Fraudulent practices in Banking Institutions: Legal Issues and Challenges

Zubair Ahmed Khan[1]

Assistant Professor, University School of law & Legal Studies, Guru Gobind Singh Indraprastha University, Dwarka, New Delhi.

Abstract

The continual presence of frauds in the banks is not a recent observable fact. Frauds in Indian banks only prove that financial flexibility exacerbate trend of shallow markets to cherish excessive speculation and deteriorate growth of the market in such way that recovery seems difficult. Revelations of fraud, evidence of insider trading and a ensuing debacle of investor interest have led to an almost insuppressible decline in Indian banks. The paper will also discuss different kinds of fraud and remedial measures. The paper deals with different kind of preventive, detective mechanism required for fraud investigation.

Keyword : *Dishonest Intention, Forgery, Computer Fraud, Default, Inspection.*

I. Introduction

Banking system has a very crucial role in shaping a strong Indian economy. A banking institution has a significant role and indispensable in a modern society. It plays as a driving force inthe economic development of a nation and forms the main crux of the financial sector as per the need of advanced economy.The traditional banking practice as followed in Banking sectors has gone a paradigm shift altogether with the passage of time in India. Corrupt practices in banking sector due to lack of transparency, inefficiency due lack of supervision deteriorated the goodwill and common good principle of banking business. In the pre-independence era starting from 1770 to 1920 onwards, maximum profit in disproportionate way & illegal financial transaction was given priority even at the cost of exploiting the social, economic rights of other without any scrutiny. Even after independence, banking industry was very much adversely affected by many internal & external factors like Zamindari practice; physical insecurity due to poverty, increasing crime rate; financial insecurity due to natural calamities, war with neighbouring countries, improper implementation of public welfare schemes, etc. But, Indian government has realized the importance of banking sector reforms, that is why they have undergone drastic transformation especially after nationalization of banks in the year 1969 and 1980 which resulted in adoption of socialistic pattern of banking sector, improved efficiency, effective depository system with transparency.

The transitional phase came with liberalization & globalization of Indian economy in the year 1991. Radical changes were brought by giving huge opportunities to private sector to stimulate the growth of financial sector. Keeping in tune with the fast growing economic policies and its implementation, many structural changes were brought in banking sector via Narasimham Committee to bring strong stability, like inclusion of prudential norms, direct lending practice should be controlled, reduction over priority sector lending due to ambiguity, internal assessment of balance sheet & audit of banking institution for bringing transparency, direct control of banking institutions by Reserve Bank of India, etc.

While the functioning &instrumentality of the bank have become moreimportant for exponential growth, many minor and major discrepancies including banking fraud have also increased simultaneously and with the passage of time, fraudsters are becoming more and more experienced, insightful and resourceful as well.The manifestation and existence of frauds in the banks is not a frequent evident phenomenon, in fact the transgression & wrongdoing of forgery is may be as old as writing itself.

The concept of fraud is not specifically defined under Indian Penal Code. Though Indian Penal Code includes and mentionspunishment, which leads to perpetration& execution of fraud through various means. Even section 17 of Indian Contract Act, 1872 provides an inclusive definition of fraud. It means a kind of agreement in which one of the party is inducing other with deceitful intention to suggest certain facts which is not true but make it believe other to be true. It is kind of arrangement in a legal relationship where deliberate non-disclosure of facts exist by adopting chicanery & tricks.There isan element of dishonest advantage and disproportionate profit in every case of fraudulent activity. The phenomenon of financial fraud is matter of grave concern in global market. Sometimes it is difficult to establish criminal liability in the case of financial fraud because of lack of specific definition and provision in law irrespective of the fact that banking & non-banking financial institution suffers huge monetary losses either in collusion with bank personnels or with employees of other financial institutions. Persistent rise of monetary losses take the shape of unfettered commercial disadvantage resulted into many complicated cases of scam. There is no doubt about the fact that financial fraud is very vulnerable issue which needs to be tackled with due care & diligence with much scrutiny, since it affects goodwill and public faith in the overall market structure. Social & economic dependence of customers exist on the sustainability & stability factor of the any financial institution. In fact, public faith &confidence are the main basis for the growth of banking business in banking institutions. Consistent market frustration &collapse, unexposed & undetected frauds deteriorate financial institutions to such a level that it hampers the basic doctrine of good governance.

