Financial Misbehavior in Banking Sector

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Abstract
This paper relates to banks and their behavior- excessive risk taking ahead of the crisis and multiple instances of misconduct on both the financial wholesale and retail markets. This relates to the fact that the magnitude of misbehavior is directly related to the motive and objective pertaining to a particular sector of the banking industry. In private sector, banks with high sales incentives, high commission product is recommended. Likewise public sector banks target on deposit mobilization. This also highlights the various commercial and regulatory pressures that they are vulnerable to. Banks rarely make voluntary disclosures on product features which are at times incompletely or inaccurately disclosed.

Introduction
"Trust is difficult to measure, but on the basis of the surveys conducted and anecdotes reported in the media, there appears to be an erosion of trust in the financial sector as a whole, and banking in particular, in advanced economies." Indeed the media seem full of stories about financial misbehavior, ranging from LIBOR fixing to the mis-selling of certain complex products to retail clientswho may not have needed or understood them.
Individuals or firms throughout the economy that have demonstrated over time that they can be trusted will acquire a good reputation that will attract clients in future.

The people vesting that trust may not know the identity of the individuals concerned: they have trust in the 'financial system' in so far as they believe that it provides key decision makers with desirable incentives.

The real fact of the scenario can be easily stated as misbehavior and in any situation the stipulation and tricks of banking as a major player of financial sector has increased day by day. With every new day, new sense of misbehavior is engrossed in the banking sector and with time, India will have very bad reputation in terms of banking as a major source of function and occupation. Also, day by day people residing in India or Abroad, will loose faith in the Indian banking sector due to financial misbehavior.

Keeping the fact in mind that banking system can be said to be the backbone of India due to its services, functions and help in economic growth, but still, the real face of its misbehavior cannot be ignored.

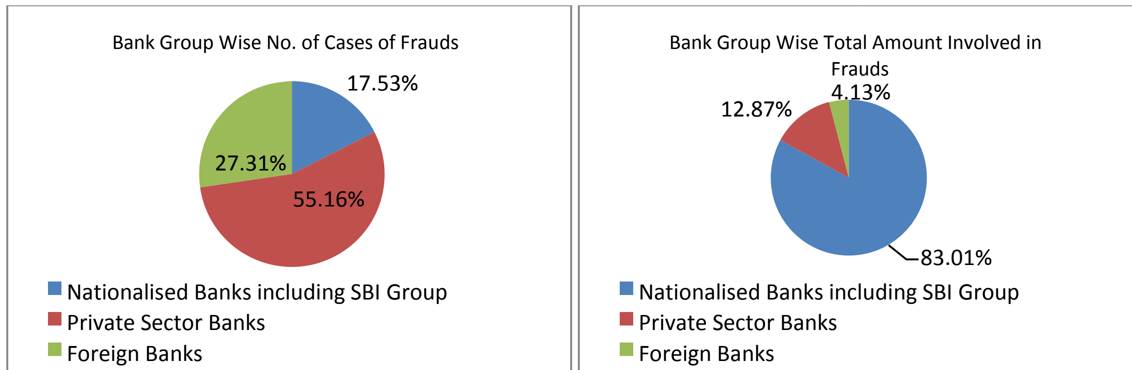
As per the RBI, bank frauds can be classified into three broad categories: deposit related frauds, advances related frauds and services related frauds.

Deposit related frauds, which used to be significant in terms of numbers but not in size, have come down significantly in recent years, owing to a new system of payment, and introduction of cheque truncation system (CTS) by commercial banks, use of electronic transfer of fund, etc. Advances related fraud continue to be a major challenge in terms of amount involved (nearly 67 percent of total amount involved in frauds over last 4 years), posing a direct threat to the financial stability of banks. With ever-increasing use of technology in the banking system, cyber frauds have proliferated and are becoming even more sophisticated in terms of use of novel methods. Also, documentary credit (letter of credit) related frauds have surfaced causing a grave concern due to their implications on trade and related activities.

