person is said to do a thing fraudulently if he does that thing with intent to defraud but not otherwise.

In United States, fraud has been referred by American Jurisprudence as "unfair dealing; malfeasance; a positive act resulting from a willful intent to deceive; an artifice by which a person is deceived to his hurt; a willful, malevolent act, directed to perpetrating a wrong to the rights of the others; anything which is calculated to deceive, whether it is a single act or a combination of circumstances, or acts or words which amount to a suppression of truth, or mere silence".

Bank Frauds

The number of frauds in Indian banking sector and the money involved in these cases has been on the rise in recent years. In Banks, the fraud may be committed by the involvement of either of the following one or more of the parties viz., (a) The employees; (b) The customers; (c) The outsiders.

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The Reserve Bank of India (RBI), in exercise of its supervisory powers vested with it, has been focusing on the bank frauds perpetrated by the employees and outsiders. The RBI has identified the following as fraud-rauds.

Factors of Fraud

The following factors facilitate the perpetration of fraud:

1. Wrong persons got introduced both in deposit and borrowal accounts without detailed enquiry/ scrutiny and thus were given access to banking services.
2. Certain persons acting as Middlemen/brokers without proper identification were entertained as agents of so called depositors/ borrowers.
3. Large credit, debit and cash transaction in newly opened accounts did not arouse the suspicion of the staff and no attempt was made to verify the genuineness of the transactions with reference to the business of the account holder.
4. Reconciliation of inter-branch accounts, clearing adjustment account, follow-up of large outstanding entries in the nominal heads of accounts remained pending for a long time.
5. The role of controlling office particularly in regard to receipt and scrutiny of control returns and house keeping was far from being effective.
6. There were huge arrears in the areas of balancing of books.
7. The bank's critical stationery, its stock on hand, indent, custody, issue, movement, loss etc, was not properly monitored.
8. Appraisal and review of borrowal accounts were carried out as a matter of routine and early warning signals were not acted upon.
9. Inordinate delay in completion of investigation of detected frauds by Investigating Agencies and also delay in completion of departmental action not only failed to send a clear and strong message to the errant staff but also demoralised hones t staff who because of the case being treated as composite e one, came within the purview of investigation.
10. Unlimited computer access was provided to vendors and staff not related to the book-keeping and supervision.
11. The system of concurrent audit as operative in the banks failed to achieve its objectives inasmuch as the early signals of gross irregularities were not timely reported and acted upon.
12. Generally, non-observance of laid down systems and procedures by the bank functionaries, nexus of bank staff with the borrowers and depositors, negligence on the part of the dealing officials and branch managers, commission of fraud by the bank staff themselves, failure of internal control system and inadequate appraisal of credit proposals and ineffective supervision over advances.

Modus Operandi

The Report of the Study Group on Large Value Bank Frauds presented to the Board for Financial Supervision (BFS) of the RBI identifies the modus operandi adopted for perpetrating bank frauds. The modus adopted to be (a) opening of new fictitious deposits accounts by persons not properly identified by the bank followed by deposit of fake/stolen/forged instruments in such accounts and immediate withdrawals of the proceeds, (b) submission of false stock/financial statements to avail of finance, (c) clandestine removal of goods hypothecated and siphoning of sale proceeds, (d) acceptance of deposits both Resident and Non-Resident through middlemen and thereafter allowing/availing of overdraft against fraudulent discharge of these deposits receipts by forgoing power of attorney and loan documents of third parties who were also not properly identified, (e) raising of accommodation bills, (f) kite flying, (g) manipulation in outward/inward clearing, (h) raising unauthorised debits on nominal heads of account, (i) manipulating and tampering with the books of accounts by passing unauthorised entries, (j) sanction of one time ad hoc credit facility to non-clients, (k) issue of letter of Credit, Bank Guarantees without recording in the branch books, (l) issue of pay orders/demand drafts without consideration, (m) fake documentation, etc.

No one can prepare an exhaustive list of Bank frauds. An illustrative list may be:

1. Misappropriation of cash tendered by a bank's constituents and misappropriation of cash in remittances.
2. Withdrawal from deposit accounts through forged instruments.
3. Fraudulent encashment of negotiable instru-ments by opening an account in fictitious name.

4. Misappropriation through manipulation of books of accounts.
5. Perpetration of frauds through clearing instruments.
6. Frauds in demand drafts issue and encashment.
7. Misutilisation/overstepping of lending/discretionary powers and non-observance of prescribed norms/procedures in credit dispensation.
8. Opening/ issue of Letter of Credits, bank guarantees, co-acceptance of bills without proper authority and consideration.
9. Frauds in foreign exchange transactions through non-adherence of RBI's prescribed norms and procedures.

