BANK FRAUDS & ITS REPORTING

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What is Fraud

- Kautilya in Arthashastra in 300 BC describes Forty ways of embezzlement, some of which are :
  - "*what is realised earlier is entered later on; what is realised later is entered earlier; what ought to be realised is not realised; what is hard to realise is shown as realised;*
  - *what is collected is shown as not collected; what has not been collected is shown as collected; what is collected in part is entered as collected in full; what is collected in full is entered as collected in part; what is collected is of one sort, while what is entered is of another sort."*
- Some of the above actions continue to be the modus operandi adopted in many instances of financial frauds that have hit the headlines in recent times.

Define Fraud

- RBI, the regulator of banks in India, defines fraud as

  "A deliberate act of omission or commission by any person, carried out in the course of a banking transaction or in the books of accounts maintained manually or under computer system in banks, resulting into wrongful gain to any person for a temporary period or otherwise, with or without any monetary loss to the bank".

- Fraud is intentional deception made for personal gain or to damage another individual;

- Defrauding people or entities of money or valuables is a common purpose of fraud.

- Wilful Default is also fraud as per RBI Definition.

Why Frauds Happen

- Mans Greed to get Rich Quick – Pyschological , Social, Moral, Ethical factors
- Opportunity because of Poor or Inadequate Internal controls
  - poor control environment, lack of segregation of duties, lack of physical safeguards,
  - lack of independent checks, lack of proper authorizations, lack of proper documents and records, the overriding of existing controls, and an inadequate accounting system.
- Lack of Transparency/ Complex financial transactions that are difficult to understand are an ideal method to hide a fraud. The Barings fraud was perpetrated by use of an accounting 'dump account' that no one understood.
- Lack of fraud risk framework in banks and poor importance to it by Management
- Non adherence to Know Your Customer (KYC) guidelines-The RBI has recently fined 22 banks for non-adherence to KYC norms.

Bank Characters & Risks

- Custody of large volumes of monetary items, including cash and negotiable instruments, whose physical security has to be ensured and Risks associated.
- Engagement in a large volume and variety of transactions in terms of number and value which necessarily requires complex accounting and internal control systems and widespread use of Information Technology (IT). Significant exposures in short time.
- Significant dependence on third party agencies e.g. Cash Replenishment Agencies, Telcos, etc. bearing risks of outsourcing of certain important banking processes. Risks associated with outsourcing RBI.
- Operation through a wide network of geographically dispersed branches and departments necessitating a greater decentralization of authority and dispersal of accounting and control functions. Risk of control breakdow
- Assumption of significant commitments including without actual any outflow of funds. These items, called 'off-balance sheet' items without accounting.
- Direct Initiation and completion of transactions by the customer without any intervention by the bank’s employees. For example, over the Internet or mobile or through ATM, Integration with other networks like NEFT/SWIFT.

Structures of Internal control

- Delegation of Powers & Authorisation of Transactions -
  - SBAs should specifically review the delegation of powers to note the authorization, approval, exception, waiver and ratification powers of each bank official
- Segregation & Rotation of duties
- Maintenance of adequate Records and documents
- Accountability for and safeguarding of assets
- System configuration and account mapping
- Independent checks and Inspections
- Understand the Risk Management process
  - *Oversight and involvement in the control process Those charged with governance (TCWG).*
  - *Identification, measurement and monitoring of risks*
  - *Control Actiivties – Who, What, When, Where, Why, How*
  - *Monitoring Activities*