The data reveals that more than 95 percent of number of fraud cases and amount involved in fraud comes from commercial banks. Among the commercial banks, public sector banks account for just about 18 percent of total number of fraud cases, whereas in terms of the amount involved, the proportion goes as high as 83 percent. This is in stark contrast with private sector banks, with around 55 percent of number of fraud cases, but just about 13 percent of the total amount involved in such cases (Figure 1). The PSBs are more vulnerable in case of big-ticket advance related frauds (1 crore or above) in terms of both number of fraud cases reported and total amount involved (Figure 2).

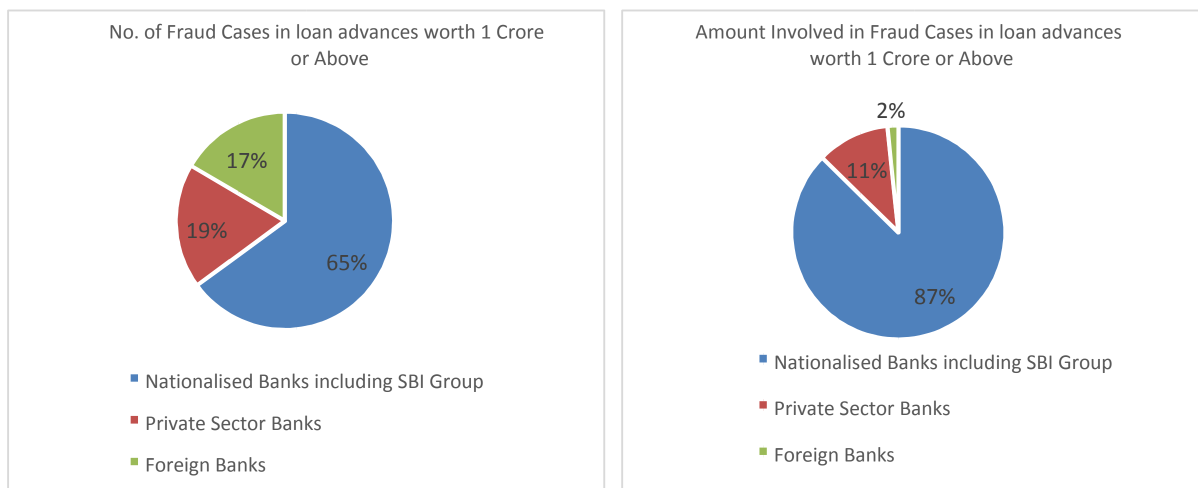
The correlation between rising level of NPAs of public sector banks and frauds probably indicates lack of requisite standards of corporate governance leading to more instances of high value bank loan default and possible collusion between corporate entities and high echelon bank officials. Also, in case of private banks, high number of fraud cases with relatively low cost of fraud indicates very nature of fraud - online/cyber/technology related frauds with a high frequency of occurrence and relatively low associated cost.

Figure 1: Group wise summary of bank fraud cases



Note: Data pertains to the period from March 31, 2010 to March 31, 2013.

Figure 2: Group wise summary of advance related fraud cases



Note: Data pertains to the period from March 31, 2010 to March 31, 2013.

According to findings of Deloitte (2015), number and sophistication of frauds in banking sector have increased over the last two years. Around 93 percent of respondents suggested an increase in fraud incidents and more than half said that they had witnessed it in their own organizations. Retail banking was identified as the major contributor to fraud incidents, with many respondents saying that they had experienced close to 50 fraudulent incidents in the last 24 months and had lost, on an average of Rupees ten lakhs per fraud. In contrast, survey respondents indicated that the non-retail segment saw an average of 10 fraud incidents with an approximate loss of Rupees two crore per incident. Many respondents could not recover more than 25 percent of the loss.

The risks undertaken by banks are still a cause of worry although it has moderated a bit. This is indicated by the bank stability indicator. Similarly, banks were worried by poor asset quality. System level credit risk is determined by gross NPA ratio which is expected to be around 5.4 percent by September 2016 and 5.2 percent in March 2017 as per RBI (2015c). Further, the ratio of stressed assets has increased significantly in the last few years. As of September 2015, stressed and written off assets (SWA)[1] are at 14.1 percent. The trends however are divergent, with public sector banks having an SWA of 17 percent and private sector banks having an SWA of 6.7 percent according to Mundra (2016).

As far as credit risk is concerned, 16 out of 60 banks (26.5 percent market share) were not able to cover their expected losses from their current framework.