Mitra Committee

The Expert Committee on Legal Aspects of Bank Frauds was set up by the BFS of the RBI in 2000 under the chairmanship of Dr N L Mitra. The terms of reference included charting procedural laws to deal with financial frauds, examining the process of investigation of bank frauds, providing suggestions to operationalist the recommendations relating to legal aspects of bank frauds and examining the role of the central bank with regard to frauds reported by banks. The Committee submitted its report in September 2001 to RBI. The recommendations of the Committee consist of two parts. Part I covers the recommendations, which could be implemented without any legislative changes and these, were forwarded to banks in May 2002 for implementation. The recommendations in Part II require legislative changes. The report along with comments of RBI was forwarded to the 'High Level Group on Frauds in Banking Sector' constituted by Central Vigilance Commission (CVC) for comments.

The Committee recommended a two-pronged strategy to check corruption and fraud cases in the nationalised banks. First, in-house preventive measures to minimise malfeasance were required. Second, banks should adopt a prohibitive approach to deal firmly with such incidents.

Emphasising the need for urgent legislative attention to such frauds, the Committee said, "Financial frauds are required to be criminalised with the burden of proof to be shifted on the accused to prove absence of commission of fraud".

The Committee provided an illustrative legislation to combat financial and bank frauds.

The Committee had also suggested development of best practice code, internal check and control, application of criminal laws to financial frauds, separate investigating authority for investigating serious financial frauds and special court for trying such offences and separate act to deal with financial frauds.

The report also recommended establishment of a separate special bureau to deal with major frauds and provide certain operational guidelines for the recovery of the defrauded amount. The bureau, with a director at the head, should investigate all frauds involving Rs 10 crore or more, singly or in totality with series of transactions or causing national publicity and concern among others.

There should be a special court and prosecutors constituted to try the cases investigated by the bureau, it added.

In order to facilitate the operation of the Bureau, it recommended the establishment of a Statutory Fraud Committee under the chairmanship of RBI nominee with representation from Securities Exchange Board of India and Insurance Regulatory and Development Authority.

The Committee said similarly there should be a committee constituted by nominees from banking, insurance and capital market regulators - to make preliminary inquires in the allegations of frauds and advise the regulator whether such act amounts to financial fraud or to deal with such incidence of contractual or tortuous fraud.

On system reform in banking practice, the committee said every bank, financial institution and financial intermediary should be required to develop Best Practice Code (BPC) within a timeframe and submit the same to the regulator. They should also chalk-out effective measures to internalise BPC in the staff, supervise, control and monitor variation from the code, it said.

Measures were needed to be put in place to enforce BPC in the use of discretionary power and make documentation of the same, periodically review the use to this power, audit and obtain compliance certificate. "Growth of non-performing assets must be linked with the degree of supervisory control and regulation and must relate inversely to future power of use of discretionary power", the committee said.

The Committee recommended financial fraud to be defined as an offence. It also provides a definition of financial fraud. Financial fraud needs to be criminalized by inserting a definition for the offence on 'financial fraud' and a penal provision in the IPC in a new Chapter XXIV with Section 512 and 513. The definition may be as follows: "Financial fraud means and includes any of the following acts committed by a person or with his connivance or by his agent, in his dealings any bank or financial institution or any other entity holding public funds: (a) the suggestion as a fact, of what which is not true, by one who does not believe it to be true; (b) the active concealment of a fact by one having knowledge or belief of the fact; (c) a promise made without any intention of performing it; (d) any other act fitted to deceive and (e) any such act or omission as the law specially declares to be fraudulent."

A few illustrations can be added with the above definition suggesting the following acts or omissions as offence: (a) Insider trading; (b) Price rigging in the financial market; (c) Any act of deceiving a bank or a financial institution; (d) Any act, which can be a fraudulent preference in an insolvency or bankruptcy proceeding; (e) Any unauthorized act or market interception or deceit whether done through institutions in India or abroad; (f) Vanishing company; (g) Any company raising public money through equity or loan without having any intention to perform the objectives laid down by the company or by any unincorporated body of group of persons. Such illustrations may only narrate the wide scope and dimension of the offence.

The offence must be made cognizable with imprisonment up to seven years and also fine. But a serious fraud must be made punishable with imprisonment up to ten years and fine of double the amount involved in the fraud. However, the minimum punishment should be for five years. Such a provision can be provided in Section 513 of the IPC.

Central Vigilance Commission

The RBI has moved to crack down on bank fraud. It has advised banks to initiate departmental action against officials involved in fraud simultaneously with criminal action.

RBI directed banks to strengthen their control mechanisms to detect and prevent fraud and to implement the recommendations of the high-level group constituted by the CVC.

