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Why Indian bankers are hesitant to report frauds

BY ASHWIN MANIKANDAN, ET BUREAU | UPDATED: OCT 09, 2019, 11.33 AM IST

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For bankers, bad loans due to an economic downturn is par for the course. Bigger worry is corporate fraud. With 'extend and pretend' coming to an end, banks are hesitant to report frauds. For a better system, banking industry needs to be prompt in reporting and action.

At a recent bankers' summit organised by a high-street lender at an uptown Mumbai five-star hotel, one could overhear a veteran banker sharing a joke with a small gathering of journalists: "If you owe the bank Rs 1 lakh, that's your problem. If you owe the bank Rs 100 crore, that's the bank's problem." This famous old quip came after a pesky reporter had asked the banker about mounting corporate defaults — and the seemingly bottomless sinkhole for loaned funds.

While the veteran banker clothed the tricky question in a motley garb, the joke, as they say, was on the Indian banking system. All banks, across the board, have a problem with unscrupulous borrowers milking lapses and loopholes in the system, and defrauding them. The most surprising part is that banks take years to even recognise that they are victims of an elaborate web of deception.

As per the latest Reserve Bank of India (RBI) data, an unprecedented 6,801 frauds, totalling Rs 71,500 crore, were detected in FY19. That amounts to a 15% rise in volume and 80% climb in value from last year. This rise eclipses the FY18 banking fraud at Punjab National Bank (PNB), the most infamous in India's history when it was revealed that over the course of 7-8 years, fugitive diamond merchants Nirav Modi and Mehul Choksi allegedly siphoned off nearly Rs 13,000 crore from the lender.

Multiple shades of grey

"Most of the frauds that are getting reported are credit-related, and they are not black and white like operational frauds," said Arundhati Bhattacharya, chairman, SWIFT.

"Did the company fail due to adverse economic situation, was it bad management, was it because of a liquidity squeeze, or was it because of a bad ... it's not so easy to determine. Following the money trail is impossible once it crosses borders," said Bhattacharya, who is a former chairman of the State Bank of India.

Of these frauds, 73% were large ticket corporate frauds worth over Rs 100 crore. Public sector banks originated 92% of those fraudulent loans. Many of these frauds took place at least five years ago, and some over a decade ago. The most shocking data of all was the fact that average time for a fraud over Rs 100 crore to be detected was 55 months!

Such is the intensity of the problem that the central bank has alerted the entire banking system at least four times over the last six months; twice in speeches by senior RBI officials and twice in their eminent periodical reports. Most banks are not by themselves guilty of fraud and are oftentimes victims themselves, but the problem of underreporting stems due to a reluctance to engage with the prescribed system of due diligence.

Their reluctance stems from reputational risks, interference of probe agencies, and the instinct of self-preservation. Sometimes, even failure by the third-party ecosystem, such as credit rating agencies or auditors to highlight risks is also to blame.

Just this year, with still about four months to go, the central bank has already fined banks a record 76 times, totalling Rs 123 crore, for non-reporting of fraud. RBI deputy governor MK Jain urged all present and non-present senior bankers to start developing a 'compliance culture' within their respective banks. He added on a solemn note that lack of adherence to compliance was perhaps the single biggest reason bank frauds were on the rise.

Underreporting of frauds

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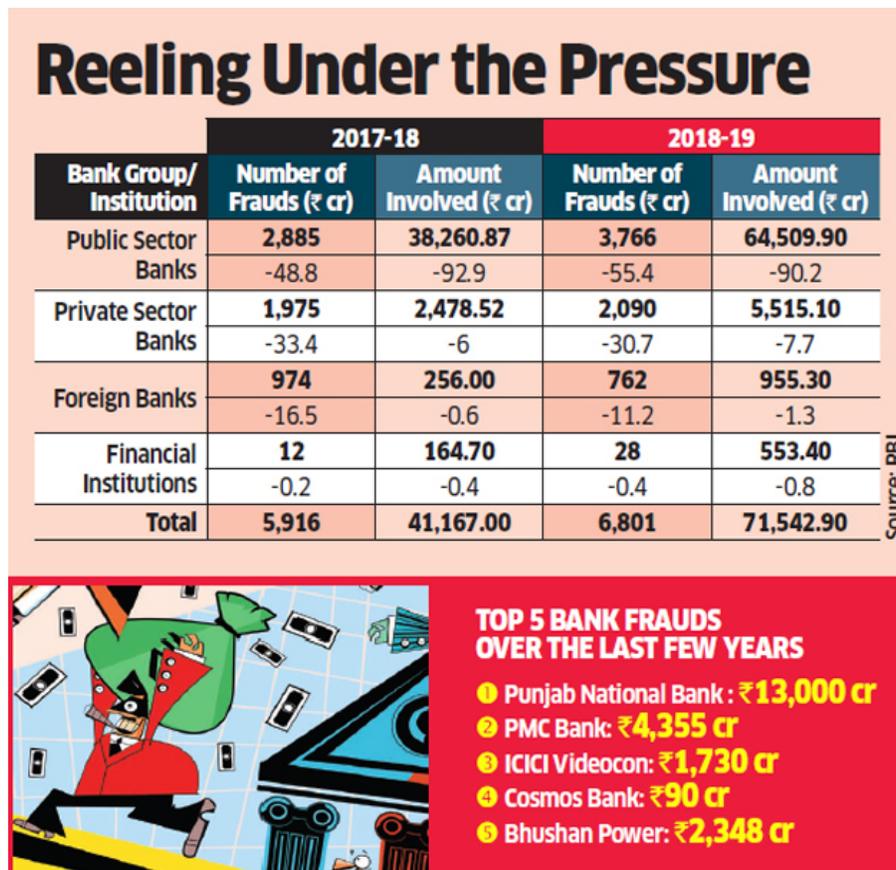
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"Underreporting of cyber frauds is not acceptable," Rajnish Kumar, chairman, State Bank of India (SBI), told **ET** during a recent interview. "Timely reporting is very important because I am only looking at my bank, but if another bank is hit by a cyber fraud and it is reported in time, it can be analysed quickly and such future frauds can be avoided. If there is a delay in reporting, we miss that opportunity."

