CHARAN SINGH – CCS PROJECT REPORT

Frauds in Banking

Corporate Governance Issues

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Abstract

Indian banking sector has witnessed a massive growth since liberalisation of the Indian economy in 1991. It is regulated and supervised by the Reserve Bank of India (RBI) and has a reputation of being governed with stringent laws and regulations in place. It is widely believed that it was because of these regulations that Indian economy could emerge unscathed from the jitters of the Financial Crisis of 2008 that were felt all over the world. However, the banking sector in India faces its own challenges when it comes to ethical practices, financial distress and corporate governance. This report deals with a detailed analysis of these issues using an interview-based approach, spanning across all players involved in reporting financial misconduct. It therefore provides a 360 degree viewpoint and seeks to pitch recommendations for the same.

Chapter 1: Introduction

Banking and financial systems have been the essence of growth and development of all of mankind since hundreds of years. The robustness of the banking and financial system of a country helps determine the production and consumption of goods and services within a country. It is directly indicative of well being and living standards of a country's citizens. Therefore, if banking system is plagiarized with high levels of non-performing assets on balance sheets of banks, financial distress of borrower clients and inefficiencies in transmission mechanisms then it is a cause of worry for the economy. Indian economy suffers o a great extent from these problems and this served as a motivation for us to carry out this detailed study of the Indian banking system from a 360 degree view. The report talks about various regulations in place, issues faced by the Indian banking sector with special emphasis on public sector banks (as most NPAs lie on the balance sheets of these banks) and possible recommendations that can help mitigate these problems.

Chapter 2 explains the objective of the study and the methodology followed to carry out this analysis. Chapter 3 sums up the literature review performed prior to start of the analysis. Chapter 4 gives a brief overview of current systems and practices in place. Chapter 5 talks about issues prevailing in the Indian banking system from a 360 degree view, covering all major players involved in identification, reporting and investigation of frauds in banking. Chapter 6 brings in the lens of ethics and its role in banking system. Chapter 7 talks about possible recommendations to address issues identified in the analysis. Chapter 8 concludes the report.

Chapter 2: Objective and Methodology

The objective of this study was three fold.

1. To study Indian banking and financial system along with current processes and regulations in place
2. To identify issues in the current system and reasons for these issues
3. To suggest recommendations that can help the system tackle these issues

The methodology adopted by us was a survey – based and interview – based approach. We started with a comprehensive study of financial regulations in place across the world and then in India. We then identified issues that concern Indian banking and financial system. A 360 degree analysis was conducted by interviewing prominent figures belonging to each of the major players involved in detection and reporting of fraudulent activities in a bank. To understand the role of senior management, board of directors and employees of a bank we interviewed a retired Chairman and Managing Director of a major public sector bank. In order to study the role of third parties and judiciary, we spoke with a senior official of a top auditing firm in India and a highly experienced lawyer of an esteemed banking regulatory authority in India. Chief Vigilance Officer of another major public sector bank helped us understand challenges faced by the vigilance department inside the bank as well as the Central Vigilance Commission of India. Chairman and Director of a top multinational engineering and electronics company helped us assess the issue from the viewpoint of a borrower corporate client. Officials from a top investigating agency helped us understand the perspective of investigating agencies involved in inspection of cases involving financial frauds. All these interactions with top personalities from both government and private entities in India helped us come up with recommendations that we believe can address existing issues to resolve frauds in banking to a great extent.

Chapter 3: Literature Review

Financial markets around the world have suffered due to lack of strong regulations, greed and unethical practices for a long time now. In response to every crisis that hit the world, newer and better regulatory reforms were introduced. Following is a study of these reforms and how effective they have proven to be over time.

The Great Depression and the Glass Steagall Act (1933)

After the famous Pecora hearings in 1932 that left the world shocked to the core, the following year saw enforcement of Glass Steagall Act by US Senate as a response to the Great Depression with an *objective* to reduce risks to financial system by limiting a bank's risk taking ability as well as the many conflict of interests that exist in banking. The act

- Separated commercial banking functions from 'risky' investment banking functions.
- Established Federal Deposit Insurance Corporation, an insurance system for depositors.

As soon as the act was passed, however, lobbying efforts to repeal it began. A series of deregulations by the board of governors of Federal Reserve System & Office of Comptroller of the Currency as well as federal courts gradually enabled commercial banks to participate in a variety of risky financial activities earlier restricted by the Glass Steagall Act. *So even before the act was repealed in 1999, it had been diluted to a great extent rendering it ineffective.*

Those in favour of repeal of the Glass Steagall Act argued that in the current state of highly deregulated financial markets, distinction between loans, securities and deposits cease to exist. Depository institutions were losing out to less regulated security institutions. Also, since no such act existed in the rest of the world, they argued that this will put US on a back foot as compared to Shanghai which was fighting so hard to become the next financial capital of the world.

Those who were against the repeal of the Glass Steagall maintained the issue with conflict of interests in banking, possible consolidation into financial giants that may end competition in loans and investments market, highlighted the various threats due to risky activities that banks might engage in if let loose and how not very competent most commercial banks were to handle and maintain these risks if the act was repealed.

Eventually, those in favour won and the act was repealed in 1999. Between 1999 and the 2008 crisis, regulation and supervision of traditional banking bodies weakened. They engaged in a wide range of financial activities and operated with fewer constraints. It started to become more and more difficult to distinguish between activities that will benefit the bank vis-a-vis activities that will benefit customers of these banks. For instance, the JP Morgan Chase Whale Trades tell us about how commercial banks used deposits partly funded by the federal government to make risky bets that they themselves did not fully understand. Mergers of giants in the industry gave birth to the concept of "too big to fail", which was thoroughly misused by all.