Bank fraud is kind of manoeuvring action by using deceptive methods to obtain illegal money & financial assets which was owned or kept in possession by a financial institution. Nowadays, the misappropriation can be done in many ways, sometimes difference also arise with respect to factors like presence of certain unauthorized methods, complication due to jurisdiction issue. There is a possibility where the extentof fraudulent action resulted into higher degree of serious offence like theft,dacoity, burglary and robbery in professional manner.It can be a part either organized crime or white-collar crime also in certain situation action was done in a more strategic and pre-concerted plan.It is quite obvious that any enterprise which deals with huge amount of financialassets is very vulnerable to frauds and it become more common in the case of enterprises or persons which are heavily indebted to banks at large. So, it is clear that the cases of banking frauds are also escalating very abruptly.

Historically, while looking closely, though there many advantages of nationalization of banks but it resulted into increase of multiple branches in various part of country without any effective supervision and control. Unfortunately, corruption also arose in banking sectors due to reduced efficiency in providing services and undesired political interference & monopoly. Banking sectors has also deficient number of experienced & trained banking personnel for handling complicated cases. It is also clear that the government were overburdened with multiple tasks especially after taking the responsibility of looking into priority sector lending which is major tool to boost the agricultural& industrial economy in the country. So, efficient supervision was not possible due to lack of specific legislation and guidelines. The paradigm shift fromtraditional way of lending where security issues are given priority to modern style of banking where lending process is considered as promotional strategy for expansion and development of banking business.

Uncertainty& speculation in the market plays a very crucial role in the growth of business of financial institution. But fraudulent cases in Indian banks can increase the extent of financial flexibility to such a level that it can leads to excessive uncertainty with unreasonably high risk involved in doing business, resulting into disintegration of the market. Sometimes, banking fraud issues along with insider trading and ensuing downfall of investor's interest have generated into unmanageable slump in Indian banks. Disproportionate gain and low stake along with manipulative tactics leaves a weak position against which offenders exploit it for doing fraudulent activities. There are many dimensions of fraud that occurred in banking activities like manipulative practices adopted in the utility of cheque, deposit account fraud where there is existence of illegal transfer of money, dubious& misrepresentation wrt movable assets in the case of hypothecation fraud, high extent of default with deliberate intention in the case of loan fraud, etc. There are three aspects by which bank frauds are engendered & organized namely,

Machination with active collusion among banking staffs either in involvement with internal or external factors. Willful misconduct and dereliction of duties of bank staff to follow guidelines as formulated by Reserve Bank of India. Extrinsic factors proliferating frauds by doing mischievous acts like forgery, illegal alteration of cheques or misappropriation of drafts; non-observance of Know your customers (KYC) Norms.

There is a presence of financial pressure to exploit businessopportunities among banking & non-banking financial institutions. Related factors like consistent economic downturn, intensely cutthroat commercial atmosphere has compelled banking companies to overlook the security issue, thereby deviating from normal existing processes. With the objective to achieve maximum profit, all possible kind of anti-competitive measures has been adopted to get their highly expected business targets by flouting bank norms.

II. Adverse Effect of Fraud

There are various instances of fraudulent act happening in banks on consistent basis that go overlooked & inconspicuous. Monetary loss and damage to the reputation & goodwill of the bank are most direct impact of frauds. Serious aberration & misapplication resulted into fraud will definitely raise question over tenability & utility of secured technological capabilities of the institution and their traditional method of protection.

Frauds related to Internet banking, mobile banking, ATMs dent the morale of customers resulted into lack of trust &reliability over these services. Fraudulent activity will also subvert the profit & overall efficiency of banking services. It can corrode the productivity and adversely affect the interest of investor resulting into unexpected increase in operational & capital risk of the bank. It can become a great impediment in the growth of banking business while bringing instability in liquidity and mismanage capital adequacy norms. Even , the extent of default in lending process has become so serious that it overburdened the securitization company.

III. Recommendation of A K Ghosh Committee on Banking Frauds

Reserve Bank of India is very much concerned with the meteoric rise of instances of banking fraud. So Reserve Bank of India has organized & set up a high level committee to introspect the grim situation of fraud and related malpractice in banks under the chairmanship of A K Ghosh.[2]

There are certain objectives of the committee to ensure transparency in banking services namely,

Security of assets with no legal objection

Complete adherenceof existing policies and procedures without any dereliction.

