Article

Fraud Reporting Framework - A systematized way to detect fraud

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RBI vide a notification dated 7th May, 2015 had set up a framework for dealing with loan frauds for banks[1] and for fraud risk management in banks. The framework has come into immediate effect.

The pretext to the framework is that in the present day, detection of frauds takes time and frauds are reported after all mechanisms of recovery are exhausted, eventually delaying the actions that banks can take against unscrupulous borrowers. The delay in detection and reporting of frauds also delays the process of cautioning other banks which result in frauds perpetrating elsewhere as well.

The framework thus states that the presence of Early Warning Signals (EWS) should be sensed early for prompt detection, reporting and prevention. Presence of EWS should lead to banks ear-marking an account as Red Flag Account (RFA) which would mean that there is suspicion of fraudulent activity. A EWS is a trigger for launching investigation into an RFA. The threshold for EWS is set at Rs 500 million or more at the level of the bank irrespective of solo lending or consortium lending arrangement. This means, all accounts beyond Rs. 500 million will be monitored by banks for EWS. Once an account is classified as RFA or Fraud, the banks are required to report the same to CRILC along with the dates on which the account was classified as RFA or Fraud.

RBI has provided for illustrative list of EWS which are indicative of fraudulent activities. A quick scan through the list indicates some items on the list, which cannot be comprehended to be fraudulent in nature. For instance reduction in stake of promoters/ directors, resignation in KMPs and frequent change in management, substantial related party transactions, and frequent request for general purpose loans or change in accounting policies may all be very well a part of business decisions.

Monitoring system

Banks are required to monitor EWS on an on-going basis and are required to synchronise the fraud monitoring process with the credit monitoring process. Banks are mandated to study the annual report of large accounts in details and not just the financial statement. Special emphasis has been given on reviewing the related party transactions in the notes to accounts.

Fraud reporting hierarchy

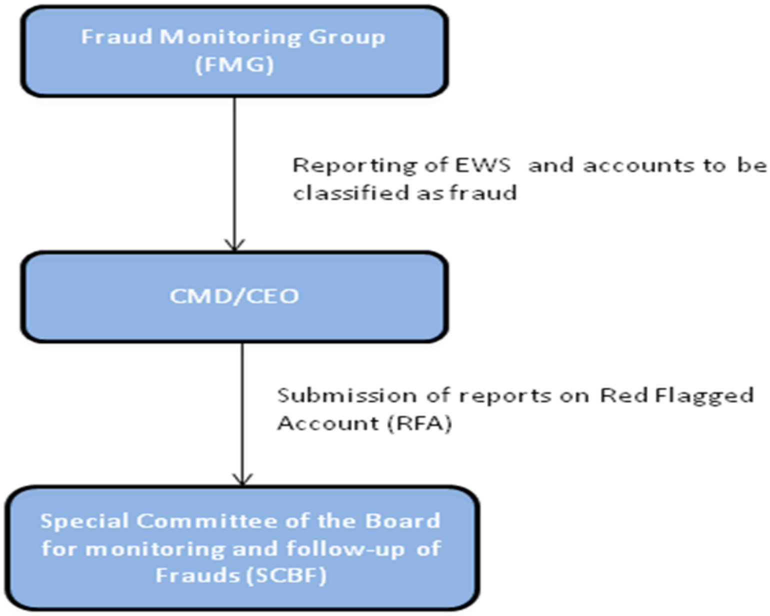
Banks are required to set up Fraud Monitoring Group (FMG) and also designate an officer to undertake EWS monitoring on an on-going basis.

The designated officer reports to FMG, the FMG shall report of all accounts classified as EWS, together with the decision to classify them as RFA or otherwise to CMD/ CEO every month.

A report on the RFA accounts may be put up to the Special Committee of the Board for monitoring and follow-up of Frauds (SCBF) providing, inter alia, a synopsis of the remedial action taken together with their current status.

[1] https://rbi.org.in/scripts/NotificationUser.aspx?Id=9713&Mode=0

The following structure shows the reporting framework:



Further, the framework requires the Banks to Risk Management Group (RMG) or any other appropriate group of the Bank shall carry out the following, for the purpose of early detection of fraud:

a. **At the pre-sanction level** – The RMG shall be responsible for collecting information on the potential borrower which could be as an input by the sanctioning authority.

b. **At disbursement stage** – The RMG shall ensure that at the disbursement stage there is focus on adherence to terms and conditions of sanction. Where there is a dilution of the terms and conditions, such dilution should be subject to the review of the RMG.

c. **Annual review** – In addition the continuous monitoring of the account, the Banks should also be vigilant from the fraud perspective while reviewing annual accounts. The framework requires the Banks to comment on the aspects of diversion of funds in an account, adequacy of stock vis-a-vis stock statements, stress in group accounts, etc. Besides this, the RMG should also track market developments relating to the major clients of the Banks and report the same to the credit officers.