RBI states that NPAs from retail banking are just 2 percent, whereas NPAs from corporate banking are 36 percent. Given the size of transactions in corporate banking, it is important that banks implement a robust monitoring mechanism post sanction and disbursement of facilities, and be vigilant to early signs of stress in the borrower accounts.[5]

India has witnessed a massive surge in cybercrime incidents in the last ten years - from just 23 in 2004 to 72,000 in 2014-15 (Figures 3 and 4). As per the government's cyber security arm, computer emergency response team-India (CERT-In), 62,189 cyber security incidents were reported in just the first five months of 2015-16.

Figure 3: Cyber Frauds

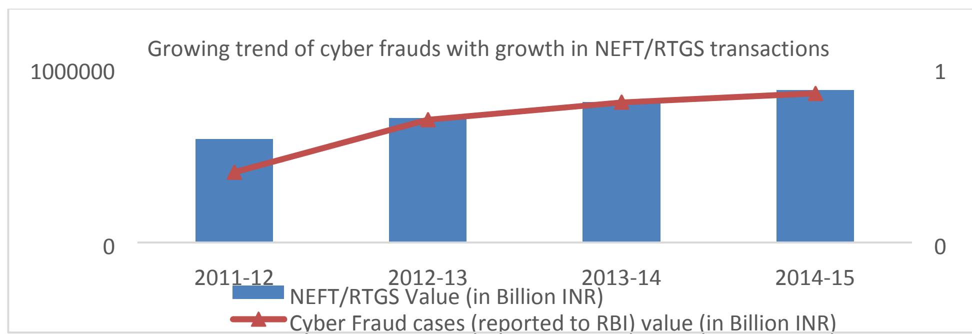
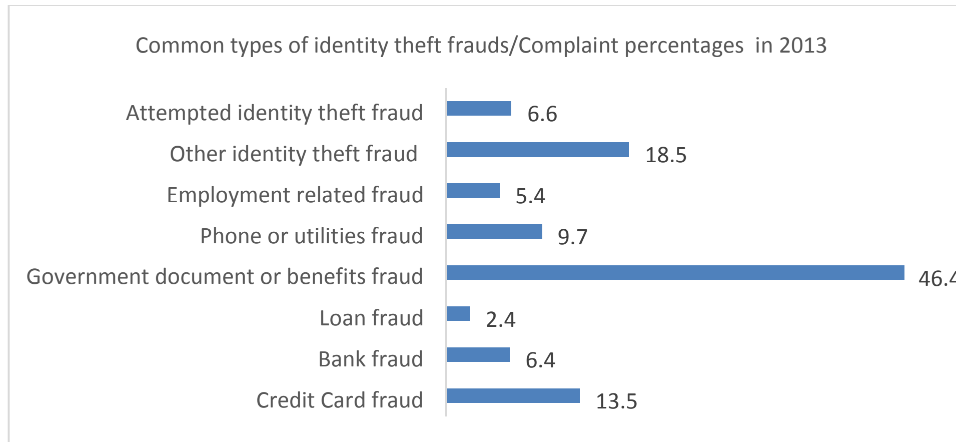


Figure 4: Identity Theft Fraud



Objectives

1) To identify the main causes that induce bankers to indulge in Financial Misbehavior.
2) To identify the regulatory framework to combat mis-selling
3) To provide appropriate solutions for the same.
4) To provide an appropriate tier mechanism of fraud detection and complaints.

Financial behaviour v/s Misbehavior

When it comes on the subject of financial behaviour, it simply means to be financially honest and clear in terms of financial product purchase and keeping all terms and aspects clear with the fact and conditions.

Regulatory Framework

Bank Regulation is a form of Government Regulation which subjects banks to certain requirements restriction and guidelines, designed to create market transparency between banking institutions and the individual and corporation with whom they conduct business, among other things.

Banks are considered as a backbone to the financial system and play an important role in the economic development of nation .They act as a catalyst for complete utilization of funds by channeling funds from surplus units to deficit units. The efficient banking system aims at leading the economy to positive road of economic development.