Auditor’s Responsibilities Relating to Fraud in an Audit

- (SA) 315, “Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment” requires Auditor to identify and assess risks of Material Misstatement **whether due to Fraud or Error,** at Financial statement level and assertion level and Plan Audit and perform Audit Procedures accordingly.
- (SA) 240, “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements”, the auditor’s objectives are to identify and assess the risks of material misstatement in the financial statements due to fraud, to obtain sufficient appropriate audit evidence on those identified misstatements and to respond appropriately.
- (SA) 330, “The Auditor’s Responses to Assessed Risks” deals with the auditor’s responsibility to design and implement responses to the risks of material misstatement identified and assessed
- The attitude of professional skepticism should be maintained by the auditor so as to recognise the possibility of misstatements due to fraud.
  - Management’s assessment of the risk that the financial statements may be materially misstated due to fraud, including the nature, extent and frequency of such assessments as well as the controls in place to prevent and detect fraud.
  - Management’s process for identifying and responding to the risk of fraud in the bank, including any specific risks of fraud that management has identified or that have been brought to its attention; or classes of transactions, account balances, or disclosures for which a risk of fraud is likely to exist; and the internal control that management has established to address these risks.

Operating Framework for Identifying and Dealing with Frauds

- The operating framework for tracking frauds and dealing with them should be structured along the following tracks:

(i) **Detection and reporting of frauds. –**

The fraud report should be a diagnostic assessment, clearly bringing out the causes of the fraud and identify whether the fraud occurred due to 'system failure' or 'human failure, Reporting of wilful default as fraud

(ii) **Corrective action.-**

Recovery of the amount siphoned off through the fraud.

(iii) **Preventive and punitive action. –**

Exception reports, Incentive and disincentive in their HR Process.

(iv) **Provisioning for Frauds.**

Reporting of Fraud

- RBI reporting is on the basis of the provisions of Indian Penal Code (IPC), as under:
  - Misappropriation and criminal breach of trust.
  - Fraudulent encashment through forged instruments, manipulation of books of account 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.
  - Irregularities in foreign exchange transactions.
  - Any other type of fraud not coming under the specific heads as above.
- Cases of theft, burglary, dacoity and robbery are not treated as fraud.
- Statutory Branch Auditors have to issue a certificate whether they have not come across any fraud or suspected Frauds.
- The SBAs may verify the contents of certificates to be issued at branch level. All the Returns submitted by branch to various higher authorities of the respective bank and also to various authorities of the regulators as per the Master Directions dated July 03, .2017 shall be verified. Branch Auditors should ensure the correctness of financial implication caused due to such frauds and confirm that the adequate provision for the same has been effected.
- More than one crore direct reporting to RBI and less direct to Audit committe

Provision for Fraud

- RBI circular RBI/2015-16/376 DBR.No.BP.BC.92/21.04.048/2015-16 dated 18th April, 2016, decided to amend the provisioning norms in respect of all cases of fraud, as under:

  Banks should normally provide for the entire amount due to the bank or for which the bank is liable (including in case of deposit accounts), immediately upon a fraud being detected.

  While computing the provisioning requirement, banks may adjust financial collateral eligible under Basel III Capital Regulations - Capital Charge for Credit Risk (Standardised Approach), if any, available with them with regard to the accounts declared as fraud account;

  However, to smoothen the effect of such provisioning on quarterly profit and loss, banks have the option to make the provisions over a period, not exceeding four quarters, commencing from the quarter in which the fraud has been detected;

Operating Framework for Identifying and Dealing with Frauds

- All banks have policy and operating framework in place for detection, reporting and monitoring of frauds as also the surveillance/ oversight process in operation so as to prevent the perpetration of frauds.

- The RBI, , vide its Circular No. DBS. CO.FrMC.BC.No.10/23.04.001/2010-11 dated 31st May 2011, had identified certain areas wherein frauds had shown occurrence or increasing trend in banks. These areas include:-
  - loans/ advances against hypothecation of stocks.
  - housing loans cases.
  - submission of forged documents including letters of credit.
  - escalation of overall cost of the property to obtain higher loan amount.
  - over valuation of mortgaged properties at the time of sanction.
  - grant of loans against forged FDRs.
  - over-invoicing of export bills resulting in concessional bank finance, exemptions from various duties, etc.
  - frauds stemming from housekeeping deficiencies.

