

# FINANCIAL FRAUDS IN BANKS SYSTEMS AND PREVENTIONS

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# Issues

- ⦿ Historical Background
- ⦿ Data on Financial Frauds
- ⦿ Causes of Financial Frauds
- ⦿ Prevention and strengthening the mechanism for dealing Financial Frauds

# Historical Background

- After independence, the All India Financial Institutions were engaged in Term Financing, Project Appraisals, Monitoring, Implementation
- Commercial Banks were exclusively financing working capital needs of borrowers.
- FIs had adequate expertise, experience in such appraisals and TEV studies.

- With the advent of Universal Banking the FIs and Banks are now considering multifarious types of financial needs of clients including project finance, leading to financial frauds and resultant risks.
- Need for strengthening the mechanism to deal with financial frauds and understanding best practices.

# Data on Financial Frauds

- Increase in gross NPAs in Public Sector Banks in 9 months period ending 31.12.2013- from Rs. 1.80 lakh crore to Rs. 2.43 lakh crore indicates 35% growth.
- Top 30 NPA accounts amounting to Rs. 63,671 crore i.e. 1/3 of total NPA and 25% of gross NPA is accounted for by 50 corporates.

- The amount involved in loan frauds especially large value corporate frauds has increased substantially from Rs 2037 crore in 2009-10 to Rs. 8646 crore by 2012-13 i.e. an increase of 324.27%.
- Although Number of fraud cases has shown a decreasing trend from 24,791 cases in 2009-10 to 13293 cases in 2012-13 i.e. a decline of 46.37%, but there has been increase in large value corporate frauds.

- Large value cases (> Rs. 50 crore) has increased from 16 cases involving an amount of Rs 1796.20 crore in 2010-11 to 45 cases in 2012-13 involving an amount of Rs. 5334.75 crore .

# CAUSES OF FINANCIAL FRAUDS

Lack of proper risk assessment

- a) At pre sanction level.
- b) At disbursement level
- c) At security creation level
- d) End-use of funds
- e) Monitoring and follow up

# Lack of proper risk assessment - at pre sanction level

- Lack of expertise in Commercial Banks for Project Appraisal, Pre-Feasibility Study, Feasibility Study.
- Absence of Management Efforts to develop special cadre for such activity.
- Faulty succession plan; retirement of experienced workforce.
- Dependence on young, fresh Finance/Marketing/Personnel for Project Appraisal with no or negligible practical exposure.

- ◉ Submission of false/forged audit report, false certificate of CA relating to raising of capital, end-use of funds, etc by corporate which are accepted by banks without verification.
- ◉ The audited balance sheets no longer inspire confidence as creative accounting is being adopted by Corporate.
- ◉ Banks not doing critical appraisal of application/ proposal from borrower, especially in respect of new accounts takeover of loans.
- ◉ Accepting non-realistic sales projections. Not assessing the business cycle of a sector on a realistic basis.

- Not doing proper peer-group analysis.
- Not developing a Technical Efficient Risk-Analysis/ Risk Rating System for borrowers.
- Dilution of Risk Rating for accommodating specific clients.
- Interface with the promoter is not generally done by branch managers and other field staff at senior level. Background of promoters such as market reports not resorted to instead banks dependence on CIBIL and existing lender's financial reports which could not reveal any irregularity persisting in operations with them.

- Committee System of credit approval where in the responsibility/ accountability gets diluted. The members of committee other than chairman of committee being junior executives are not able to express themselves independently e.g. Committees headed by Chairman, EDs, CGMs, ZMs etc. there is no voice of dissent. Instead of committee decision its actually decision which is often predetermined.

- Mushrooming of multiple banking finance causing problems in proper appraisal of finance needs, monitoring and conduct of accounts, lack of creation of security favoring lending banks uniformly.
- Wooing/pampering the borrower in a multiple banking setup by some banks for availing credit leading to over financing.

- Overdependence on consortium leaders in appraisal and monitoring.
- Encouraging financing by non-consortium member banks/ outside consortium.
- Cut thro at competition among Banks to increase credit dispensation sacrificing credit quality.