Based on the recommendations of the Group, the CVC also decided to take fraud cases out of Vigilance 'A' category and reclassify them as Vigilance 'F' to ensure speedy completion of departmental proceedings.

Category 'F' frauds may be defined as frauds of Rs. 1 crore and above, perpetrated with a criminal intention by any bank official, either alone, or in collusion with insiders/outsiders, including: (i) Misappropriation and criminal breach of trust; (ii) Fraudulent encashment through forged instruments, manipulation of books of accounts or through fictitious accounts and conversion of property; (iii) Unauthorised credit facilities extended for reward or for illegal gratification; (iv) Negligence and cash shortages; (v) Cheating and forgery; (vi) Irregularities in foreign exchange transactions; (vii) Any other type of fraud not coming under the specific heads as above.

RBI Circular on Classification and Reporting of Frauds

The Department of Banking Supervision (DBS) of the RBI has been advising banks from time to time about the major fraud prone areas and the safeguards necessary for prevention of frauds. The RBI in its circular No. DBS. FrMC. BC. No. 1 /23.04.001/2006-07 dated July 2, 2007 addressed to the Chief Executives of all commercial banks (Excluding Regional Rural Banks), and Financial Institutions updated the Master Circular on 'Frauds - Classification and Reporting'. The salient features of the circular are briefly summarised below:

Classification

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

(a) Misappropriation and criminal breach of trust.
(b) Fraudulent encashment through forged instruments, manipulation of books of account or through fictitious accounts and conversion of property.
(c) Unauthorised credit facilities extended for reward or for illegal gratification. .
(d) Negligence and cash shortages.
(e) Cheating and forgery.
(f) Irregularities in foreign exchange transactions.

(g) Any other type of fraud not coming under the specific heads as above.

Cases of 'negligence and cash shortages' and 'irregularities in foreign exchange transactions' are to be reported as fraud if the intention to cheat/defraud is suspected/ proved. Cases of cash shortage up to Rs. 1,000/- reported on the same day by persons handling the cash and where there is no suspicion of fraud, need not be reported as fraud. However, cases of cash shortage involving more than Rs. 1,000/- and those detected by the management/ inspecting officer, irrespective of the amount, may be reported as fraud.

To ensure uniformity and to avoid duplication, frauds involving negotiable instruments may be reported only by the paying banker and not by the collecting banker.

Reporting Frauds involving Rs. 1 lakh and above: Fraud reports should be submitted in all cases of fraud of Rs. 1 lakh and above. Fraud reports should also be submitted in cases where central investigating agencies have initiated criminal proceedings suo moto and/or where the RBI has directed that they be reported as frauds.

The fraud reports in soft and hard copy format should be sent to the Central Office (CO) as also the concerned Regional Office of the RBI, DBS, under whose jurisdiction the Head Office of the bank falls, in the format given in FMR 1, within three weeks from the date of detection.

Frauds committed by unscrupulous borrowers: It is observed that a large number of frauds are committed by unscrupulous borrowers including companies, partnership firms/proprietary concerns and/or their directors/partners by various methods including the following:

(i) Fraudulent discount of instruments or kite flying in clearing effects.

(ii) Fraudulent removal of pledged stocks/disposing of hypothecated stocks without the bank's knowledge/inflating the value of stocks in the stock statement and drawing excess bank finance.

(iii) Diversion of funds outside the borrowing units, lack of interest or criminal neglect on the part of borrowers, their partners, etc. and also due to managerial failure leading to the unit becoming sick and due to laxity in effective supervision over the operations in borrowal accounts on the part of the bank functionaries rendering the advance difficult of recovery.

In respect of frauds in borrowal accounts involving an amount of Rs. 5 lakh and above, additional information as prescribed under Part B of FMR 1 may also be furnished.

Frauds involving Rs. 100 lakh and above: In respect of frauds involving Rs. 100 lakh and above banks may report the fraud by means of a D.O. letter addressed to the Chief General Manager of the DBS, RBI Central Office, within a week of such frauds coming to the notice of the bank's Head Office. The letter may contain brief particulars of the fraud such as amount involved, nature of fraud, modus operandi in brief, name of the branch/ office, names of parties involved (if they are proprietorship/ partnership concerns or private limited companies, the names of proprietors, partners and directors), names of officials involved, and whether the complaint has been lodged with the Police/Central Bureau of Investigation (CBI). A copy of the D.O. letter should also be endorsed to the Regional Office of RBI under whose jurisdiction the bank's branch, where the fraud has been perpetrated, is functioning.

Cases of attempted fraud: Cases of attempted fraud, where the likely loss would have been Rs. 100 lakh or more, had the fraud taken place, should be reported to the DBS, RBI Central Office indicating the modus operandi and how the fraud was detected. Such cases should not be included in the other returns to be submitted to the RBI.