- Fraudulent removal of pledged stocks / disposal of hypothecated stocks without the knowledge of the bank /
- Inflating the value of stocks in the stock statements & drawing excess bank finance.
- Diversion of funds, lack of interest or criminal neglect on the part of the borrowers partners etc., in adhering to
  - financial discipline and managerial failure with mala fide intent leading to the unit becoming sick and laxity in
  - effective supervision over the operations in borrowable accounts on the part of bank functionaries rendering the advance difficult for recovery and resulting in financial loss to the bank
  - Cheque/bills discounting facility used for liquidation of funds without any physical collateral or just for deferment of liability.
  - Repayment of third party loans despite bank's loan account irregular or out of order. Maintenance of bank accounts with other bank without consent of lender bank.
  - Inordinate delay in conducting stock inspections by bank officials and/or stock auditors at the instance of the borrower not to

Types of Bank Frauds

- Based on Persons
  - Insider or Staff Frauds
  - Outsider or Customer Frauds
  - Both – Ghosh Committe
- Based on Modus Operandi
  - People related
  - Technology related
- Based on Balance sheet
  - Deposit Related Frauds or Liability side frauds
  - Loans & Advances related Frauds or Asset Side frauds
- Based on Portfolio
  - Retail Frauds
  - Corporate Frauds

Management & Employee Frauds

- Camouflage of depositors by hiding their identity in connection with funds transfer or money laundering.
- Unrecorded deposits.
- Theft of customer deposits particularly, from dormant accounts.
- Loans to fictitous borrowers
- Transactions with connected/associated/related parties/companies.
- Kick backs and inducements.
- Selling recovered collateral at below market prices.
- Bribes to obtain release of security or to reduce the amount claimed.
- Theft or misuse of collateral held as security.

External Frauds

- Money Laundering.
- Fraudulent instructions.
- Counterfeit currency.
- Impersonation and false information on loan applications.
- Fraudulent valuations.
- Misappropriation of loan funds by agents / customers

Money Laundering

- The RBI has from time to time issued guidelines (“Know Your Customer Guidelines – Anti Money Laundering Standards”), requiring banks to establish policies, procedures and controls to deter and to recognise and report money laundering activities- Customer Acceptance polic, Customer Identification, Monitoring – Risk categorization.
- Involves 3 steps – Placement, Layering & Integration. – Money Mules
- Breaking up of cash into smaller amounts and depositing it in to the bank below the monitored reporting thresholds.
- Physically moving the cash into locations or jurisdictions and depositing it in off shore banks with lesser stringent enforcement laws and regulations. Using business typically known to receive revenue in cash to be used to deposit criminally derived cash.
- Trade based laundering – Over or Under Invoicing. Shell companies operating in jurisdictions not requiring reporting of beneficial owner to earn tax favored profits.
- Round Tripping wherein money is deposited in a controlled foreign corporation offshore preferably a tax haven where minimal records are kept & then shipped back as FDI to earn tax favored profits through a shell company.
- Use of Casinos – Chips are purchased with laundered cash and on winning, the buyer either gets back the winnings in cheque or gets a receipt for the winnings.
- Real estate Transactions – seller agrees to understate the value of the property and collects
- At Branch level the Statutory Branch Auditors may review process of documenting explanations received from customer regarding AML alerts. STR – Suspicious Transaction Reports whether sent at HO/Branch level.

LFAR

- Furnish particulars of frauds discovered during the year under audit at the branch, together with your suggestions, if any, to minimise the possibilities of their occurrence
- Enquire about any fraud reported to Controlling Authority/vigilance dept. Head Office during the financial year.
- The auditor should also examine whether:
- the branch is having an effective credit monitoring for its Advances portfolio.
- the branch has an adequate system in place to identify Early Warning Signals(EWS) of incipient sickness / fraudulent activities in respect of loans. Some of the Early Warning signals which should alert the bank officials about some wrongdoings in the loan accounts

EWS Early Warning Signals or Red Flags

- 1 a) Default in undisputed payment to the statutory bodies as declared in the Annual report. b) Bouncing of high value cheques
- 2 Frequent change in the scope of the project to be undertaken by the borrower
- 3 Foreign bills remaining outstanding with the bank for a long time and tendency for bills to remain overdue.
- 4 Delay observed in payment of outstanding dues.
- 5 Frequent invocation of BGs and devolvement of LCs.
- 6 Under insured or over insured inventory.
- 7 Invoices devoid of TAN and other details.
- 8 Dispute on title of collateral securities.
- 9 Funds coming from other banks to liquidate the outstanding loan amount unless in normal course.
- 10 In merchanting trade, import leg not revealed to the bank.

