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"Industrial Loans Fraud Detection Framework for Public Sector Banks"

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Abstract

Industrial loan Frauds incidents are on the rise with cases mostly spanning over Public Sector Banks (PSBs). Generally PSBs consider loan fraud risk as inherent risk but in recent times the amount involved has increased substantially and had a serious impact on bank's profitability. Public Sector Banks in India are failing to manage loan frauds effectively. The rising incidents of loan frauds is a clear indicator of growing problem in Public Sector Banks and has been a matter of discussions at government and regulator's level. But questions related to early detection and corrective measures remain unanswered that raise concerns of stake holders regarding effectiveness of Fraud detection approaches. This paper is an attempt to explore and study various approaches of fraud detection. This paper proposes a hybrid conceptual framework based on governance, compliance and fraud risk management to facilitate early detection of loan fraud. Finally the guide lines have been presented for successful implementation.

Keywords: *Loan frauds, Public sector Banks, Fraud Risk Management, Governance, Compliance;*

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1. Introduction

Banking sector plays role of backbone as it supports the financial sector and contributes to the economic growth of India. It plays leading role in planning and implementing financial policy in all economic systems of India. Indian banking sector has grown at a brisk pace and has undergone significant changes in last two decades. However, this has come with serious issues, like loan frauds in Indian banks have seen significant rising trend and there is an urgent need to address these issues. Loan frauds involving large amounts have resulted in rising NPAs. Size of loan frauds compared to the total volume of NPAs is relatively small, but these frauds have been increasing, and high profile fraudsters are not getting penalized[1][2][3].There is an imperative need to explore and analyze factors that leads to industrial loan frauds in public sector banks. This is an open area of research and requires a continuous effort as the fraud landscape in banking sector is not static and changes with time. There is need to study and evaluate existing frameworks and practices related to early detection of industrial loan frauds in public sector banks.

The matter of Non-Performing Assets (NPAs) in the Indian banking industry is critical and needs scrutiny. Banks' capacity to lend funds is inversely proportional to NPAs and hence rising NPA has affected Bank's lending capacity [3]. Indian government and regulatory bodies are also examining the performance of public sector banks with respect to their rising problem of NPAs, and loan recovery mechanisms available. The strength of a banking system of the country helps determine its production and consumption of goods and services and it further affects well-being and living standards. Therefore, if the rising trends of NPAs in banking system is not controlled, this may lead to dip in economy [8][9].

Indian economy suffers to a great extent from these problems, and this served as the prime motivation for the authors to carry out this detailed study of frauds in the Indian banking system and examining frauds from different angles. This study takes into consideration, different aspects of Indian Public Sector banks. Specifically for this study, primary semi-structured interviews were conducted with bankers and industry veterans to better understand sector dynamics. Finally, an attempt has been made to prepare hybrid framework for fraud risk management with focus on early detection of loan frauds.

2. Literature Review

As per Reserve Bank of India (RBI) records it is clear that State Bank of India has highest amount of gross NPAs [5] among all the public sector banks followed by Punjab National Bank as shown in figure 1.