Clarity with respect to accounts and related records

Systematic delegation of duties and obligations of staff towards customers and bank

Timely thwarting and tracking down of frauds and malpractices

The committee emphasized that the banks should take obligation of safeguarding cash and other valuables. It should reflect a dual aegis on the part of bank. Rotation of staffs for better functioning of the bank with proper division of financial and administrative powers.Banks needs to formulate safety measures against cash theft and frauds in case of guarantees.

A sincere responsibility is expected from banks to got for scrutiny and surveillance in credit, investment sector and balance sheet. So far as portfolio inspection is concerned in this regard, the approval of Reserve Bank of India is important. Specific procedural formalities should be followed like vigilance officer in those cases should refer chief vigilance commission where there is presence of vigilance factor. The committee raised few apprehensions by explaining that shrewd customers can take undue advantage in those cases where bank staffs are relatively careless in obliging their well established duties and safety measures.[3]

IV. Possible Types of Frauds Occurring in Banks

4.1 Frauds occurring in case of deposit accounts

Sometimes, it is possible that that while opening an account of customer in a bank, certain precautionary principle was not adopted like proper identification of the person, his origin resulting into misuse either through fictitious or kind of impersonation. In those cases, chances of theft & deliberate alterations of cheques are (either removing words or change in name or amount mentioned) there for payment purpose. It is possible that huge amount of money has been withdrawn from dormant account of a customer by a fraudster using forged signature. Under the same category of fraud, it is also possible that bank staff has also malicious involvement to get illegal money by withdrawing it from the account of a customer without any authority. It can be done either through manipulating passbook in an unscrupulous manner or bankers take the position of joint account holder without the explicit consent of customer, thereby withdraw the money.

There are some misappropriate practices which can be usedto create embezzlement in banking services. It becomes easy for a fraudster or imposter to withdraw money by an unauthorized possession & use of chequebook with fake signature. Counterfeiting cheques and bank drafts are also common practice to deceive and swindle customers. Even in a traditional method of banking practice, fraudulent activity occurs in case of illiterate customer whose banking service directly depends on their thumb impression on the concerned papers. Forged fingerprints have become sham trick to delude & cheat customers.

4.2 Fraud arise in case of lending process

One of the utmost recommendations of nationalization is to achieve success in commercial lending and priority sector lending. But, banks are overburdened with the responsibility of providing best services from priority sector lending. A huge amount of loan was withdrawn from customers under the priority sector lending scheme in various sub-sectors. Multiple cases of defaulter list came into picture. Though the scheme was adopted for improving economic status of customers belonging to small &medium scale industry, agricultural sectors and growth of agricultural economy, but it resulted into failure due to financial incapability of customers in returning the loan, sometimes absconding from their own place of residence or business.Bank staff for sake of personal monetary benefit as bribe, does not do proper scrutiny of documentation for lending process or bank staff are misrepresented directly or indirectly by other immaterial facts deliberately.

Fictitious & unregistered firm doesn't hold any integrity & accountability in the market, somehow they convinced banks to provide loans. There are certain complicated situations where customers succeeded to manipulate with securities provided to banks for loans & advances. The most common manipulation is when customers misrepresented the facts related to value of collateral securities in lending process and it turned out to be disproportionate in correspondent to the money lent by bank or sometimes valueless. Foreclosure as remedy (i.e., compulsory sale of collateral securities in case of default in lending process) won't be sufficient enough as preventive measure due to inadequate value of security.

In lending process, some customers deliberately use those kind of hypothecated goods whose price are relatively very fluctuating with the passage of time and banks are kept ignorant of the same initially in a very tactful manner. In few cases, banks are also kept ignorant or wrongly informed about the legal status of security used in loans. For example, those securities are used whose title is already in question like

i. Title deeds of securities are forgedone
ii. Title deed is subject matter of legal dispute, i.e. not free from any encumbrances.
iii. One particular asset is used as security for lending process with multiple banks by hiding relevant information.
iv. Securities, which are used for loans, are not of same quality (worse)orquantity which are promised earlier.
v. Fraudulent disposition of securities by customerseitherthrough collusionwith bank staff or recklessness on the part of bank staff.

Another instance of fraud in lending process occur where there is direct involvement of a corporate body. Banks provide huge amount of investment loans to these rich corporate bodies on the basis of their strong financial capability, impregnable market structure, robust goodwill in the competitive market and strong influence or commercial relationship with Government. These corporate bodies kept banks under delusion that they repay the debt amount. It does not result only into failure to repay the debt and but also create the situation of non-performing assets.