Reserve bank of India is the apex monetary institutions of India known as the central bank of the country. it was established on 1-APR-1935 in accordance with the provisions of the RBI Act ,1934. It was formed with a view to regulate the issue of bank note and keeping of reserves with a new to securing monetary stability in India and to smoothly operate the currency & credit system of the country.

The banking regulations Act was enacted owing to safeguard the interest of the depositors,to control abuse ofpowers by some bank personnel controlling the banks in particulars and to the interests of Indian economy.

Additionally, public finance management Act of 1999 was formulated to regulate the financial management in the governmentand to ensure that all revenues,Expenditure, assets and liabilities of the government are managed efficiently &effectively, and to establish the responsibilities of persons entrusted with financial management in that governments and to provide for matters connected there with. The regulators have responded to misconduct of banks by strengthening consumers protection regulation to improve incentive alignments between distributors &consumers and facilitate more informed decisions making by the consumers .This is undertaken by following ban on commissions &volume based payment and mandatory disclosure requirements. They might also require accurate & complete disclosure by sales staff .This still needs to be identified that agents/staff make intentional mistakes during disclosures which seems to have a large consequences in environment like Indiawhere both financial literacy & regulatoryenforcement appears weak.Regulations should require the managers to make disclosures rather than shrouding it with their inability and ignorance to engage in such regulatory attention.

The co-existence of public and private banks owing to different ways of functioning and regulatory arbitrage between multiple regulators in the financial landscape requires them to make disclosures at the time of sales as these are required by regulation. In order to justify regulatory framework the managers should seek answer for the following questions so as to identify their disclosure as accurate:

1) What products do bank managers recommend.

2) What product features get disclosed? Do all the attributes of a product, such as returns gets disclosed more frequently.

3) Are these disclosures accurate.

4) What are the drivers of product recommendation ?

For the protection of customers, RBI has directed banks to frame a policy ensuring six basic rights of customers. These includes the right to transparency, fair and honest dealing that mandates that the deal is transparent and fair. The second is right to suitability which involves an assessment of the customer to gauge his financial circumstances and understanding.

The financial products gets regulated by different regulators like SEBI(Securities and Exchange Board of India) is the capital market regulators while the Insurance Regulatory Development Authority of India (IRDAI) is the insurance regulator. The framework requires bank managers to comply with regulations on the sale of products. The RBI have advised banks through the master circular on para-banking activities to disclose details of all the commissions /other fees received, from the various mutual fund / insurance companies in case of marketing or referring their product.

Areas of Misbehavior

The intermediaries/banks are particularly not interested in understanding their customers' requirements when it comes to selling &thus resort to mis- selling of product. This misbehavior is again dependent on the type of bank like in a private sector banks, where remuneration are linked to sales, managers recommend highest fee-paying product like a life insurances policy. On the contrary a public sector bank targeting deposit mobilization will tend to recommended fixed deposits largely.

The private sector thus prescribes the most expensive product to accelerate their income whereas the public sector prescribes the least default product to ensure mobilization of deposits. In either of the cases unbiased and prudent financial advice seems missing. It is also observed that financial institutions sell products by deceiving customers and shrouding prices. There have been evidence suggesting that financial intermediaries reinforce biases of investors in their own interests and overwhelmingly recommend products which provide them high commission and seem unsuitable to customers. The managers although make some disclosures which might not be completely true on their part.

While recommending any financial product, the following parameters should be taken care of:

1) **Cost at the time of investment**: The costs of investment, cost of on-boarding , fund management ; early surrender and exit should be considered. There are some products like FD, PPF and MF which have no costs to the investor for investing in a product.

2) Transaction costs: T**ransaction costs** are fees charged by financial companies in the sale and purchase of securities. When investors purchase or sell securities via a broker or other financial intermediary, the intermediary charges a commission or fee for providing this service. These are costs to the client that generally contain two components: 1) the basic fee charged by the intermediary, and 2) the spread, or differential, between the price paid by the broker for the security and the price at which he is selling it.For investors with a finite amount of money to spend on investment activities, *transaction costs* need to be carefully considered since they diminish the number of securities that may be purchased.

Like in case of Unit Linked Insurance products, the industry standard of charging commission from the investors cant be rule out.

