BANK FORENSIC AUDIT

(BY CA ASHWANI RASTOGI)

FAFD (FORENSIC) CERTIFIED BY ICAI

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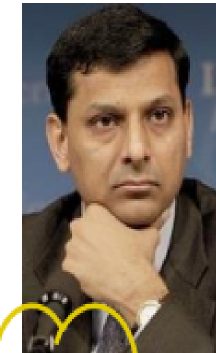
Stressed assets in the banking system

March	2013	2014	2015	2016
	Total			
Gross NPA Ratio (%)	3.27	3.86	4.37	7.61
Net NPA Ratio (%)	1.72	2.17	2.48	4.63
Stressed Assets/advances (%)	NA	9.75	11.01	11.5

March	2013	2014	2015	2016
	Public Sector Banks			
Gross NPA Ratio (%)	3.59	4.34	4.94	9.6
Net NPA Ratio (%)	1.99	2.53	2.9	6.1
Stressed Assets/advances (%)	NA	11.04	12.68	14.5

March	2013	2014	2015	2016
	Private Sector Banks			
Gross NPA Ratio (%)	1.86	1.82	2.14	2.7
Net NPA Ratio (%)	0.52	0.63	0.87	1.3
Stressed Assets/advances (%)	NA	4.29	4.59	4.5



Our intent is to have clean and fully provisioned banks' balance sheets by March 2017

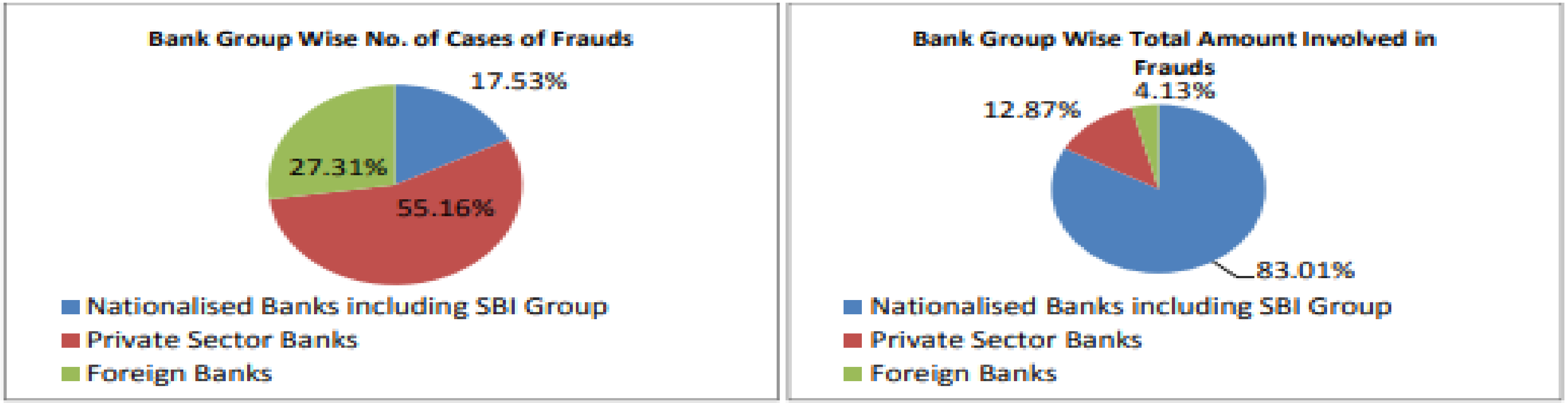
All out of the court debt restructuring processes like **CDR, SDR, S4A** and **5:25** have proved unsuccessful and **bad loans have piled up in the system after their implementation**

Source: RBI

Cont'd.