- 11 Request received from the borrower to postpone the inspection of the godown for flimsy reasons.
- 12 Funding of the interest by sanctioning additional facilities.
- 13 Exclusive collateral charged to a number of lenders without NOC of existing charge holders.
- 14 Concealment of certain vital documents like master agreement, insurance coverage.
- 15 Floating front / associate companies by investing borrowed money
- 16 Critical issues highlighted in the stock audit report.
- 17 Liabilities appearing in ROC search report, not reported by the borrower in its annual report
- 18 Frequent request for general purpose loans.
- 19 Frequent ad hoc sanctions.
- 20 Not routing of sales proceeds through consortium I member bank/ lenders to the company.

- 21 LCs issued for local trade I related party transactions without underlying trade transaction
- 22 High value RTGS payment to unrelated parties.
- 23 Heavy cash withdrawal in loan accounts.
- 24 Non production of original bills for verification upon request.
- 25 Significant movements in inventory, disproportionately differing vis-a-vis change in the turnover.
- 26 Significant movements in receivables, disproportionately differing vis-à-vis change in the turnover and/or increase in ageing of the receivables
- 27 Disproportionate change in other current assets
- 28 Significant increase in working capital borrowing as percentage of turnover
- 29 Increase in Fixed Assets, without corresponding increase in long term sources (when project is implemented).
- 30 Increase in borrowings, despite huge cash and cash equivalents in the borrower's balance sheet

- 31 Frequent change in accounting period and/or accounting policies
- 32 Costing of the project which is in wide variance with standard cost of installation of the project
- 33 Claims not acknowledged as debt high
- 34 Substantial increase in unbilled revenue year after year.
- 35 Large number of transactions with inter-connected companies and large outstanding from such companies
- 36 Substantial related party transactions
- 37 Material discrepancies in the annual report
- 38 Significant inconsistencies within the annual report (between various sections)
- 39 Poor disclosure of materially adverse information and no qualification by the statutory auditors
- 40 Raid by Income tax /sales tax/ central excise duty officials
- 41 Significant reduction in the stake of promoter /director or increase in the encumbered shares of promoter/director.
- 42 Resignation of the key personnel and frequent changes in the management

Tech related Frauds

- Cyber Risks - Use of Internet / Mobile Banking has changed the dimension of banking and with it resulted in new risks – Cyber risks or risks associated due to Identity Thefts, Hacking, Spam, Phishing / Vishing / Dos or DD attacks, e-mail spoofing, virus attacks, Use of malicious codes, compromise of digital signatures etc., resulting in loss or compromise of data is very common.
- Risks associated with usage of Debit & Credit Cards or through ATM operations are also increasing.
- Hacking or cracking, Phishing, Vishing and Smishing, Data Theft, Email spoofing, Denial of service, dissemination of virus, Botnets, malware,
- Cyber extortion, cyber terrorism, computer vandalism, PUP, Misuse of Digital signature
- Credit Card Frauds – skiming, stealing
- Auditor has to review whether risks faced by the Branch are appropriately identified and assessed and whether appropriate controls are put in place, implemented and monitored to reduce/mitigate risks to an acceptable level. Testing of efficiency, effectiveness of controls and reporting to give an assurance thereon is a key audit function