4.3 Fraud arise in the era of modern technology

The transitional change from traditional banking practice (mainly on papers) to modern practice has brought radical change in efficiency of banking service. The biggest advantage from this transformation is that banking service is working efficiently and in a speedy manner without any discrepancy. Today, almost all branches of the banks have been computerized to introduce paperless service wherever feasible. But the extent of increasing cyber crimes is alarming and matter of grave concern. There are few kinds of fraud that are very vulnerable.

1. Spy-software: This activity is used by fraudster to decode passwords and enter into system for misappropriating datas for malice interest and get the money illegally.Hacking is another sinister type of mechanism adopted by criminals to access the information in computer system in an unauthorized manner by purloining password. This act is done not only for illegal monetary profit but also to cause irreparable damage to the system of the other person.[4]
2. Wire tapping is also kind of unscrupulous act whereby fraudster record signals & steal the password to withdraw the money. This act is possible by tapping the wire of ATM machine when a customer use the same to get money.

There is one specific legislation which deals which penalty for fraudulent acts related to computer system. Section 43 of the Act provides compensation upto 10 lakhs to the aggrieved person. It is applicable in the case of unauthorized access to copy and download certain sensitive information.

3. Though online banking is very efficient due to less complication, speedy process and reduced costs, but there is always a serious apprehension related to security and level of risk, which is involved. There are some fraudulent tactics adopted by cyber criminals who entice their customers by asking them to visit their websites and click something to download or to read and accordingly they get trapped. They introduce themselves to offer profit-making schemes for customers so that customers get interest and follow the same, and they steal all sensitive information stored in the computer system of the customer. There can be another way out for fraudsters to get personal&financial details like credit card information, passwords, etc from customers by allowing them to do any kind of online trading through unsecured websites. It can be done either through Phishing or any kind of Identity theft.

Credit or debit card frauds took place in systematic manner by which the card is used by fraudsters so that they can withdraw money illegally. Duplication of credit card is the most common method used by fraudster. Theft of the card and disclosure of sensitive information like (Personal Identification number(PIN) number to another are also part of credit/debit card.

V. Legal Concepts Relating to Bank Frauds

Forgery is crime where the accused person create a false record or credential with a specific intention to cause harm or injury. A record must be in existence where contents of the same should be explained & interpreted well through words, marks,figures so that it can be used for illegal purpose. [5]It is not relevant though where such marks, figures or letters were made. The most important element of offence of forgery is the presence of deceit , improbity and criminality. Though it is not always necessary for the offence of forgery that document has to be in writing or it has signature as a part of formal procedure. Any record or document can leads to fabrication even by expunging signatures or any particular figure. It is important to understand different conceptual nuances of intention to remove ambiguity. There is difference between two particular acts which involve intention to do fraudulent manipulation and intention to get wrongful gain to himself & wrongful loss to other. If a person gets disproportionate profit by an action at the cost of other person's loss, then it is only considered as dishonest act. Whereas, a fraudulent act always involve intention to deceive for getting illegal advantage.

Whenever the question of determination of offence of forgery comes, it is clear the act should be completed with intention to defraud, though actual damage or harm may not be necessary. It is also not necessary that a fraudster have certain relative power to defraud or certain circumstantial chance to do the same. In fact, any kind of previous engagement or relationship between people committing forgery and aggrieved person is also not necessary. So whenever, a person claim his authority or title over the forged document, it is important to introspect & verify the documentation. Since forgery of signatures is one of the most prevalent fraud occurring in daily basis commercial transaction. Verification can be done in this regard either with the help of expert opinion[6] or someone who is acquainted with handwriting & signature by comparing the same with any previous existing record.[7]It is expected from the bankers to due care & diligence while performing their duties meticulously.

It is important to understand the meaning of cheating in the context of criminal law. A dishonest act with the presence of deception to get a property or to do an act can be termed as cheating. So, bank staff can prevent the offence of cheating or cheating by personation[8] by proper identification of the concerned person(for quashing the possibility of fictitious or anonymous customer) and so far as authenticity of documents is concerned, it is important to scrutinize the legitimacy and veracity of documents either related to place of residence, business or nature of security. A bank staff holds a very responsible task in performing his job. His service depends on principle of trust and confidence. He needs to perform his job in the instruction or direction of his superior authority and in accordance to the procedure established by terms of employment and recommendation as banking norms given by Reserve Bank of India. Where a banker misuse or misappropriate the security lodged with bank for loan provided to the customer even before the expiry of term of loan or before existence of default. This kind of action will definitely result criminal breach of trust because criminal breach of trust involve a dishonest action where improper & inappropriately use of the property in an unauthorized manner violating direction of law prescribing the procedure and thereby resulting into disproportionate loss of another.[9] So, it is necessary to scrutinize the overall functioning of the bank. Periodic inspection of actions and vigilance over particular issues should be taken into consideration seriously. The extent of vigilance & precautionary principle will have to follow on a different platform in those suspicious transactions where vicarious liability can exist.