3) **Cost of early redemption:** when any security or financial product id redeemed before maturity, the investor has to bear the cost pertaining to early exit. There are basically two costs of early redemption-

- The chances of losing the tax deduction if it is redeemed earlier.
- The costs in terms of what the manufacturer can deduct as surrender charges.

Procedure for Fraud Detection

A semi-structured interview was conducted by the authors with various officials of the banking industry and investigating agencies. Detailed projects can be made available on request. Thus, from the study, the authors were able to come up with the following insights and key findings:-

1. Fraud detection procedure in public sector banks: The authors analyzed 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 (Figure 5).
   a) First, a fraud is internally reported to senior management of a bank. These may include chief general managers, executive directors, chairman and managing director. They may also be reported to vigilance department of the bank.
   b) If reported to the vigilance department of the bank, it investigates the fraud and then reports it to both senior management as well as the central vigilance commission (CVC) to whom they are required to report monthly.
   c) Although CVC can report fraud directly to investigating agencies like CBI, usually final decision to either report fraud to an external agency or to deal with it internally is made by senior management of the bank. Depending upon size of the bank, amount of money involved in fraudulent activity and number of third parties involved, senior management may choose to deal with the fraud internally or file an FIR and report it to either local police or CBI.
   d) A committee of the RBI also independently monitors fraudulent behaviour in banks and reports its observations on quarterly basis to central board of the RBI. The board may then report the matter to either central vigilance commission or ministry of finance (MoF).
   e) Auditors, during the course of their audit, may come across instances where transactions in accounts or documents point to possibility of fraudulent transactions in accounts. In such a situation, auditor may immediately bring it to the notice of top management and if necessary to audit committee of board (ACB) for appropriate action.
   f) Employees can also report fraudulent activity in an account, along with the reasons in support of their views, to the appropriately constituted authority (Table 1), under the whistle blower policy of the bank, who may institute a scrutiny through the fraud monitoring group (FMG). The FMG may 'hear' the concerned employee in order to obtain necessary clarifications. Protection should be available to such employees under the whistle blower policy of the bank so that fear of victimization does not act as a deterrent.

Figure 5: Flow Chart depicting procedures post Fraud Detection and Reporting in PSB.
Table 1: Current Structure for filing Police/CBI complaints[2]

Category of bank	Amount involved in the fraud	Agency to whom complaint should be lodged	Other Information

Private Sector/ Foreign Banks	Rs.1 lakh and above	State police	
	Rs.10000 and above if committed by staff	State police	
	Rs.1 crore and above	Serious fraud investigation office (Ministry of Corporate Affairs)	In addition to state police
Public Sector Banks	Below Rs. 3 crore	State police	
	Rs.3 crore and above and up to Rs.25 crore	CBI	Anti-corruption branch of CBI (where staff involvement is prima facie evident) Economic offences wing of CBI (where staff involvement is prima facie not evident)
	More than Rs.25 crore	CBI	Banking Security and Fraud Cell (BSFC) of CBI (irrespective of the involvement of a public servant)

2. Reason for higher advance related frauds in public sector banks and rising NPAs: Higher advance related frauds of above Rs. one crore loans (87 percent of total amount involved in loan worth Rs. one crore or above in value) (Figure 2) in public sector banks as compared to private sector banks (11 percent of total amount involved) could be due to the proportion of the loan advanced by both PSBs (~ 70 percent) and private sector banks (~ 30 percent) especially in large and long gestation projects like infrastructure, power or mining sectors. Also, the higher number of fraud cases reported by PSBs (65 percent of total) as compared to PVBs (19 percent of total) may be attributed to stringent oversight of CVC in PSBs. It may also be due to a possible underreporting/evergreening of loans on the part of the PVBs, evidenced by RBI's measures to curb such practices in recent times.
3. Third party agencies involved: Big loan advance frauds are not so easy to commit and it often results because bank officials collude with borrowers and sometimes even with officials of third parties such as advocates or chartered accountants (CAs). In such cases, the third parties such as the CAs or the advocates often get away as it is nearly impossible for the banks to prove criminal intent on the part of such persons due to various reasons such as lack of clear understanding of legal matters to bankers, and lack of expertise and legal advice on this subject, and unwillingness to reveal some sensitive data to courts/ public domain.