Staff empowerment

Employees should be motivated to report any kind of fraudulent activity through the whistle blower mechanism of the Bank to the FMG. The FMG may seek necessary clarifications from the concerned employee and accordingly take action.

Role of Auditors

In the course of audit, the auditors may come across several instances of fraudulent activities in the account. The auditors shall report the same to the top management and if necessary to the Audit Committee of the Board (ACB) for prompt redressal.

Incentive for Prompt Reporting

In a situation whereby an account is classified as a fraud account, banks are required to make a provision equivalent to the fraud account irrespective of the value of security. However, in order to propagate fraud reporting, benefit of provisioning split over four quarters shall be given to those banks that adhere to the reporting norms at the earliest. Contrary to this, delaying will cause Multiple Banking Arrangements (MBA) or member banks in the consortium to create provision in one go. In this context, delay would mean "*failure to report that the fraud was not flashed to CFMC, RBI or reported on the CRILC platform, RBI within a period of one week from its (i) classification as a fraud through the RFA route which has a maximum time line of six months or (ii) detection/declaration as a fraud ab initio by the bank as hitherto.*" [2]

Bank as a Sole Lender

Situations where bank is the sole lender, FMG will detect whether the account in which EWS are observed to be treated as RFA or not. Once classified as RFA, FMG within a period not exceeding six months shall devise remedial measures to protect bank's interest. In this regard, bank may engage an expert team to reconsider the status of fraud account. Post expert suggestions, a final report on all RFA accounts may be presented before the SCBF.

Lending under Consortium or Multiple Banking Arrangements

In case of consortium lending, the lender banks shall individually and collectively be responsible towards reporting of fraud accounts to the Central Fraud Monitoring Cell (CFMC) within the prescribed timelines.

In case an individual bank declares any standard or NPA account as RFA or fraud, it shall also inform CRILC platform of the fraud status. Thereafter, the consortium should convene the meeting of Joint Lender's Forum (JLF) within a period of 15 days from the declaration of RFA by individual bank. The meeting should be held within 15 days of receipt of notice to convene meeting. In case of broad agreement account will be classified as fraud or in case where banks holding atleast 60% total lending agrees to it, the account would be declared RFA by all the banks in the consortium and shall be subjected to forensic audit.

The forensic audit shall be the basis on which the CBI would take the necessary action on behalf of banks in the consortium.

Staff Accountability

[2] https://rbi.org.in/Scripts/NotificationUser.aspx?Id=9062&Mode=0

Banks shall put in place staff accountability exercise within six months from the date of classification as a fraud. Any action taken in this regard shall be intimated to RBI at quarterly intervals.

Filing Complaints with Law Enforcement Agencies

Once the fraud is detected, the banks will be required to file complaints to the law enforcement agencies. They shall also establish a nodal point/office for filing complaints on behalf of the banks with the CBI.

Penal measures for fraudulent borrowers

The penal provisions pertaining to wilful defaulters will apply to the holders of fraud account including the promoters and whole time directors of the company. The nominee and independent directors will be liable only when substantial proof is available against them. Further, all those defaulters, who are also fraud account holders will be debarred from accessing any financial assistance from banks for a period of five years from the date of full payment of the defrauded account.

Central Fraud Registry

RBI is in the process of establishing a database of defaulters / fraud reported by banks. This will assist the lender banks in prescrutinizing various aspects before advancing credit facilities to the borrowers.

Conclusion

It is very pertinent to note that the list of EWS provided by the RBI is indicative in nature and the banks should not only limit themselves to that list. One thing has to be very clear, mere adhering to the list will certainly not help them to overcome the increasing number of frauds. The framework will become another gospel unless the same is implemented sensibly by the banks.

The penal provisions under the framework will be as that under the wilful defaulter [Our detailed write ups on wilful defaulters can be viewed here], like the borrowers who have defaulted in making payments and have committed fraud will be debarred from raising institutional finance from scheduled commercial banks, Development Financial Institutions, Government owned NBFCs, investment institutions etc. for a period of 5 years. So the banks should bring in a lot of sense and care while handling the red flagged accounts, otherwise, there can be serious repercussions from the borrowers, considering the severity of the punishments under the framework.

But, set aside the question of implementation of the framework, we must admit that with the detailed guidelines, RBI has done a commendable job to systematise the procedure of fraud detection.