The Financial Crisis of 2008 and Dodd Frank Act[1] (2010)

In response to the 2008 financial crisis, the Dodd Frank Wall Street Reform and Consumer Protection Act was signed by President Barack Obama in 2010 with a view to reduce the many risks involved in banking and financial system of United States of America. It gave birth to the following new agencies to help monitor and prevent fraudulent practices.

[1] https://www.sec.gov/about/laws/wallstreetreform-cpa.pdf

1. ***Financial Stability Oversight Council:*** Created to monitor firms that were "too big to fail", FSOC has the authority to liquidate or restructure these firms if need be. It also led to creation of Financial Research Office within the Treasury to support the council.
2. ***Consumer Financial Protection Bureau:*** Created to monitor mortgage lending practises in the industry, CFPB is responsible for other lending practices like credit and debit cards, payday loans, consumer loans (except auto loans) as well. It requires all information regarding lending to be disclosed to potential borrowers.
3. ***Office of Credit Ratings at SEC:*** It was created to provide investors with credible credit ratings of firms.
4. ***Federal Insurance Office:*** It is tasked with monitoring insurance firms and identifying risky ones. It is also responsible for information collection and to make insurance affordable for the masses.

Volcker Rule: It is a part of Dodd-Frank Act that bans banks from engaging in proprietary trading operations for profit. This means that banks cannot keep funds more than three percent of their revenues as profits and cannot own or invest in funds like hedge funds, private equity funds etc. The rule came into effect on April 2014. Banks have been asked to divest existing funds within seven years starting July 2015.

IEO Evaluation on IMF Response to Crisis[2]

When the 2008 crisis happened, International Monetary Fund (IMF) was in a relatively weak position. Based on common belief that the Global economy had entered a moderation phase, IMF was in the process of gradual downsizing. The resources at IMF's disposal were very low and a lot of seasoned staffs had started leaving the organization. Some member states accused IMF of not warning the world regarding the increasing risks and vulnerabilities that led to the crisis.

IMF provided analytical support as well as coordinated with the G20 for a global fiscal stimulus and promotion of financial stability. When the G20 leaders called for collaboration between IMF and Financial Stability Board (FSB), IMF complied, though there were concerns on IMF's independence while coordinating with other organizations. According to authorities from developed and emerging market economies, sufficient analysis was not done on the approach followed by regulatory and supervisory agencies, or the changing regulatory environment's impact on investments.

IMF coordinated with European Commission (EC) and European Central Bank (ECB) on crisis response programs. While European authorities appreciated the effort, considering the experience brought in by the IMF, authorities of other economies criticized the move of IMF to be side by side of the member countries while taking policy decisions. They felt it to be bad governance and raised the question whether IMF shall follow similar lines of action if crisis in future involves other member countries.

Further IMF's advice of expansionary fiscal measures and accommodating monetary policies post 2008-09 seemed appropriate and timely, but the optimistic growth forecast and the fiscal consolidation advocacy following this forecast did not turn out to be the best of decisions. Additionally, the monetary expansion approach combined with fiscal consolidation did not seem appropriate considering the huge private debt that underlines the financial crisis.

IMF's pre-crisis view on financial markets being self-stabilizing underwent an evolution as the crisis unfolded. The need for bank recapitalization was advocated by IMF, along with the role that regulatory and supervisory gaps and international policy coordination issues played in the market failures leading to the crisis. IMF did not give appropriate importance to how the incentives and actions of the

[2] http://www.ieo-imf.org/ieo/files/completedevaluations/FULL%20REPORT%20final.pdf

financial institutions were shaped by the regulatory and supervisory gaps, as well as the deficiencies in Basel II frameworks. Post crisis, IMF has worked towards making the 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. IMF supported enhanced capital and liquidity buffers requirement on these institutions, highlighted the nature of the prevailing risks and advocated the capabilities of macro-prudential tools towards financial stability.

Gaps were identified with respect to coverage of countries under financial surveillance as well as on the frequency of such surveillance, for which IMF recommended enhancing the capacity of such surveillance programs and conducting them more frequently than current level of once in five years, especially in economies with truly systemic financial sectors, whose failure might trigger a financial crisis. IMF also expanded the array of risk and vulnerabilities detection framework, like introduction of Early Warning Exercise (EWE), different vulnerabilities exercises for developed economies and spillover reports, especially to understand the impact of outwards spillovers from countries with systemic risks. While the EWE is considered a very important innovation, there is call to make it available to wider group of policy makers. From global financial safety net strengthening front, IMF acted successfully via its resource mobilization efforts, lending instruments reforms and programs incorporating the learnings from the past crises.

Systemic banking crisis and Reference to IMF Report (2012)

Several noteworthy observations were made by the updated IMF report[3] on systemic banking crises. During the period 1970-2011, around 40% of the systemic banking crises started during August, September and December, pointing towards the tendency of crises to start towards the second half of a year. Approximately 1 in 3 banking crises followed a credit boom, which shows a correlation between relaxed credit expansion policies by banks and crises.

Advanced economies tended to have larger and prolonged impact of banking crisis, from the perspective of output losses and increase in public debt. This shows dependency on expansionary macro-economic policies, and diversion of effect from actual reorganization of banks, by indirectly improving the banks' growth and recovery prospects without incentivizing the requisite restructuring. Though a point to be noted is that deep banking systems in developed economies amplifies the impact of a banking crisis. On the other hand, owing to depreciating currency and increased capital outflows from developing economies during the crisis, they resort to tightening monetary policy. Fiscal costs incurred by developing economies were larger than those of developed ones.

While markets around the world encountered crises, Indian financial system was relatively less affected due to stringent regulations in place. However, the system continues to endure various other corporate governance issues that have caused piling up of non-performing assets, money laundering and financial distress. Following is an analysis of the various pressing concerns in the Indian financial system.