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

a) Bank auditors – There are 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 common legal framework due to faith placed on them by banks. The two types of auditors are:
   i. Statutory auditor – These look into financial statements of all borrowers that borrow from a bank. These are external auditors.
   ii. Concurrent auditor – These help supplement the functioning of bank in terms of internal checks and check on financial statements of its borrowers. These may be external/internal auditors
b) Statutory auditors of the borrower – These auditors work for the borrower firm and help in reporting their financial statements.
c) 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.

In our discussions, one factor that emerged was that there is a lack of competent auditors in India. The reasons were:

a) 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 many young auditors is 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. In addition, the auditors have clerks/articleship students working with them, who can be easily manipulated.
b) 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 veracity of documents they produce and no one challenges the financial information that they generate. In some cases, they are not equipped with the working knowledge of different instruments used by banks and are technically handicapped.
c) Attention to early warning signals: 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 organization recognize potential fraudulent malpractices in existence.
d) Weaker enforcement of laws in our country: Law enforcement agencies in India are burdened with excessive work pressure and therefore have to choose between different assignments. This is due to insufficient resources and manpower available at their disposal. In such situations, auditors happen to be most dependent for law enforcement agencies.

4. Senior management and board of directors: At times, senior management themselves may like to cover-up some cases to meet their short term targets and goals, and create a good

picture for the shareholders. In fraud cases, within the banks, with suspected involvement of senior management, there is significant resistance while prosecuting officers in 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.

5. Bank employees: Incentive structure for employees needs a re-evaluation 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 have been instances of frauds involving collusion of staff with third party agents like auditors to indulge in fraudulent activities on customers. Detection of such frauds takes a long time, and is only discovered when there are customer complaints of fraudulent cases. 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 guidelines. Political reasons may also be responsible for indulgence in loans proceed which has substantial risk of being defaulted or defrauded, especially when a red flag is raised on the loan. As legal opinion is not the strength of a banker, advocate’s directions in that matter assume importance.

   Frauds also result from lack of awareness of staff towards appropriate procedures in place and red flags they should be aware of. Technology related frauds are primarily due to nonadherence to standard procedures and systems in place, by the employees. Even when any employee detects some fraudulent activities in existence involving people in power, whistle blower protection policy does not guarantee adequate safety.

6. Borrowers and clients of banks: Frauds may also arise solely from the borrower’s side. Companies have been found to take 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 were initially set out and based on the project evaluated by the banker.

7. Legal aspects of frauds and role of investigative agencies: Investigating and supervisory bodies like central vigilance commission (CVC) or central bureau of investigation (CBI) are already overburdened with many pending investigations and have limited resources at their disposal.

   The biggest hurdle in pursuing fraudsters is proving criminal intent on their part in the court of law. Most of the bank frauds are detected very late and by that time, fraudsters get enough time to wipe out trails and it becomes very difficult to establish criminal intent due to loss of relevant documents and non-availability of witnesses.

   Also, while pursuing fraudsters, banks and investigation agencies face many operational issues. Bankers are not experts in legal paperwork, and formal complaints against fraudsters drafted by them often lack incisiveness. Also, in absence of a dedicated department handling fraud matters, investigating officers (CBI/police) have to deal with multiple departments and people within the bank, which often results into poor coordination and delay in investigation.

This results in very low conviction rate for fraudsters (less than 1 percent of total cases). Even after conviction in fraud cases, there is no legal recourse to recover the amount lost in the bank frauds and the country's legal system is perceived to be very soft on defaulters. Also, lack of strong whistle-blower protection law inhibits early detection in case of involvement of internal employees.

Conclusion

It is observed that PSBs fare better than PVBs in terms of total number of bank frauds. However, the total amount involved is much higher in PSBs as compared to the private sector.
This can be attributed to large size of loans which PSBs offer to customers.
Credit related frauds have the maximum impact in all the banking frauds in India because of the high amount involved and the cumbersome process of fraud detection followed by CVC.
The frauds may be primarily due to lack of adequate supervision of top management, faulty incentive mechanism in place for employees; collusion between the staff, corporate borrowers and third party agencies; weak regulatory system; lack of appropriate tools and technologies in place to detect early warning signals of a fraud; lack of awareness of bank employees and customers; and lack of coordination among different banks across India and abroad. The delays in legal procedures for reporting, and various loopholes in system have been considered some of the major reasons of frauds and NPAs.
Also, despite efforts, banks have not been very successful in conviction of individuals responsible for financial crimes. One of the root causes of this problem is identified as lack of specialized financial sleuths with knowledge of nuances of forensic accounting as well as a good legal understanding of frauds.