FY 16-17 (Amt Rs. In crore)					
No	Bank	Gross NPA		Net NPA	
		AMT	%	AMT	%
1	PNB	55370.45	12.53	32702.11	7.81
2	BOB	42718.70	10.46	18080.18	5.06
3	BOI	52044.52	13.22	25305.05	6.90
4	Canara Bank	34202.04	9.63	21648.98	6.33
5	Union Bank	33712.28	11.17	18832.10	6.57
6	Syndicate Bank	17609.31	8.50	10410.98	5.21
7	IDBI Bank	44752.59	21.25	25205.80	13.21
8	Central Bank	27251.33	17.81	14217.83	10.20
9	OBC	22859.27	13.73	14117.83	8.96
10	Corporation Bank	17045.22	11.70	11692.18	8.33
11	Allahabad Bank	20687.83	13.09	13433.51	8.92
12	IOB	35098.25	22.39	19749.32	13.99
13	Andhra Bank	17669.98	12.25	10354.81	7.57
14	UCO Bank	22540.95	17.12	10703.39	8.94
15	Indian Bank	9893.29	7.49	5634.71	4.41
16	BOM	17188.71	16.93	11229.56	11.76
17	Dena Bank	12618.73	16.27	7735.12	10.66
18	Vijaya Bank	6381.78	6.59	4118.16	4.36
19	United Bank	10951.99	15.53	6591.85	10.02
20	PSB	6297.59	10.45	4375.08	7.51
Total		506894.81	13.74	286138.55	7.75

Figure 1: Group wise summary of bank fraud cases



Note: Data pertains to the period from March 31, 2010 to March 31, 2013.
Source: Chakrabarty (2013).

Figure 2: Group wise summary of advance related fraud cases

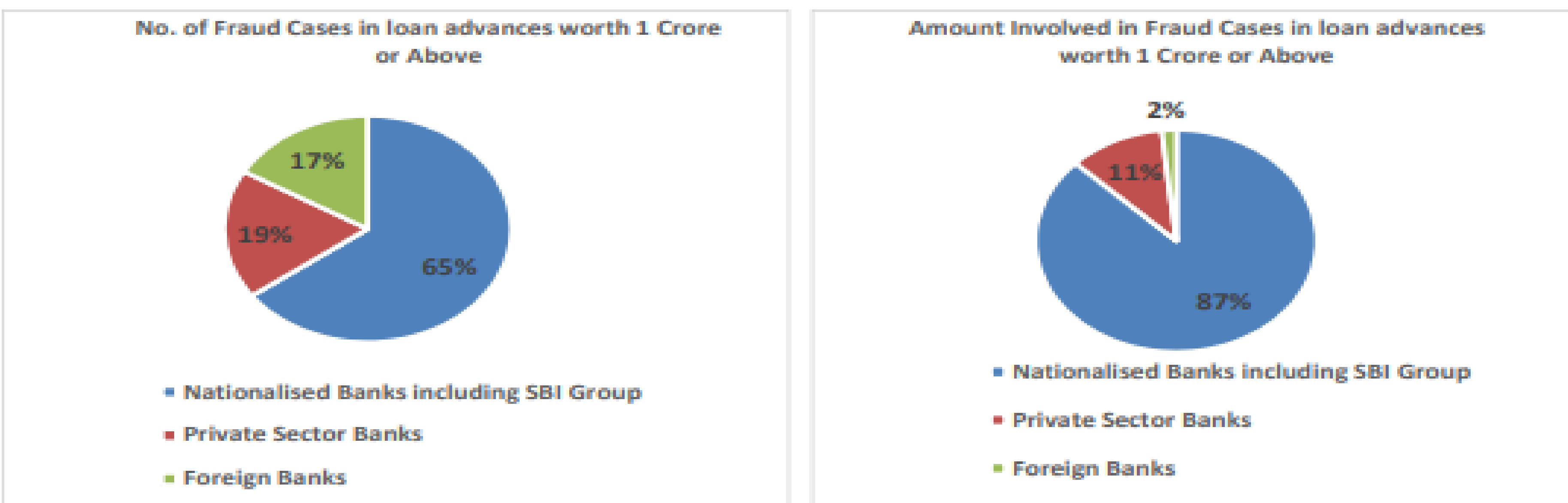
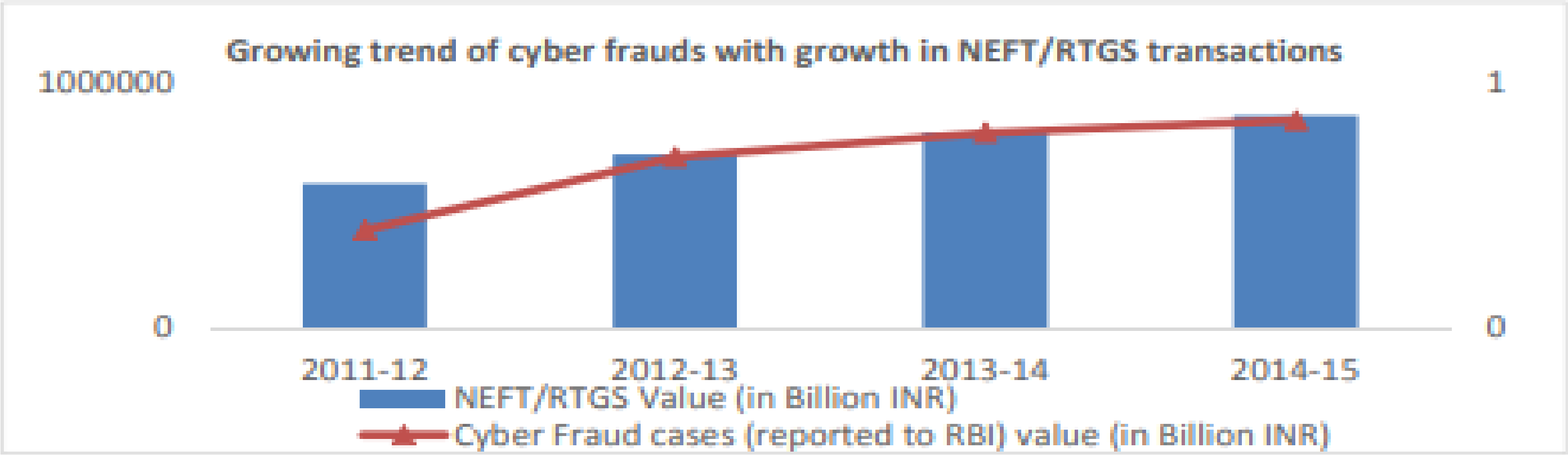