Jilani & Ghosh Committee Recomendations

- High level Committee on fraud and malpractice in banks under chairmanship of Shri A. Ghosh ex deputy governor to Enquire into various aspects of frauds and malpractices in bank . Jilani committee on Internal control almost 25 years ago.
- Proper system exists to ensure:
- Safety of assets
- Compliance with laid down policies and procedures
- Accuracy and completeness of accounting and other records
- Proper segregation of duties and responsibilities of staff
- Timely prevention and detection of frauds and malpractices

- Joint custody and dual responsibility of cash and other valuables
- Rotation of staff/duties
- Designation of one of the officers as compliance officer
- Financial and administration powers of officials to be laid down
- Exercise of caution at the time of opening of new deposit of all types
- Precautions against theft of cash •
- Precautions in writing of drafts/mail transfers •
- Precautions for averting frauds in letter of credits, guarantees
- Screening/selection of employees in EDP cell, computer area • Standards for fully computerized branches

- Banks to introduce portfolio inspection in critical areas such as credit, investment, off balance sheet item etc
- Periodical movements between bank officials and investigating officials of CBI/Police •
- Six months prior to retirement officials should exercise their sanctioning powers jointly with next higher authority •
- Paper used for cheque/drafts should be such that any use of chemical for making material alterations in instrument should be visible to naked eye
- .BRs should not be outstanding for more than 7 days
- Obtain photographs of depositors at the time of opening of accounts

Role of Auditor

- The RBI has issued a Master Circular on “Willful Defaulters” (DBR.No.CID.BC.22/20.16.003/2015-16 dated July 01, 2015) which also specifies the role of auditors including recommendations about action to be taken against negligent / deficient auditors wherein falsification of accounts on the part of borrower is observed.
- Further, it specifies that to monitor end-use of funds, if the lenders desire a specific certification from the borrowers’ auditors regarding diversion / siphoning of funds by the borrower, the lender should award a separate mandate to the auditors for the purpose. In addition to this banks are advised that with a view to ensuring proper end-use of funds and preventing diversion/siphoning of funds by the borrowers, lenders could consider engaging their own auditors for such specific certification purposewithout relying on certification given by borrower’s auditors.

Role of Auditor

- The RBI issued a Circular No. DBS.FGV.(F).No. BC/ 23.08.001/2001-02 dated May 3, 2002 relating to implementation of recommendations of the Committee on Legal Aspects of Bank Frauds (Mitra Committee) and the recommendations of the High Level Group set-up by the Central Vigilance Commission applicable to all scheduled commercial banks (excluding RRBs).

- Regarding liability of accounting and auditing profession, the said circular provides

  "If an accounting professional, whether in the course of internal or external audit or in the process of institutional audit finds anything susceptible to be fraud or fraudulent activity or act of excess power or smell any foul play in any transaction, he should refer the matter to the regulator. Any deliberate failure on the part of the auditor should render himself liable for action".

  Suo Motto action by ICAI under second schedule of Act

Conclusion

- Frauds can't be eliminated as such. It is a necessary evil. The effort lies in trying to contain the menace. Its effect can be widespread, causing long term financial and reputational damage.

- Fraud risk is something that no bank would like to deal with. Internal controls need to be strengthened as they can weaken over time due to technological advances or human intervention or because of the rise in new fraud schemes.

- Nonetheless, having anti-fraud measures in an organization's control environment can go a long way in deterring individuals from perpetrating fraud. But Remember the fraudster is always a step ahead!!

Danda Niti

- whoever is desirous of the progress of the world shall ever hold the sceptre raised (udyatadanda). Never can there be a better instrument than the sceptre to bring people under control."
- But when the law of punishment is kept in abeyance, it gives rise to such disorder as is implied in the proverb of fishes (matsyanyayamudbhavayati); **for in the absence of a regulator (dandadharabhave), the strong will swallow the weak; but under his protection, the weak resist the strong**
- Honours and rewards shall be conferred upon those that are contented, while those that are disaffected shall be brought round by conciliation, by gifts, or by sowing dissension, or by punishment.
- Auditors role is going to be increasingly important and he is no longer going to be just a Watch Dog,