Report on Frauds Outstanding: Banks should submit a copy each of the Quarterly Report on Frauds Outstanding in the format given in FMR 2 to the Central Office and the Regional Office of the RBI under whose jurisdiction the Head Office of the bank falls within 15 days of the end of the quarter to which it relates.

Progress Report on Frauds: Banks should furnish case-wise quarterly progress reports on frauds involving Rs. 1 lakh and above in the format given in FMR 3 to the Central Office of the RBI, DBS as well as the concerned Regional Office of the DBS under whose jurisdiction the bank's Head Office is situated, within 15 days of the end of the quarter to which it relates.

In the case of frauds where there are no developments during a quarter, a list of such cases with a brief description including name of branch and date of reporting may be furnished in Part B of FMR 3.

Cases of theft, burglary, dacoity and robbery should not be reported as fraud. Banks should arrange to report such cases to the authorities immediately on their occurrence by telegram/ fax / e-mail. The report should include details of modus operandi and other information as per FMR 4.

Banks should also submit to the RBI, DBS, Central Office as well as the concerned Regional Office of the RBI under whose jurisdiction the bank's Head Office is situated a quarterly consolidated statement in the format given in FMR 4 covering all cases pertaining to the quarter. This may be submitted within 15 days of the end of the quarter to which it relates.

Conclusion

Delay in reporting of frauds and the consequent delay in alerting other banks about the modus operandi could result in similar frauds perpetrated elsewhere. Banks may strictly adhere to the time frame fixed for reporting to help the RBI to prevent the frauds.

References

1. RBI circular No. DBS. FrMC. BC. No. 1 /23.04.001/2006-07 dated July 2, 2007 http://rbidocs.rbi.org.in/rdocs/notification/PDFs/78351.pdf
2. The Report of the Expert Committee on Legal Aspects of Bank Frauds (2001) http://www.rbi.org.in/scripts Publication Report Details.aspx? UrlPage = &ID = 247

Table 1: Road Map Suggested by Mitra Committee

1. Draft a financial fraud bill to:
   (a) Definition of terms;
   (b) Establishment of Financial Fraud Committee with allocated powers;
   (c) Establishment of multi-disciplinary bureau for investigation of major financial fraud
   (d) Power of the investigators
   (e) Special prosecutor
   (f) Special Court for major financial fraud
   (g) Annexure 1 to criminalize financial fraud by amending IPC
   (h) Annexure 2 to amend the Indian Evidence Act to shift the burden
   (i) Annexure 3 to amend Criminal Procedure Code to incorporate provisions for investigation by the officials of the Bureau
2. Preventive aspects to be notified by the regulator though guideline. The same is required to be infused and internalized by periodical motivational training
3. Fraud Committee may be constituted
4. Until the Act is passed, experts from banks, insurance, financial market regulators and finance should reinforce the financial offence investigation cell of the CBI. When the Bureau is constituted, the body has to be multi-disciplinary.
5. The liability of the Auditor is required to be fixed with provision for submission of report with required disclosure to the appropriate regulator.
6. In case of any allegation on account of fraud, the concerned bank and institution may (1) file an FIR with the Police; or (2) refer the matter to the Bureau/CBI; or (3) refer the matter to the Regulator to inquire whether the action of the inhouse official was fraud or an act bona fide done in pursuance of business prudence.
7. The regulator may (1) refer the matter to the Bureau for investigation; or (2) refer the matter to the Fraud Enquiry Committee seeking its advice; or (3) refer the matter to the Government for taking appropriate action.
8. Annual report of the Fraud Enquiry Committee and the CBI/Bureau on Financial Fraud should be placed before the Parliament through the Ministry of Finance.
9. The regulator may stipulate time to institutions to draft their Practice Code and submit the same to the regulator to finally approving the BPC.
10. BPC for the discretionary power to be framed.
11. Monitoring strictly the variation where certificate of compliance is not given.
12. Annual legal system audit and compliance certificate to be insisted.
13. Regulator's guideline must be scrupulously followed.

Table 2: Forms for Reporting of Frauds to RBI

FMR-1	Report on actual or suspected frauds in banks Part A: Fraud Report Part B: Additional information on frauds in borrowal accounts
FMR-2	Quarterly report on frauds outstanding Part A: frauds outstanding Part B: Category-wise classification of frauds reported during the quarter Part C: Perpetrator-wise classification of frauds reported during the quarter
FMR-3	Quarterly progress report on frauds of Rs 1 lakh and above Part A: Summary information Part B: Details of cases where there is no progress Part C: Case-wise details of progress
FMR-4	Report on dacoities/robberies/thefts/burglaries