Figure 3: Cyber Frauds



Source: PWC India and ASSOCHAM (2014).

Figure 4: Identity Theft Fraud

Source: PWC India and ASSOCHAM (2014).

Bank forensic fraud detection techniques
Source: IIM, Bangalore Working Paper

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.

Bank forensic fraud detection techniques
Source: IIM, Bangalore Working Paper

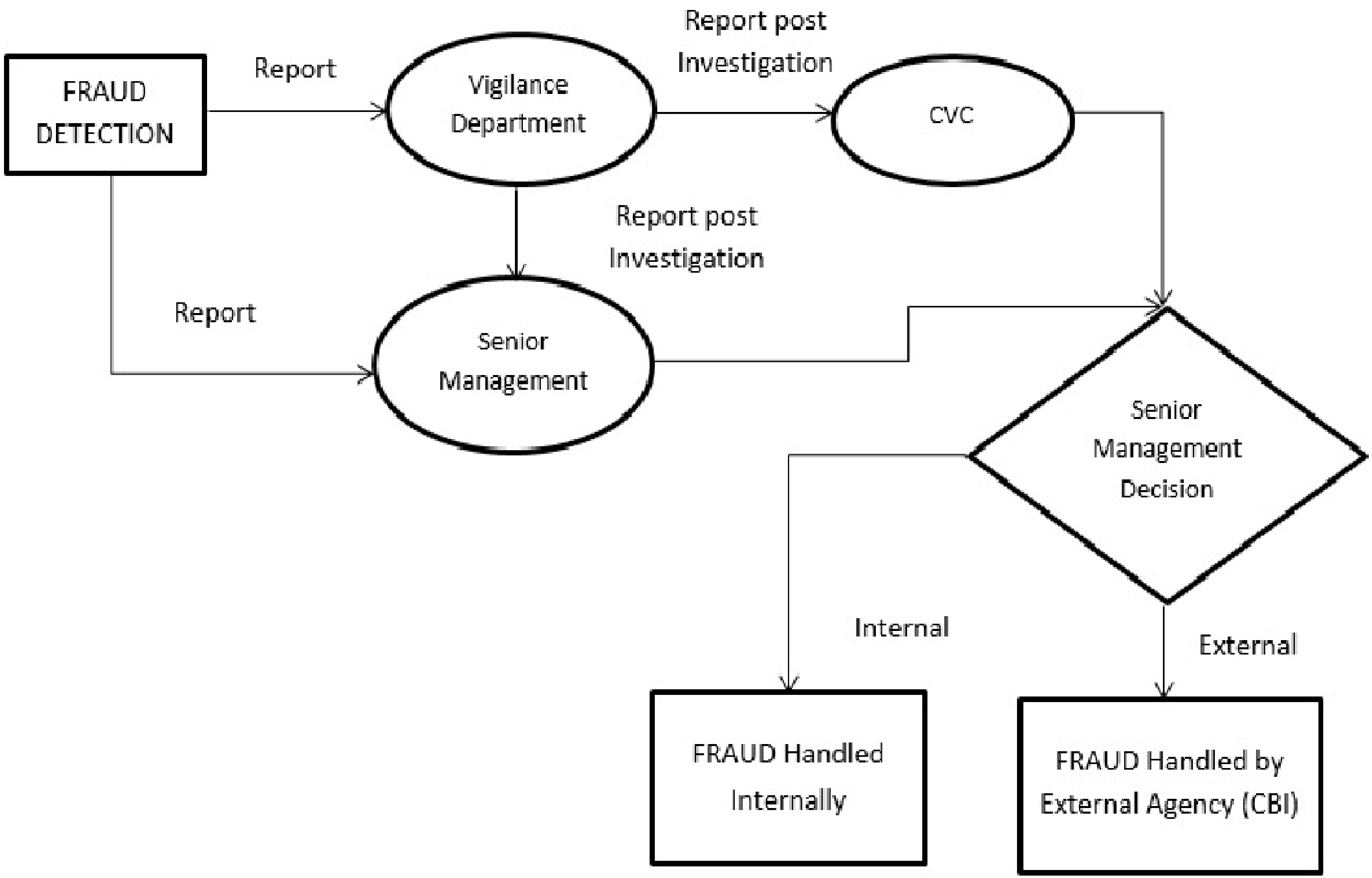
d) A committee of the RBI also independently monitors fraudulent behaviour in banks and reports its observations on quarterly basis to central board of the RBI. The board may