Growing Non Performing Assets (NPAs)

Growth in NPAs results in a vicious cycle affecting the sustainability of the banking system. Mismanaged NPAs often result in failure of banks. The issue gained significance post the massive bailouts following the failure of several banks that had a major share in global financial crisis.

[3] https://www.imf.org/external/pubs/ft/wp/2012/wp12163.pdf

In his speech at 2014 conference held by ASSOCHAM, Shri R. Gandhi (Deputy Governor, RBI) discussed about causes of growing NPAs and recommendations towards addressing those aspects[4]. Assisted by external factors like recessionary pressures, there has been notable increase in NPAs owing to reduction in quality of assets, primarily due to overruns and delayed clearance of several projects, policy issues resulting in deadlocks, etc. The underlying weakness in banking sector is primarily due to absence of robust credit appraisal system, inefficient supervision post credit disbursal and ineffective recovery mechanism.

A working paper by RBI[5] provides evidence on several macro-financial variables linked with reduction in asset quality, namely credit cycle (where banks have a tendency to freely issue loans during economic booms), GDP growth (inverse relation), interest rate cycle (direct relation), inflation, asset prices etc. Further the paper accesses sector wise NPA growth. Among the priority sectors, agricultural NPAs experienced an average growth rate of approx. 55% during 2011 and 2012, primarily due to high credit growth during the pre-financial crisis period, while SSI sector has been experiencing NPA growth due to recessionary pressures. Among the non-priority sectors, retail loan segment has a high share in overall NPAs, owing to rise in credit towards personal and housing loans due to relaxation, during the pre-crisis period. Additionally, the slowdown in real sector impacted the banks' asset quality, when the real sector was affected by the global economic slowdown resulting in fall in exports, domestic demands, slowing capacity expansion as was planned, etc.

Money Laundering

Money laundering refers to the process in which the offender disguises the money or proceeds from illegal or criminal activities and makes it appear to have been derived from a legitimate source. Among the current tools against money laundering, anti-money laundering (AML) and counter terrorist financing (CTF) regimes are the most comprehensive tools to counter such illicit flow of money. Based on OECD[6] analysis, there are a wide variety of channels and methods that are used to launder the illicit gains, and several financial and non-financial institutions, ranging from banks to "trust and company service providers (TCSPs)", may get involved in money laundering activities, both willingly and unwillingly. The 2014 OECD analysis on compliance with 2003 financial action task force (FATF) recommendation notes weaknesses in regulation and performance of "Designated Non-Financial Businesses and Professions (DNFBP)". DNFBP comprises of lawyers, TCSPs, real estate agents and other dealers.

TCSPs are the financial intermediaries which link the customers with the financial institutions. Based on the study by FATF,[7] the primary factors responsible for TCSPs being involved in such activities are weak or ineffective anti-money laundering framework, lack of appropriate knowledge and expertise of the staffs or presence of staffs in the TCSPs who get involved in money laundering activities willingly. A report by OECD[8] advocated that law enforcement authorities should target information sharing of beneficial ownership and control of corporate vehicles (like the TCSPs) and knowledge of the source of assets with the foreign authorities requiring that information to prevent the misuse of these corporate vehicles. The Offshore Group of Banking Supervisors' list of best practices includes conducting independent review of TCSPs and giving the auditors being utilized the necessary statutory protection to report breaches in any matter.

[4] https://rbidocs.rbi.org.in/rdocs/Speeches/PDFs/SPR02062014F.pdf
[5] https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/WSN03070214F.pdf
[6] http://www.oecd.org/corruption/Illicit_Financial_Flows_from_Developing_Countries.pdf
[7] http://www.fatf-gafi.org/media/fatf/documents/reports/Money%20Laundering%20Using%20Trust%20and%20Company%20Service%20Providers.pdf
[8] http://www.oecd.org/corporate/ca/43703185.pdf

Additionally, the 2012 FATF[9] recommendations require that financial institutions and the key DNFBP should implement appropriate customer due diligence mechanisms (namely, "*knowing the customers, their risk profile, source of wealth, and monitoring of transactions*"), putting in appropriate safeguards if their client is a politically exposed person (as the risk of illicit activities increases for such type of clients), looking out for 'unusual' transactions and maintaining relevant business records for at least five years, among other guidelines. A common method of being involved in money laundering and other illegal activities is using a layer of corporate vehicles or other legal structures as shield or disguise that makes it very challenging to identify the original "beneficiary owner(s)". Towards this aspect, FATF requires countries to "*prevent the unlawful use of legal persons or companies and trusts or arrangements by ensuring that accurate and timely information on beneficial ownership and control of these can be obtained by competent authorities*". Further, FATF suggests international coordination in handling the roadblocks faced when the illicit activities involve financial institutions and DNFBP across several countries.

KC Chakraborthy: Causes, Concerns and Cures[10]

With advent of creative financial products and increasing scope and magnitude of transactions across boundaries, frauds in the financial world have escalated to new highs. Banks, urban cooperative banks as well as registered NBFCs that fall under jurisdiction of RBI are monitored by it regularly for fraudulent activities. Although a decline in number of frauds has been observed since 2009, the amount involved in such activities has increased four folds. A major reason for this is the hike in number of cases involving more than Rs 50 Crore. While most number of frauds has been attributed to private and foreign banks, public sector banks have made the highest contribution towards amount involved. The industry has also witnessed a mindboggling increase in both number of accounts opened as well as amount of transactions made which has dwarfed the amount involved in fraudulent activities to some extent.

There are three categories of frauds, namely technology related, KYC related and advances related. Although the number of technology related frauds is the highest among the three, the highest amount comes from advances related frauds. Moreover, the latter involves multiple banks mostly from public sector.