While the veteran banker arrives bang on point on how advanced fraud analytics solutions can be used, in the words of another tech-savvy banker, 'for predicting future events using past behaviour,' the truth is that less than 10% of the frauds that were detected in FY19 were cyber-related.

The public perception of a fraud is mostly a Nirav Modi-style external attack on a bank, perpetuated by a crook with the help of an insider with corrupt motives and planned meticulously for months. However, in most cases, RBI data suggest that these are just defaults by promoter lacking equity due to stalled or 'zombie' projects, where an overzealous banker may not have conducted proper due diligence and ended up lending way more than the leverage on the bloc.

"It happens when an economy is too reliant on one source of funding. Banks have been for long the sole source of funding for the corporate sector and in a scenario where the trajectory is growth, the level of diligence for every incremental funding is compromised," a public sector banker, on conditions of anonymity, told **ET**. "Furthermore, it is in most people's interest to 'evergreen' these loans to enable the promoter to keep paying past interests to prevent losses on balance sheets."



Skating on thin ice

In such a scenario, where the line between a default and a fraud is more than just a matter of classification, it is important to understand the distinction.

"Frauds are different from normal NPAs in that the loss is because of a patently illegal action, by either the borrower or the banker," according to Raghuram Rajan's 22-page note to Parliament on NPAs in September 2018. The former RBI governor had said that without any precedent of recovery or successful prosecution of alleged fraudsters, the classification of an account as fraud itself creates a self-serving problem equivalent to that of the proverbial chicken and egg story.

"Unfortunately, the system has been singularly ineffective in bringing even a single high-profile fraudster to book. As a result, fraud is not

discouraged. The investigative agencies blame the banks for labelling frauds much after the fraud has actually taken place, the bankers are slow because they know that once they call a transaction as fraud, they will be subject to harassment by the investigative agencies without substantial progress in catching the crooks," Rajan had said.

Additionally, Rajan also noted that it is a matter of systemic failure. The problem of frauds cannot be looked at as an isolated problem of the banks.

According to experts, the professional support ecosystem such as auditors and rating agencies are sometime as complicit or more with the fraudster as anyone else.

"If you are going to buy a house and the valuation expert is hand in glove with the owner of the house and artificially increases the value of the house, and you go and buy it, you get defrauded. But there is an expectation that the valuation will not be biased. There are professional standards around these things," explains a lawyer dealing with white-collar crimes.

Reputational risks

In some cases, the lack of disclosure may be down to just a banker's unwillingness to lose his job. During the RBI's Asset Quality Review exercise undertaken in 2015, so much was the discrepancy in standards of structuring of loan accounts that exposures to multiple banks were reported as non-performing in some banks and performing in others.

"When a banker gives a bad loan and loses money, that's not a crime; it's bad banking and you may lose your job. But when you cover it up, that becomes a crime," said Omer Erginsoy, senior director at Kroll, a global fraud investigative agency that works extensively with Indian banks. "And it could be because they had some personal interest or just that they were just a bad banker and still wanted to keep their job, which in most cases is a very strong motive to cover up."

The lack of disclosure misleads regulators about the liquidity position of the bank, and it reflects in inflated revenues and delinquency figures on the balance sheet, fooling both the stakeholders and investors. "It's a disclosure breach, it's a misrepresentation of data fraud and a capital market fraud. It's a crime on so many levels," adds Omer.

Since the AQR to check the financial health of its banks, more than Rs 10 lakh crore, or roughly 25% of the loans to the corporate sector, were declared toxic in 2017, which prompted the central bank to issue its now famous February 12 circular on restructuring of bad loans. Some experts believe that an increased identification of frauds may not necessarily be a bad thing for Indian banks.

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