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 PSBs



Source: Author's line-chart.

Table 1: Current Structure for filing Police/CBI complaints

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)

Source: Reserve Bank of India.

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.7

The reason for large NPA's of PSBs could be attributed to greater amount of lending/exposure to mining, infrastructure and power sector projects, whose performance and associated cash flows closely follow the economic cycle of boom and recession. Also, in India, post - 2008 global crisis, a number of governance and other external issues such as policy paralysis, inordinate delay on account of stringent environmental laws/regulation, Supreme Court decision on coal mines as well as weak demand crippled these sectors and resulted into weaker cash flows. These developments severely affected the ability of such firms to service their loans leading to higher NPAs.

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. Also, self-regulatory bodies of advocates, auditors or accountants like bar council and the institute of chartered accountants of India do not generally bar their errant members. Also, in this context, cost of pursuing such individuals and delay caused by courts often deter the PSBs.

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 different corporate banks where two main types of auditors work to look into financial statements of its borrowers. They work as per their scope and knowledge. They can be held responsible for any misreporting under common legal framework due to faith placed on them by banks. Following are the two types of auditors:

i. Statutory auditor – These look into financial statements of all borrowers who borrow from a bank. These are external auditors.

ii. Concurrent auditor – These help supplement for 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 provide an external view on statements reported by the borrowers to the bank.

4. 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 an NPA. Such breach of contract is another instance of fraud since the funds are not utilized for the purpose they were initially set up and based on the project evaluated by the banker.

5. Legal aspects of fraud and role of investigation 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's fraud get 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 due to lack of 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 a poor coordination and delay in investigation. This results a 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.

6. Judicial system: The long and elaborate judicial process is an another major deterrent towards timely redressal of fraud cases. The delay in judiciary to prosecute those guilty of fraudulent practices, could lead to dilution of evidence as well as significant cost building on part of the victim bank.

Also, wilful default is still not considered as a criminal offence in India. Fraudsters, both big and small, take undue advantage of these means of evasion and commit maligned activities without risk of conviction.

7. Technological and coordination perspective: RBI has an elaborate set of early warning signals (EWS) for banks to curtail frauds. However as of now, there are inadequate tools and technologies in place to detect early warning signals and red flags pertaining to different frauds. The authors' interaction with a former chairman of a big public sector bank shockingly revealed that there is only one provider of vigilance and monitoring software for banks and price discovery is poor. Even the biggest of public sector banks cannot afford to buy that software. Also, lack of coordination among different banks on fraud related information sharing is an another major roadblock.