There is an urgent need to strictly monitor banks and other financial services institutions so as to ensure that proper corporate governance checks and balances are in place. The board of directors and senior management need to be made more responsible. Exchange of information needs improvement to impress financial discipline. Internal systems and control should be able to identify fraudulent activities and raise timely red flags. Delays in reporting these activities should be minimised as it gives the fraudster enough time to erase her trail making it difficult for investigative agencies to find convincing proofs. The law should ensure that perpetrators are dealt with strictly and are barred from accessing banking and other financial facilities once convicted of a fraud. RBI has issued various guidelines to deal with these malpractices for all of banking and financial services industry to follow.

RBI Circular on Classification and Reporting[11]

Currently frauds in banks are detected long after being committed. Timely handling of the frauds shall result in substantial reduction of losses owing to those frauds, and at the same time help in prevention of frauds of similar nature elsewhere. To maintain uniformity in fraud reporting, frauds have been classified based on their types and provisions of the Indian Penal Code, and reporting guidelines have been set for those. An annual review of frauds shall be conducted by the banks, which shall look at the system adequacy in dealing frauds, efficacy of the actions taken, plugging of the loopholes and

[9] http://www.fatf-gafi.org/media/fatf/documents/recommendations/pdfs/FATF_Recommendations.pdf
[10] https://rbi.org.in/scripts/BS_ViewBulletin.aspx?Id=14351
[11] https://rbidocs.rbi.org.in/rdocs/notification/PDFs/16MCFRC16062014F.pdf

fraud reporting aspects. Towards monitoring of frauds by the Board of Directors, RBI issued circular[12] to cooperative banks to set up committee to oversee the internal inspection and auditing and plan on appropriate preventive actions, followed by review of efficacy of those actions. The anti-fraud initiatives start with Board of any bank, by giving importance to ethical values and taking exemplary actions when frauds are detected. Employee empowerment starts with presence of impartial policy guidelines and whistleblower policy in place which shall go a long way in enhancing employees' trust on the bank towards handling frauds.

In his speech, Shri R. Gandhi,[13] stressed on the basic principles that can go a long way in preventing fraud, namely the principles of knowing the customer, employees as well as partners. He also pointed out the significance of a robust appraisal mechanism and continuous monitoring in preventing fraud.

Framework for dealing with loan frauds

Towards the target of handling loan frauds, the RBI circular[14] 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. Considering the relation between credit risks and fraud risks, the circular suggested integration of EWS tracing with the credit monetary mechanism of the banks. Additionally, the loan appraisal mechanism should be robust and banks should be vigilant during account review. To handle the issue of dealing with loan fraud issues across multi bank arrangement, each bank must take responsibility towards review of loans for red flags and appropriate documentation to share it later with other banks involved. Further, for enhancing the convenience in filing complaints, banks are required to establish an officer who shall serve as single point of contact for coordination and Redressal of weaknesses in complaints. A Risk management group shall be in charge of collecting market intelligence of potential borrowers as well as clarify on the non-dilutable core terms and conditions while sanctioning the loan disbursement. The plan for design of a single database (Central Fraud Registry) to document and access fraud details is in process.

PJ Nayak Committee Report

Few of the key findings by the PJ Nayak committee,[15] included the stress of asset quality and marginal capitalization faced by public sector banks. Additionally, the wholesale funds liabilities for public sector banks were high and on an upward trend. Further the issues pertaining to business strategy, risk, financial inclusion and customer protection were given low priority in both the public and private banks. The committee recommended privatization of public sector banks or design of a radically new governance structure to improve the efficiency of these banks, as well as upgrading the domain and strategic skills of the board members, with provision of appropriate independence.

The committee also suggested a few changes in the hiring and qualification criteria and tenure related policies to prevent an impending management crisis when 60-90 percent of the current general managers and deputy general managers retire by March 2017. It challenged the control over banks by government solely as utilities, which hindered the differentiation and competitive advantage of the public banks. The committee identified the shortage of skills in the top management of the team performing credit appraisal process, even if it is a very important process.

While the private sector banks are not subjected to external constraints like their public sector counterparts, special attention is needed to be given towards risk management, asset portfolio quality, integrity of financial reporting, in addition to random and detailed check on sophistication in balance

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[12] https://rbidocs.rbi.org.in/rdocs/notification/PDFs/10PCBSCA070115.pdf
[13] https://rbidocs.rbi.org.in/rdocs/Speeches/PDFs/ACFF26062015DDD11F8A6130479C90E96F57359BA500.PDF
[14] https://rbidocs.rbi.org.in/rdocs/notification/PDFs/CR5900713FDE445A947BC883964ED34BCA00E.PDF
[15] https://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/BCF090514FR.pdf

sheet. In the absence of strong consumer protection act in India, the boards need to have oversight on good selling practices and speedy resolution of consumer complaints.

Popular beliefs point to the fact that privatization, as advocated by the P J Nayak panel, is not the key to address the banking issues. Mark Carney,[16] Governor of the Bank of England, in his speech pointed out that social capital is as essential in banking system as rewarding of individual incentive in the banking system. He stressed upon the fact that complete faith in the financial markets and corruption in some of the banking systems has resulted in an erosion of social capital.

Raghuram Rajan[17] stressed on good governance and more autonomy to be conferred to public sector banks as the need of the hour to increase their competitiveness and be able to raise money from the markets easily. This can be achieved by government distancing its influence from the banks, along with appropriate measures at an operational and management level. At the same time, the public sector banks should retain the 'public' good objectives. Privatization is not the pre-requisite for competitiveness. Another major takeaway of the report was the impending gap in management following large scale retirement of officers. As pointed out by Shri S S Mundra,[18] RBI has been looking at the concern by sensitizing the bank management to address the talent deficit.