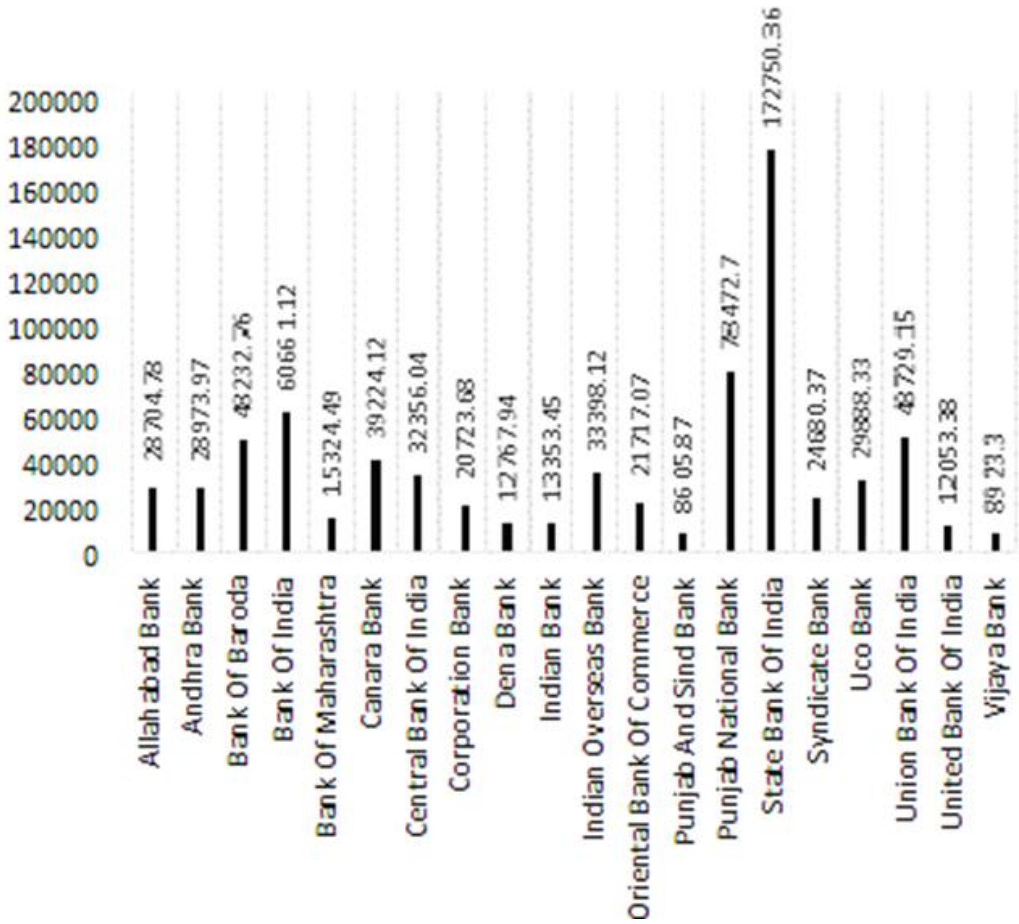

Figure 1. Net NPA in public sector banks (2019), RBI data.

RBI has been issuing policies and guidelines to address loan frauds, and as a result numbers of banking fraud cases have declined, but amount of money lost has increased [13]. An initial investigation in these cases has revealed involvement of both midlevel employees and senior most management. The rising trend of NPAs in PSBs is severely impacting their profitability [6][7]. Loan Fraud is an intentional act by the borrower where there is a scam of funds involved. In a case PNB officials were involved in issuing fake Letter of Undertakings worth Rs. 11,000/-crores. Other examples include Vijay Mallya accused of defrauding a consortium of lenders for Rs.9,000/-

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crores and Rotomac Global accused of cheating a consortium of 7 lenders for Rs. 3700 crores [10][11]. Profitability of a bank is measured by its Return on Assets (RoA), which is the ratio of the bank's net profits to its net assets [12]. Banks have witnessed a decline in their profitability in the last few years (Figure 2), making them vulnerable to adverse economic shocks and consequently putting consumer deposits at risk.

Figure 2 – Trend of Gross NPAs and Return on Assets from 2008-2017

As per recent survey of fraudsters by KPMG 58% of the fraudsters belong to senior management or executive Directors and 93% of frauds were materialized because of weak internal controls and collusion practices by internal people [14]. This clearly indicated failure of governance and internal control practices. The survey also highlights various means of detecting fraud like Management review, Formal whistle blowing report/hotline, Internal audit, External audit, Proactive Forensic Audit and Data analytics.

KPMG in their research proposed a framework for loan fraud and focus is on operational techniques

and data analysis for detecting frauds [15]. The framework specifies various activities into following four sections.

- Bank statement: This includes analysis of bank statements that may cover tracing cash transactions, identifying customers operating with multiple bank accounts, tracing history of credit and payments. It may further include tracing of inward and outward transactions of an account.
- Public domain checks: This includes analysis of data outside the system and may include cases of negative media reports and data related to disputes and litigation. This may include further data available in public domain like mandatory disclosures, reports submitted to regulatory bodies and data related to associated entities.
- Review of financial and accounting records: this may include analysis of financial statement and other related documentation like insurance coverage, Project cost and audit reports.
- Physical review: This analysis includes field visit and monitoring market operations. This may include study of project changes, recurrent management changes, comparison of borrower and competitors.

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The framework presents effective guidelines to detect loan fraud but lacks governance and collusion practices and fraud risk management perspectives. Hence there is scope of enhancing the framework.

3. Case study: Ram Dev International Loan Fraud Case

In a recent Loan Fraud case State Bank of India registered a complaint of loan fraud against Ram Dev International, a Haryana based Rice Mill Company [16].They are exporter of Basmati rice to the Middle East and European countries. The CBI booked Mr Naresh Kumar (MD), Mr Suresh Kumar (Director) and Ms Sangita (Director) for cheating six banks for Rs 411 crores. SBI has filed a complaint against defaulters with CBI but they have already left the country and moved to Dubai. On January 27, 2016 the account became NPA. Ram Dev International Rice Mill has cheated SBI for Rs 173.11 crores by showing loans from banks as a capital infusion via circular movement of fund transfers. They also removed all the machinery from the old plants and fabricated balance sheets to gain at the cost of the bank's funds unlawfully. The case came into light when SBI ordered a special audit and found falsified accounts of the accused. Ram Dev International has been involved in loan frauds with six banks for crores of rupees as shown in figure 3 below.