Suggestion for an early detection of frauds by IIM- Bangalore

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 how to 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.

Suggestion for an early detection of frauds by IIM- Bangalore

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 analyzing 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 incentivizing 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.

Suggestion for an early detection of frauds by IIM- Bangalore

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 punitive measures for third parties: The government should consider examining the role of third parties such as chartered accountants, advocates, auditors, and rating agencies that figure in accounts related to bank frauds, and put in place strict punitive measures for future deterrence. There is also a case to be made to question the certification/credentials of third parties like auditors to decide their competence in evaluating accounts containing potentially fraudulent entries.

g) 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.

Suggestion for an early detection of frauds by IIM- Bangalore

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 willful 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.

h) 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 specialized investigating agency is also needed with expertise from agencies such as CBI, RBI, SEBI and commercial banks.

Suggestion for an early detection of frauds by IIM- Bangalore

i) 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.

j) 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.

k) 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.

Suggestion for an early detection of frauds by IIM- Bangalore

l) Coordination between agencies: there needs to be a confidential coordination between banks and agencies such as the Central Board of Direct Taxes (CBDT) to share vital information on personal wealth of promoters. In case of any information that may raise red flag, the CVC and the RBI should jointly investigate the promoters for fraudulent activities.

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.

Scope of Forensic Audit

The scope of Forensic audit will extend to following aspects relating to a borrower:

1. Capacity to pay: Examine as to if the borrower has defaulted in meeting its payment/repayment obligations to the bank even when it has the capacity to honor the same.

2. Money trail & End use of funds financed by the Bank/lenders.

3. Diversion of funds: diversion of funds on the part of borrower would be construed in any of the undernoted occurrences

4. Utilization of short term working capital funds for long term purposes not in conformity with the terms of sanction;

5. Deploying borrowed funds for purposes/activities or creation of assets other than those for which the loan was sanctioned.

6. Transferring borrowed funds to the subsidiaries/group companies or other corporate by whatever modalities.

7. Routing of founds through any bank other than the lender bank or members of consortium without prior permission of the bank/lenders.

Scope of Forensic Audit

8. Investment in other companies by way of acquiring equities/debt instruments without approval of lenders.
9. Shortfall in deployment of funds vis-à-vis the amounts disbursed/drawn and the difference not being accounted for.
10. Siphoning off funds: siphoning off funds on the part of borrower would be construed to occur if any funds borrowed from bank are utilized for purposes un-related to the operations of the borrower, to the detriment of the financial health of the entity and /or the lender.
11. Capital Structure: Tracing the source of contribution by promoters by analyzing equity/debt infused by promoters/partners.
12. Abnormal trade transactions: commenting on transactions of substantial amount, which seem not to be normal trade transactions at arm's length.

13. Sales: Verifying revenue from operations including checking sale order, invoices and controls in billing process. The focus should be on inflated turnover/ fictitious sales and /or sales on Return (SOR) basis where profit has been booked and sales returned in the subsequent accounting period leading to writing off of stocks/debtors and reversal of booked profits. The sustainability of sales in future years should be co-related with Technical and Viability (TEV) study.

Scope of Forensic Audit

14. Finding details of assets of unit / its promoter(s)/partners to ensure recovery of loans granted by banks as there would be cases where some assets are not reported in financials of the unit /promoters / partners.
15. Examining chain of transactions pertaining to unit /promoters/partners to ensure genuineness of the dealings as there could be cases of bogus family/other transactions.
16. Examining stocks /inventory & purchase transactions in particular with related parties/sister concerns.
17. Identifying the type of fraud that has been operating, how long it has been operation for, and how the fraud has been concealed.
18. Quantifying the financial loss suffered by the bank.
19. Gathering evidence to be used in court proceedings.
20. Providing advice to prevent the reoccurrence of the fraud.
21. The list is indicative only and a Forensic Auditor may be assigned other jobs also within the ambit of Forensic Audit.
22. Details of all transaction with banks other than our bank.
23. Concentration transactions- sole customer, sole supplier, major transactions with related parties/group companies, analysis of relationship in two-way deals with the same party or indirect payments made by customers of the borrower to the vendors of borrower,
24. Details of substantial debts raised in sister/associate/group companies either through corporate guarantee of borrower or against security of promotors or promoters's family assets

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