- Overdependence on professional agencies e.g.; lender's lawyers, engineers, valuers etc.
- The properties are overvalued by the valuers facilitating the borrowers to get more finance.
- Advocates giving opinion of valid title without verifying the chain of title deeds, without verifying the records at Sub Registrar office resulting in multiple mortgages with many Banks.
- CIBIL not extracted/ not analyzed properly/ RBI default list not verified
- Borrowers in the habit of frequently changing their bankers and this fact being ignored

# Lack of proper risk assessment - at disbursement level

- ⦿ Lender's engineer submitting the report without ensuring/ verifying the end use.
- ⦿ Major frauds have surfaced where old machinery have been imported with hugely inflated price.

# Lack of proper risk assessment - at security creation level

- ⦿ Non-creation of Assets
- ⦿ Deficiency in documentation

# Lack of proper risk assessment

## - End-use of funds

- ⦿ Furnishing of forged/false invoices/bills through fictitious companies/firms which invariably are floated by concerned borrower company.
- ⦿ Allowing facilities without ensuring proper drawing power.
- ⦿ Allowing disbursement of T/Ls without ensuring end-use verification of previous disbursements.

- Not adopting suitable Program Evaluation and Review Technique (PERT) Chart for monitoring project implementation in large project finance.
- Credit to exporters-Due diligence of overseas buyers not done
- The overseas buyers are their own group firms

# Lack of proper risk assessment

## - Monitoring and followup

- Absence of periodic exchange/ sharing of information by multiple banking members as per IBA code of conduct causing defaults. Even in case of consortium lending there is total dependence on Leader of consortium in terms of due diligence, security creation, disbursement and monitoring of advances. Members of consortium become complacent.

- Unmanageable consortiums with large number of members causing communication gap, delay in decision making.
- Consensus among consortium members in taking crucial decisions is not there.
- Disquieting features in conduct of account/ financial discipline by borrower not discussed in consortium accounts.

- ⦿ Non-submission/ non-scrutiny of post-sanction follow-up returns/ control returns as per RBI guidelines/ Bank guidelines.
- ⦿ Permitting diversion/ siphoning of funds from business by not ensuring the following:
  - ⦿ - Non routing of sales proceeds
  - ⦿ - Under invoicing/ over invoicing of export/ import documents.
  - ⦿ - Financing fake/ accommodating bills.

- Fudging of Balance Sheet figures e.g. sales, receivables, unsecured advances, revaluation of assets.
- Non-verification of stocks and receivables.
- Financing receivables only which invariably turn out to be false and less physical stocks.
- Assets verification/ Stock Audits are done perfunctorily by bank empanelled auditors.
- Round tripping finance takes place without actual exports or less exports than reporting
- Frequent change of the name of the company/ Directors

- ⊙ Absence of legal protections/ legal actions against unprofessional consultants who indulge in unethical practices.
- ⊙ Inter corporate loans – diverting funds from public listed to Privately held companies in the form of inter corporate loans.
- ⊙ Creation of trust/ foundations for siphoning of company funds.

# Prevention and strengthening the mechanism for dealing Financial Frauds

- Emphasis on balance-sheet growth of 18-20% and above per annum without regard to the state of economy.
- Till recently, corporate loans “for general corporate purposes” were freely sanctioned virtually on clean basis. These were mainly used for evergreening of existing exposures. When banks stopped extending these loans, NPAs shot up.

- Frequent change of balance sheet year
- Frequent merger amalgamation/reconciliation of the company
- Switching over of accounts, with change in top officials
- Lack of proper competence in branches to handle MSME/ Large corporate advances is observed in a few instances. Specialist officers are allowed to convert to generalist cadre if they are in the grade of SM Grade Scale IV or above (e.g. Law Officers, IT, Hindi Officers, Civil Engineers etc.) and then posted as branch managers of credit intensive branches.

- Pre disbursement audit
- Post disbursement audit
- Exposure limit for a loan account to be evaluated so that banks do not take huge exposure although their net worth may allow under exposure norms.
- Spreading the risk
- Role/ responsibilities of Central Processing Centre vis a vis branch in retail segment.
- Avoiding hasty decisions
- Frequent changes in organizational structure to be avoided
- Annual review of performance of professionals

- Curtailing use of discretion for deviating from sanction terms by lower authority
- Proactive approach in case of early warning signals
- Independent appraisal by the Banks
- Robust auditing system

**THANK YOU**