B Yerram Raju: Healthy banks under healthy regulation[19]

India was fortunate that its financial sector did not face a blow of trust deficit as opposed to other countries post 2007 crisis due to healthy regulatory systems in place. Various measures have been taken since then by other countries to re-engineer their regulations due to *'high leverage ratios, limited capital buffers and little attention to operational and reputational risks'* that resulted post crisis. However, there is a common perception that increasingly strict regulations will make business opportunities take a hit. This article tries to find out if this is true.

RBI: Laws that govern regulation of banking and financial services are *Provisions of RBI Act 1934, Banking Regulation Act 1949 and Foreign Exchange Management Act 1999*. Moreover, RBI has prescribed guidelines to monitor risk, economic environment and latest innovations in banking and financial systems. Regulations do not seem to be a bar in functioning of banks after the crisis. Regulators prevented banks from engaging in high risk investments like *'farming, micro and small enterprises, retailers, exporters, housing, education etc'* in spite of external political pressures to do the same. There are norms for exposures of both individual and group borrowers. Market for borrowing chiefly comprises of government securities which take care of market risk of borrowing via interest rates and price fluctuations. Exposure to equity markets is regulated. Capital adequacy and asset liability management are being followed and improved upon. Liquidity is provided and monitored by RBI through monetary policy tools like Cash reserve ratio, Repurchase rate and Reverse repurchase rate.

However, there are ***loopholes in the Indian system*** when it comes to governance mainly because good governance is perceived to be merely following regulations. In the US, financial institutions have themselves taken an initiative to put good governance practices in place over and above regulations like the Dodd Frank Act and Volker's rule. Liquidity issues are being addressed via the 'Basel III: International framework for liquidity risk measurement, standards and monitoring'. Reporting standards followed for liquidity include 30-day liquidity coverage ratio or LCR and long-term structural ratio called net stable funding ratio or NSFR. These will both help with liquidity intermediation and maturity intermediation respectively enabling regulators to step –in early in case of liquidity

[16] http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech731.pdf
[17] https://rbi.org.in/scripts/BS_SpeechesView.aspx?Id=893
[18] http://www.bis.org/review/r141119b.htm
[19] http://thinksoft-global.blogspot.in/2014/02/healthy-banks-under-healthy-regulation_12.html

insufficiency. Basel III framework has been adopted by all counties except Turkey, Indonesia, Russia and Argentina.

Given how important regulations are for ensuring healthy and liquid banking system, the argument of regulation over-dose seems to be in vain. Basel III regulations are a start towards well functioning and efficient financial systems.

Chapter 4: Analysis of systems in place

Fraud detection in a Public Sector bank

We analysed 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.

1. Firstly, a fraud is ***internally reported to senior management*** of a bank. These may include the Executive Directors, Chairman and Managing Director or Chief General Managers. They may also be reported to the Vigilance department of the bank
2. If ***reported to the Vigilance department*** of the bank, it investigates the fraud and then reports it to both the senior management as well as the CVC to whom they are required to report monthly.
3. Although the CVC can report the fraud directly to investigating agencies like CBI, usually the ***final decision*** to either report the fraud to an external agency or to deal with it internally is made by the ***senior management*** *of the bank*. Depending upon the size of the bank, amount of money involved in the fraudulent activity and the number of third parties involved, the senior management may choose to deal with the fraud internally or file an FIR and report it to either local police or CBI.
4. A ***committee by RBI*** also independently monitors fraudulent behavior in banks and reports its observations on a quarterly basis to Central Board of RBI. The Board may then report the matter to either Central Vigilance Commission or Ministry of Finance (MoF).

Role of Auditors

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

1. **Bank auditors** – Following are the 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 the common law legal framework due to reliance placed by the banks in them.
   a. *Statutory auditor* – These look into financial statements of all borrowers that borrow from a bank.
   b. *Concurrent auditor* – These help supplement the functioning of the bank in terms of internal checks and check on financial statements of its borrowers.
2. **Statutory auditors of the borrower** – These auditors work for the borrower firm and help in reporting their financial statements.
3. **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.

Chapter 5: Issues in banking

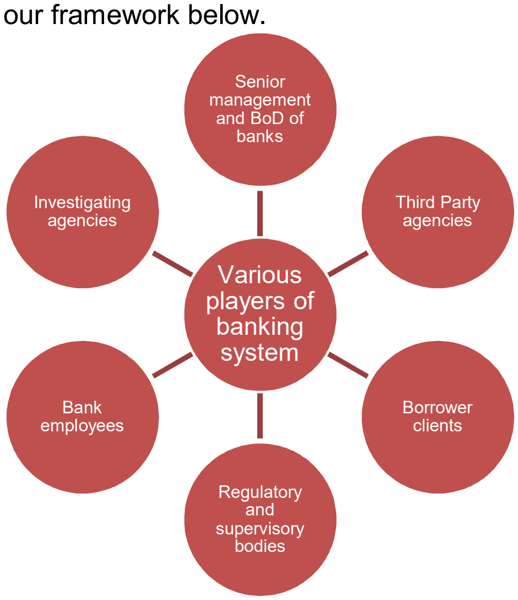
While not all non-performing assets (NPA) are frauds, most of the banking frauds pass through the NPA stage. While private sector banks account for majority of the share of NPAs by number of transactions involved, Public sector accounts for substantially large portion of the share of NPA on volume of cash involved. A further analysis is performed to identify the root cause for the same. Private sector banks function in niche segment while public sector banks perform mass banking, incl. their functioning towards financial inclusion objectives. The infrastructure financing task is primarily taken up by the public sector banks. Such financing involve huge amount of funds. 10 years ago, when the economy was booming, lots of infrastructure projects were pursued. While the projects were accepted, it was a pretty fair decision. The thumb rule growth of credit is 2.5 times GDP growth (which stood at 8 percent at that time).