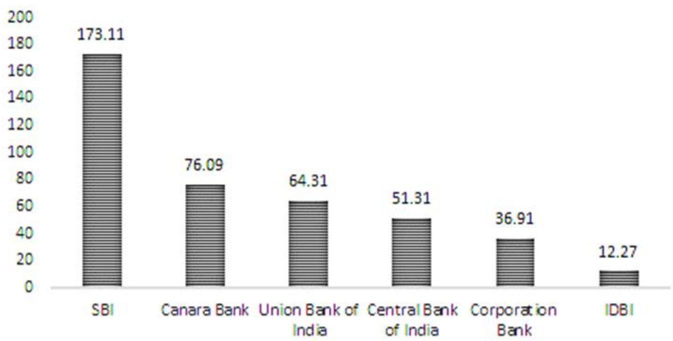

Figure 3 – Loan fraud by Ram Dev International (amount in crores)

4. Fraud Detection Framework

Recently there has been rise in cases of large companies with their politically-influenced relationships with some PSBs to get huge amount of loans and misuse those funds. This results in benefit in good times and leaves it to their banks to take the hit in bad times. This results in loss of huge amounts of public money. Proposed Fraud Detection framework mentions practices to detect such cases as early as possible. Fraud Detection framework is based on proactive real time monitoring of loan cases to facilitate early detection of fraudulent practices. Fraud Detection framework has three components shown in figure 4 and these detection frameworks take inputs from data of Fraud Prevention practices, Loan Database that contains data related to all loan cases (sanctioned and under processing cases) and historical Fraud Case Database.

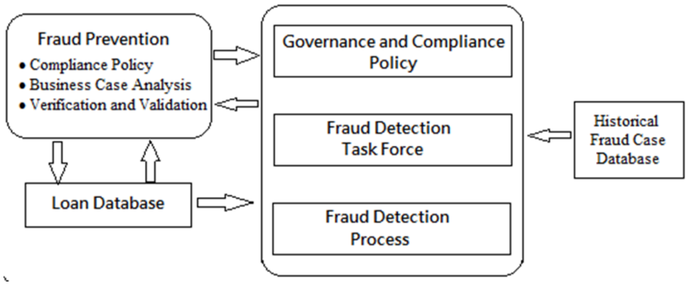

Figure 4. Fraud Detection Framework

Components of Fraud Detection Framework

- **Governance and Compliance policy:** This component emphasize on need for an ethical corporate culture and guidelines for setting it up. This also covers identification of the roles and responsibilities of different parties throughout the organization with regard to managing fraud risk, and guidelines regarding performance measurement of fraud risk management process. This component also cover various policies focusing on following points,
    - Fraud prevention and detection practices should be part of the daily responsibilities of employees at all levels of the organization.

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- Employee anti-fraud education and training should be organized regularly based on recent incidents and trends.
- Ethics policy should try to cover code of ethics pertaining to the organization under consideration with reference to regulatory compliances.
- Code of conduct should be defined with guidelines to ensure uniform culture throughout the organization.
- Whistle blowing policy should cover concerns related to security and protection of whistle blower and guidelines should try to encourage and facilitate whistle blower.

- **Fraud Detection Task Force:** This represents team of skilled professionals having required skills related to fraud detection like domain knowledge, data analysis, psychology, sociology and thorough understanding compliances and legal requirements associated with process. Task force team members should recruit and selection with thorough assessment and background check. Regular skill up gradation and advance training should be imparted to keep them competent.
- **Fraud Detection Process:** Fraud detection in banking is a critical activity that can span a series of fraud schemes and fraudulent activity from bank employees and customers. Fraud Detection Process includes use of various proactive data analysis tools and techniques. Analysis may include Descriptive Analysis, Predictive Analysis and Prescriptive Analysis. Data Analysis may include following activities to detect fraud incidents.
  - Extraction and Transformation of all available data types from various sources and incorporate them into the analytical process.
  - Continuous monitoring of transactions over various platforms and social networks and apply behavioral analytics to facilitate real-time decision making.
  - Data visualization at all levels in the organization, including proactive forensic assessment of financial transactions.

5. Conclusion

The dimensions of loan frauds in the public sector banks are ever changing. Over the years, loan frauds in the sector have become more sophisticated and have been the primary reason for increase in NPAs with cases of fraudulent diversion of funds by the borrowers. In most cases, banks rely on credit monitoring teams but this is not enough and require further upgrade to build mechanism to monitor and evaluate red flags in a systematic way. Proposed conceptual framework provides multi-dimensional perspective for early fraud detection and helps in reducing loan fraud risk. Successful implementation of proposed framework with support of top management shall help in minimizing impacts of loan frauds.

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