Frauds in Banking Sector

The Indian banking sector has experienced tremendous growth and multiple changes since liberalisation of economy in 1991. Though the banking industry is generally well regulated and supervised, the sector has its own set of issues such as enforcement of ethical practices, management of financial distress and health of corporate governance. Fraud is an outcome of such issues. This article covers issue of frauds in the banking system, which in recent years have frequently been reported in India.

Whenever any fraud is reported, investigative and formal enforcement process takes in our country a fair bit of time. Indeed, RBI data on banking frauds suggests that very few cases over the past five years have had closure, and cases of substantive economic significance remain open. As a result, the overall enforcement mechanism, at least until now, is not perceived to be a major deterrent to frauds relative to economic gains from fraud. Hence, in such a scenario, prevention of frauds becomes necessary.

The various types of frauds that can take place in banks are forgery, fraudulent loans, cybercrime, cheque kiting, etc. Some of the high-profile cases in recent times have shown that frauds not only erode profits, operating efficiencies and reliability of services but also severely damage organization’s reputation. In addition, it affects employee morale and investor confidence. Although there has been growth in monitoring, surveillance and stringent regulations in banking sector, the frequency and cost of banking frauds have increased manifold resulting in a very serious cause of concern for the stakeholders. Fraud events raise questions around the credibility of the fraud deterrent processes and the technological capabilities of the institution. Poor internal controls, non-adherence to procedures, lack of tools to identify potential red flags, delays in legal procedures for reporting and various loopholes in the system have been considered some of the major reasons of frauds. Such issues have obliged us to revisit various laws and regulations.

All commercial banks in India are regulated by the RBI under the Banking Regulation (BR) Act of 1949. Additionally, all Public Sector Banks (PSBs) are regulated by the Government of India under the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970; the Bank Nationalisation Act, 1980; and the State Bank of India Act, 1955. Section 51 of the amended BR Act explicitly states which portions of the BR Act apply to the PSBs. There are some regulations which restrict the RBI to some extent in regulating PSBs as compared to other private banks. RBI cannot remove directors and management at PSBs, supersession of a Bank Board is also not applicable in the case of PSBs (and regional rural banks or RRBs) as they are not banking companies registered under the Companies Act, removal of the Chairman and Managing Director of a banking company is also not applicable in the case of PSBs, RBI cannot force a merger and cannot trigger liquidation of PSBs, etc. Such laws need to be updated to empower the regulator to take strict actions against mal-practices. In case of private banks, persistent irregularities will affect their capital raising ability and may also lead to replacement of their CEOs by their boards or even by the RBI. Hence, it can be said that there are incentives to invest in governance to limit frauds and regulatory violations.

Although risk of fraud can’t be eliminated entirely, it is important to have a system that can effectively detect and prevent fraud. Banks’ operational risk management, internal control frameworks and external audit function should typically play a key role in preventing frauds. The important element, therefore, is that with evolving fraud threats, banks’ defensive strategies must be strengthened. Also, there is an increasing need to identify early warning signals to capture frauds closer to their occurrence. Efficient internal controls, technology and data analytics can help identify frauds faster and thereby help banks limit the losses incurred.

Current laws can be made stronger to improve accountability of auditors toward their jobs. An RBI circular on inspection and audit systems in banks proposed a series of changes to the Internal Audit function to improve its effectiveness starting with expanding the coverage of the function itself. Internal Audit teams are expected to specifically report on the position of irregularities in branches, analyse and make in-depth studies of the corruption/ fraud prone areas during their inspection; thereby leaving no scope for any irregularities remaining undetected.

Internal auditors along with their periodical audit plan shall consider the assessment of fraud risks and review the management's fraud mitigation capabilities and communicate with the person responsible for risk assessments in the organization to ensure that action, if required, can be taken in time. They should also have a well-defined action plan to handle potential frauds uncovered during an internal audit.

With banks facing deepened regulatory scrutiny, advanced analytics can help to identify potential fraud, committed by employees, customers, and third parties. Analytics can change the way banks perform monitoring and can help them to detect and identify potential fraud prior to the launch of a formal investigation/ inquiry.

Data visualization is another emerging tool that banks can use to detect frauds which has been adopted by various global banks. This tool provides a visual representation of multidimensional data patterns and outliers which can be used to discover hidden and/ or indirect relationships, exhibiting complex networks involving multiple layers and/ or several intermediaries and tracking the movement of funds especially in anti-money laundering investigations and diversion of funds by borrowers.

Additionally, with organizations increasingly adopting technology, cybercrime risk can't be ignored. A good understanding of the known threats and controls, industry standards, and regulations can guide banks to secure their systems by implementation of preventative and risk-intelligent controls. This involves several security layers to provide redundancy and potentially slow down the progression of attacks in progress, if not prevent them.

Overall, to prevent and overcome increasing number of frauds, we need better banking, better reporting and better supervision along with various technological tools.