The infrastructure financing was impacted during the crisis and needed money to be infused into the system and public sector banks duly responded. Road blocks like mining and land acquisition issues, cancellation of 2G licenses, local scams were not anticipated. This resulted in hindrance to flow of revenue stream as expected and was one of the main reasons for investments turning NPAs. Since public sector banks had a substantial share of such investments, they form a majority of chunk in NPAs based on the volume of cash involved. Generally speaking, NPA shoots up as GDP slows down. Similar was the case of INR 7000 crores[20] worth of loans to Kingfisher airlines by multiple banks, since at the time of investment, aviation sector needed financial support to grow. Security worth this big an amount is not possible and expertise of people who value and access projects is relied upon. Thus a substantial part of the loan was under-secured.

Further, corruption is rampant, but not all NPAs are due to corruption. Other reasons responsible for NPAs are external conditions like market slowdown, etc. As discussed earlier, since private banks do not deal as much with large scale projects and infrastructure financing, the amount of money involved in private banks NPAs is substantially lower than that of public sector ones.

Our Framework

We have analysed fraudulent practices in Indian banking system from the viewpoint of all major players involved, as shown in our framework below.



[20] http://www.businesstoday.in/current/corporate/cbi-kingfisher-airlines-idbi-bank-inquiry/story/209066.html

Senior Management and Board of Directors

Board of directors plays a significant role in governance by planning appropriate strategy, and ensuring that appropriate talent is in place to execute the strategy. The senior management is involved in the design, development and implementation of the strategy by the Top management, and acts as a bridge between the top management and other employees. The fraud detection and reporting in a public sector bank follows a standardized procedure. Firstly, a fraud is internally reported to senior management of a bank. These may include the Executive Directors, Chairman and Managing Director or Chief General Managers. They may also be reported to the Vigilance department of the bank which investigates the fraud and then reports it to both the senior management as well as the Central Vigilance Commission (CVC) to whom they are required to report monthly.

Although the CVC can report the fraud directly to investigating agencies like CBI, usually the final decision to either report the fraud to an external agency or to deal with it internally is made by the senior management of the bank. Depending upon the size of the bank, amount of money involved in the fraudulent activity and the number of third parties involved, the senior management may choose to deal with the fraud internally or file an FIR and report it to either local police or CBI. A committee by RBI also independently monitors fraudulent behavior in banks and reports its observations on a quarterly basis to Central Board of RBI. The Board may then report the matter to either CVC or Ministry of Finance (MoF).

At times, senior management themselves may indulge in fraudulent cover-ups to meet their short term targets and goals, and create a good picture for the shareholders. In fraud cases with suspected involvement of senior management, there is significant resistance when to prosecute officers of a bank who belong to 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. They can be made criminally liable for their actions, but only if proven guilty which may take many years.

Further, Investigating and supervisory bodies like CVC or Central Bureau of Investigation (CBI) are hesitant to expose frauds due to internal politics. Moreover, they are already overburdened with many pending investigations and have limited resources at their disposal. If the case is finally taken up in the court of law, a public prosecutor represents the bank. The prosecutor lacks a strong incentive to push for justice and 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.

Bank Employees

Incentive structure for the employees is faulty 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 are instances of frauds involving collusion of staffs with third party agents like auditors to indulge in fraudulent activities on customers. Detection of such frauds takes long time to detect, primarily when there are customer complaints of fraudulent cases. For 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 programs. Political reasons may also be responsible for indulgence in loans proceed which has substantial risk of being defaulted or defrauded, especially when an advocate raises a red flag on the loan. Legal opinion is not the job of a banker, but he/she follows advocate's directions in that matter.

Frauds also result from lack of awareness of staffs 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 place involving people in power, whistle blower protection policy does not guarantee adequate safety in practicality and the penalties attached discourage them from taking the trouble. India has Whistleblower Protection Act of 2011, which makes it necessary for complainant to disclose his identity while making the complaint. But the act makes it clear that the complainant's name must not be disclosed under any circumstance, even in courts. While the authorities try to protect the whistleblower to the best of their capabilities, it is practically impossible to protect the witness / whistleblower.

Third Party Agencies

Frauds may also involve fake balance sheet prepared by the companies. These usually occur when the companies dispose assets or fake them. The roadblocks that bankers face to have a check on such activities are distance and obsolescence. Thus, bankers rely a lot on auditors' report for taking any financial decisions. But if the auditors are also involved in financial statement manipulations or in aiding financial misreporting, it is difficult to detect frauds at an early stage since current level of market intelligence is not full proof to identify such manipulations. The situation is further worsened since there are inadequate regulations in place to investigate the involvement of third party agencies like auditors, credit rating agencies, lawyers, etc. in fraudulent activities and holding them liable when they are actually involved. Being very powerful and influential bodies, they escape the nets of regulations.

Even when external auditors do not exercise their independence appropriately to audit the financial reports, the risk of failure to detect any ongoing fraud increases manifold. Generally, the auditors send their sub-ordinates and articles (who are not even Chartered Accountants) for carrying out financial reporting. Clearly they don't have the skill or experience to detect any misreporting or manipulation.

Major reasons for Auditors committing malpractices in India:

1. ***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 those coming in is also 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.
2. ***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 varsity of documents they produce and no one challenges the financial information that they produce.
3. ***Attention to early warning signals[21]:*** 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 organisation recognize potential fraudulent malpractices in place.
4. ***Weaker enforcement of laws in our country:*** Law enforcement agencies in India are not very effective when it comes to discharging their duty. Sometimes, they also have to take a call between whether to spend time on one case trying to chase everyone involved or to move on to another case to punish the main culprits. This is due to insufficient resources and manpower available at their disposal. In such situations, auditors happen to be the last ones which are chased by various law enforcement agencies.