Every bank needs to be accountable for their every activity & transaction to the superior bank. It is one of the foremost duty of bank to prepare annual report on timely basis and to prepare balance sheet without any discrepancy & ambiguity. It is true that rendering true accounts require a meticulous approach. But if a bank staff fabricate certain important data & make false entry in the record with will to damage or deceive, those actions attractfalsification of accounts.[10] Where proper diligence is required staring from application form to the procedure how accounts are maintained. There are certain relevant legal provisions from section 489A to 489E in Indian Penal Code, which is relatedto utility of counterfeiting currency notes and related things. The objective of these sections is to provide security for careful & protective use of currency notes without the presence of any duplicity, forgery and spurious content. So, it is clear that fraudulent activity in banks is not only incessant but unfolded threat to financial market. It is required that vigilance mechanism should be evolved in every step of every banking transaction. An audacious approach is important for stimulating the growth of anti-fraud programme for meticulous monitoring for every action. Two precautionary principles like control measures related to fraud & detection of fraud should be utilized simultaneously to diagnose the problem on timely basis.

There are two possible categories of procedural techniques which is very much related with vigilance system namely:

Preventive method – It is important to understand (without any ambiguity) on the obligation and different roles according to transaction. Proper assessment of risk is required to check suspicious transaction, which may result into fraud. This practice of assessment requires internal inspection & proper audit of bank activities to ensure transparency. Minor discrepancy and error occurring in any action should be examined without wastage of time and the issue should be timely decided. Banking Ombudsman Scheme,2006 was introduced with same purpose to hear the complaints &resolve the dispute related to deficiency in banking service.

Detective method- This is traditional practice followed to check in the minor or major discrepancy occurring in banking transaction. Role of a supervisor(to put a surveillance), auditors or any external agency (sensitive information collected through Intelligence Bureau) is important in fulfilling this task. Normal investigation like checking into previous business affairs of customers(history of consistent minor or major discrepancy), financialbackground of customer, nature of commercial transaction dealing with third party, particular task done by committed forensic experts or tools. It has now become imperative for Reserve Bank of India to provide financial as well as administrative support for the creation of a fraud-monitoring cell in every type of public or private sector bank. It will definitely help in reducing the time gap in investigation initiated at internal level in banks and reports to be made as soon as possible so that police take over the matter. There are certain matters involving highest degree of fraud, can face administrative or jurisdictional complication to determine the investigation. These cases should be taken seriously Crime Bureau of Investigation without kind of financial or undue political pressure.

VI. Conclusion

Time is ripe now that our banking financial institutions require a vigorous mechanism which specifically deals with fraud identification & broad diagnosis; because this kind of system can easily compatible with complex fast growing market as well as it has become very necessary for the survival & growth of the banks. This assessment &high-risk management can prevent persistent financial loss and somehow it secures the goodwill &bring positive prominence and credibility of the bank. It provides exhaustive &far-reaching security against all possible kinds of fraud from different avenues like online banking, ATM, utility of credit card, etc.

Since, modern day fraudster are using new technology to do mischievous act for an unauthorized transaction, it's time for banks to play a vigilant role in detection of fraud well before any determination of fraudulent transaction and thereby blocked it without any hindrance. This can only be done with active involvement of fraud management technology. So, banks and other non-banking financial institutions can execute their business for expansion & maximum profit without any deceitful hassle.

Though, it is unfortunate to note that only few banks are serious in tackling the issue in a well planned comprehensive manner. It is important for banks to set their priority as prevention for fraud without wasting time. They should not be selective in finding solution only for particular complicated issues related to credit card or retail loans, etc. Their action plan & execution should be in compatible with rules established as per existing banking norms. It is equally important to update their rules and standard banking practices for efficacy and better productivity in the competitive market.

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6 Section 45 , Indian Evidence Act, 1872

7 Section 47 , Indian Evidence Act,1872.

8 Cheating by Personation, Section 416 , Indian Penal Code,1860

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