Recommendations:

The following recommendations are suggested for an early detection of frauds.

a) Independent specialized cadre: The government could consider an independent specialized cadre of officers on the lines of all India services, who are equipped with the best financial and legal know-how to detect financial frauds and are capable of carrying out an effective and time bound investigation of such scams. In short term, the government can consider forming this cadre with a pool of commercial bankers, RBI and CBI officials through lateral recruitment.
b) Know your markets: In addition to know your vendor and know your customer, the banks should also focus on know your markets. There should be a dedicated cell within each bank to assess the company/firm to which they are lending and the macro-economic environment of the concerned industry or market where products are marketed. This recommendation even seems relevant in the context of the recent crash of the Chinese market. Several Indian manufacturing companies, which were dependent on import of machinery from China, could not start their projects and generate cash flows, and this in-turn affected the banks from which loans were raised.

c) Internal rating agency: Banks should have a strong internal rating agency, which evaluates big ticket projects before sanctioning loan. The rating agency should strictly evaluate the project on the basis of business model/plan of project without being influenced by brand name or credit worthiness of the parent company, considering current macro-economic situation and exposure of the sector to the global economy. In case ratings of internal and external agencies are not similar then an investigation must be conducted to establish the causes for such differences. Also, bank should seek services of at least 2-3 independent auditors in evaluation of such projects so as to prevent chances of any possible collusion.

d) Use of latest technology: The data collection mechanism in banks is very archaic and needs a revision. The banks should employ the best available IT systems and data analytics in order to ensure effective implementation of the red flagged account (RFA) and early warning signals (EWS) framework suggested by the RBI, which would help in a better profiling of customers by analysing patterns of their transactions and rendering a near real time monitoring possible for banks. Also, we recommend that the Institute for Development and Research in Banking Technology (IDRBT) could consider incentivising development of relevant software for commercial banks at affordable costs. This is vital to enhance their monitoring of suspicious and fraudulent transactions within the branches of their banks.

e) Monitoring outlier movement at regional level: The RBI could consider extending its monitoring ambit and scope, and should monitor the outlier movements of transactions at regional level on the lines of SEBI's circuit breaker, which might be effective in tracking the earliest possible signs of financial frauds

f) Strong laws to prevent fraudulent financial reporting: There are many areas where the current laws can be made stronger to improve accountability of auditors toward their jobs.

  i. 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 (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.
  ii. 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 other countries.

g) Ground intelligence assets: Banks should be equipped with some intelligence gathering agency, which might be deployed to track activities of borrowers and is able to help the bank in ensuring real time compliance and early detection of fraud. A special fraud monitoring agency should be setup in banks with highly skilled/trained officials. A specialised investigating agency is also needed with expertise from agencies such as CBI, RBI, SEBI and commercial banks.

h) Dedicated department for handling fraud cases: There should be a dedicated department equipped with legal assistance in every corporate branch of a PSB, which serves as a single point of contact with investigating agencies and facilitates easy access to relevant documents.

i) Financial literacy: Many a times, staff does not know the exact definition of fraud and thus needs to be educated regarding this aspect. Therefore, learning sessions for employees and the best practices across the world in areas of early fraud detection and prevention should be imparted to staff on regular basis. There can be regular e-modules with e-certifications and updates made available.

j) Transparent hiring and adequate compensation: Banks have to ensure corporate governance at the highest levels. Top management needs to set guidelines and policies for ethical practices and standard procedures to be followed throughout and set an example on zero tolerance to negligence and fraudulent activities. Considering the roles and responsibilities of top management, emphasis should be given on appropriate hiring procedure at top management level, with appropriate preference for minimum service of at least 3 years, with accountability clause. Also, changes need to be incorporated on incentive mechanisms to have a balance between short term and long term targets.

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