[21] https://rbidocs.rbi.org.in/rdocs/notification/PDFs/CR5900713FDE445A947BC883964ED34BCA00E.PDF

Moreover, most law enforcement agencies lack the necessary skill set and financial acumen to identify and deal with frauds. This is due to less understanding of financial matters and lack of experts in accounting and finance.

5. ***Weaker laws to protect fraudulent financial reporting:*** There are many areas where the current laws can be made stronger to improve accountability of auditors toward their jobs.
   a. 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 or 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.
   b. 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 offense in many other countries like Pakistan. There are counter arguments to this perspective in India. It is very difficult to prove criminal intent in a fraud case. Further in a democracy like India, in the interest of protection of public, more preference is given towards avoiding punishing a wrongly accused than bringing the rightly accused person under criminal purview. There is need for proof beyond reasonable doubt before initiating criminal proceedings against an individual.

Borrower clients

Frauds may also arise solely from the borrower's side as well. Companies taking 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 are initially set out. One such instance is when Zoom[22] developers took loans worth INR 2200 crore from multiple banks for different projects in European countries, but instead siphoned away the money via several dummy firms in India, Switzerland and London, for investment in 1280 acres of land in California. This comes under the purview of Prevention of Money Laundering Act, which has certain guidelines on mutual cooperation among the appropriate authorities towards handling the case. There is lack of appropriate mechanism to notice the diversion or siphoning away of funds.

Public Sector banks 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 the P J Nayak Committee Report. Additionally, they demanded simplification of credit insurance process and strengthening of legal framework for debt recovery, apart from more usage of technology.

Investigative Agencies

Investigating and supervisory bodies like Central Vigilance Commission (CVC) or Central Bureau of Investigation (CBI) are hesitant to expose frauds due to internal politics. Moreover, they are already overburdened with many pending investigations and have limited resources at their disposal.

From an investigative agency like CBI's perspective, the common challenges faced are difficulty in proving the end use of financial gains from fraudulent activities for the investigative agencies or difficulty during the investigation of any frauds due to their inadequate financial understanding and

[22] http://realty.economictimes.indiatimes.com/news/regulatory/rs-2200-cr-fraud-ed-attaches-land-of-zoom-developers-in-us-worth-rs-1000-cr/47919419

knowhow. Worsening the matter is the nexus between the borrower corporates and third party agencies, where it is tough on the part of CBI to challenge the balance sheet that has been nicely prepared by the Chartered Accountant(s). Chartered accountants are protected by the Chartered Accountant Act. Investigative agencies like the CBI usually do not go after the third party agencies till there is any specific proof pointing in that direction. They follow standard procedures and rules in proceeding with their duties. Weak law enforcement further adds to the woes.

Judicial System

Slow judicial process is a major deterrent towards appropriate and timely Redressal of fraud cases. The judiciary takes years to prosecute those guilty of fraudulent practices which lead to dilution of evidence as well as significant cost building on part of the victom.

Technological and Coordination perspective

There are inadequate tools and technologies in place to detect early warning signals and red flags pertaining to different frauds. There is lack of coordination among different banks on fraud related information sharing.

Chapter 6: Role of Ethics in banking

Following 2008 financial crisis, various steps were taken to improve the financial systems across the world. This was done to improve trust in banking across the world in order to aim for financial stability vital for our existence. However in spite of these efforts, frauds continue to happen. ***The reasons why unethical conduct continues to exist in the financial industry are many.***

- Owing to massive consolidation most financial forms have today become too big to manage and monitor. They are huge, complex and have a global footprint.
- The attitudes and business practices vary across countries making it even more difficult to instil a sense of common culture.
- Fluid and flexible job market has promoted allegiance to an external network of traders and not to the firms that bankers work for.
- High-powered job incentives linked to short term profits is a major issue. Lastly and most importantly, the financial world has witnessed a shift from client oriented to transaction oriented activities which makes clients as counter parties and not long term partners. This had lead to increasingly de-personalised interactions making it easier to rationalize away bad behaviour.

Various steps can be taken to counter the growing disregard for ethics and law in the financial industry. A major role in this regard is that of the ***senior leadership***. Firstly, they must examine norms at their firm and take responsibility for a solution. It is important to communicate the significance of a healthy and sustainable culture to be formed at the roots of their firms. Culture can be improved by following a comprehensive approach towards hiring and firing insights for which can be gained via surveys and feedback from employees. Also, promotion criteria can be revamped to meet the above mentioned objectives. Secondly, they must promote self-policing so that employees are proactive in reporting illegal and unethical activity.

Apart from the role of senior management, ***a healthy risk-reward relationship*** should be established. The structure of compensation should broadly include when to pay, how much to pay and whether this reward should be in the form of debt or equity while trying to incentivise long term and sustainable business practices. Performance bonds are also considered to be a good solution to this problem.

Another major issue that promotes unethical conduct is the ***pretext of ethical conduct and the hush hush manner in which any case arising out of unethical practice is dealt with***. This makes it easier for those engaged in malpractices to be re-hired into other firms. Firms should make it difficult for bankers that adopt unethical means to be re-hired. Each banker should be allotted an ethical and compliance score from her past place of work prior to being interviewed for a new job. To achieve this in an efficient manner, a centralized registry that tracks hiring and firing of professionals in the financial industry should be created. Those with a questionable track record should be disallowed to work in the industry.

A ***good culture*** is the back bone of a well-functioning financial system. It needs to be actively promoted both by the top management and by the regulators even if financial firms are considered to be ‘too big to fail’.

Chapter 7: Recommendations

Senior Management & Employees of Bank

Culture and attitude of top management can be a significant deterrent to frauds. Often banks give priority to private gains over public gains. The top management needs to set guidelines and policies for ethical practices and standard procedures to be followed throughout and lead from the front of setting an example on zero tolerance to negligence and fraudulent activities. Adequate training of employees on standard policies and procedures as well as red flags and early warning signals (EWS) towards fraud detection and prevention should be ensured by the management. Even changes need to be incorporated on incentive mechanisms to have a balanced short term and long term targets. Considering the fact that majority of frauds that get detected at an early stage is due to whistleblowers[23], the company policies, in collaboration with the investigative agencies, must ensure protection of the identity of whistle blower.

Considering the roles and responsibilities of the top management, emphasis should be given on appropriate hiring procedure at the top management level, with appropriate preference continuous service and clean record, and at the same time ensure that more people apply for the posts. Thorough check must be performed on the records and qualifications of the persons referred by existing management employees, for the post. Further, limits should be placed on the tenure of senior management to discourage the frauds from being hidden.

Additionally, information disclosure related to frauds can be a step in the right direction. Cases involving fraud should be made public and all parties involved must be prosecuted to reduce their employability in the system. This will serve as a deterrent for employee involvement in fraudulent activities. Any fraud should be declared as NPA as soon as it is observed, followed by immediate adjustment to profits as per RBI regulation. Banks have a tendency to defer the adjustment with the objective to have the current balance sheet look well. Less discretion should be given to bank authorities to decide and handle fraud cases. There is a need for speedy justice.

Regulatory and Supervisory System

There is a need for strong regulatory and supervisory systems in place to monitor the involvement of third party agencies in any fraud case and to ensure appropriate punishment for the guilty. For example, there is little response by the Institute of Chartered Accountants of India (ICAI)[24] when there are any complaints received against chartered accountants, and they pass unharmed. There is a need for strengthening of Vigilance departments with the banks and provision of adequate resources to help them carry out their duties effectively.

It is believed that The New Companies Act 2013 will more than strengthen regulations in place for auditors, lawyers and other third parties involved in borrowing and lending transactions. Since it has been brought into effect only a year ago, it is still early for the results to show. A possible change that could be made to this act is to bring banks that have 51% and more controlling stake by the government under its regulatory purview as well. To achieve this, a parallel provision in the act can be made. We also need stronger enforcement of the existing law, legislation of stronger laws and access to financial expertise made available to various law enforcement agencies in India.

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[23] https://www.kpmg.com/FR/fr/IssuesAndInsights/ArticlesPublications/Documents/India-Fraud-Survey-2012.pdf
[24] http://www.icai.org/

Currently, there are several internal systems for the banks, which are usually headed by the Chief Customer Service Officer (CCSO),[25] who acts as an internal ombudsman of a bank. Appointment of CCSO is being made compulsory for every bank, by RBI. Usually a retired Senior Manager is appointed as CCSO. Further there is Banking Code of Services Board of India (BCSBI) that gives ratings and rankings to banks, as well as guidelines on how to be transparent and fair to customers. Usually, when a complaint is received from a customer, it passes through internal Redressal system followed by handling by CCSO, and if there is still a need for resolution of the issue, RBI Ombudsman Officer handles the case.

Internal committees set up solely to follow up on fraud cases, should also look at clean-up of the pending fraud cases. Adequate recruitment policies should be followed to ensure that there is no conflict of interest or sole dependency of committee members on the banks management team for promotion.

Large banks are under Risk Based Audits, on a daily basis, which is a result of tough stance by RBI. Small banks in remote locations are prone to frauds involving local staffs. There needs to be due diligence towards spotting involvement and collusion among staffs.

Technology and Coordination perspective

There is significant lack of coordination among different banks on information sharing related to fraud related data. Central Repository needs to be set up where all the banks must share fraud related information and details to be used for future reference by other banks. This shall be regulated and supervised by appropriate authorities to ensure appropriate use and prevent misuse of the data.

Appropriate provision should be made for IT department to prevent technology frauds. Adequate incentive mechanisms should be in place to enhance the number of vendors offering technology solutions which shall result in appropriate price discovery and provision of better quality technology solutions.

[25] http://www.ccocouncil.org/site/defining-the-cco.aspx

Chapter 8: Conclusion

The project started with literature review of different acts and regulations in place globally during pre and post financial crisis period to monitor the financial sector, the role of international organizations like IMF in handling the crisis, different regulations in place to prevent money laundering activities. The attention was then shifted towards Indian scenario: on the growing NPAs, common causes of frauds, RBI circular and framework in place to detect and prevent frauds from occurring, P J Nayak committee recommendations towards enhancing efficiency of public sector banks. Based on the literature review, several interviews were conducted on various experienced and tenured members from different types of organizations involved in a banking sector, namely ex- chairman from big public banks and private sector firms, advocate and auditors of reputed firms, investigative and supervisory agencies, to have a 360 degree understanding of the systems in place and the gaps or loopholes used by the parties involved in fraudulent activities.

The frauds may be primarily due to lack of oversight of top management, faulty incentive mechanism in place for employees, collusion between the staffs or corporate borrowers and third party agencies, weak regulatory system, lack of appropriate tools and technologies in place to detect the early warning signals of a fraud, lack of awareness of bank employees and customers, lack of coordination among different banks across India and abroad. Towards filling the gaps, major recommendations included improvement in culture and attitude of top management of the firm, giving priority to awareness enhancement among employees, adequate information disclosure to appropriate authorities, financial awareness enhancement of investigative agencies, strengthening and enhancing the scope of internal supervisory bodies, strengthening regulatory system for third party authorities' regulation, establishment of central repository system for fraud related information sharing across different banks, IT empowerment.

Going forward, the implementation of recommendations in the above-mentioned dimensions should help in strengthening the banking sector in India and go a long way in handling the frauds pro-actively.

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