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cutting through complexity

KPMG in India

Framework for loan fraud

Raise the (red) flag

The banking sector is currently facing pressure on credit deployment. The year on year increase of 12.6 per cent, is the lowest in the last 18 years. Deposits mobilisation is at a 19 year low. These two factors are leading to pressure on net interest margins.[1]

Over the last few years, NPAs in banks have shown an increase, leading to additional impact on the bottom lines of banks. Gross NPAs stand at 4.45 per cent as on March 2015 as compared to 4.1 per cent in the previous year.[2] Further, Gross NPAs for Public Sector Banks as on March 2015 stood at 5.17 per cent while the stressed assets ratio stood at 13.2 per cent. This is nearly 230 bps more than that for the system.

In a recent speech, Mr. S.S. Mundra (RBI Deputy Governor), challenged the statistics. He referred to a recent IMF report about high levels of corporate leverage which indicated that "36.9 per cent of India's total debt is at risk, which is among the highest in emerging economies while India's banks have only 7.9 per cent loss absorbing buffer, which is amongst the lowest".[3]

A variety of factors are leading to an increase in NPAs. A key factor, is increased incidence of frauds and fraudulent diversion of funds by the borrowers.[3]

In the recent past, various banks, on the directive of RBI or on their own accord, have conducted forensic audits. RBI has provided guidance on classifying and reporting frauds. It has also provided a uniform provisioning norm in respect of all cases of fraud. However, the spate of financial frauds is not showing signs of abating. This coupled with delays in detection and reporting is making matters worse as information is not shared with other banks on a timely basis to nip matters in the bud.

RBI has gradually been increasing its focus on frauds committed on banks by borrowers and has over a period of time set up various mechanisms towards mitigating this risk. The new concept of 'Red Flagged Account' (RFA) has been introduced in the existing fraud risk management framework to deal with loan frauds in relation with exposures in excess of INR 50 crore.

A key requirement for the RFA is that it proactively identifies loan accounts with Early Warning Signal (EWS) or typical 'red flag(s)' (a term used for describing any anomaly, unusual pattern or a warning signal).A bank is expected to evaluate such signals in a pre-determined time period to ascertain incidence of fraud, if any, and it's appropriate reporting to the RBI.

Post receipt of such information, RBI could disseminate (new) modus operandi to the banking sector with an objective to create awareness and assist in reducing fraud prevention.

In the current environment, banks monitor the account through credit monitoring teams but the traditional set up would require further upgrade to build parameters which may not be currently monitored or evaluated as a trigger or signals in a systematic way. In our view, a holistic model needs to be developed and credit monitoring teams trained and equipped to handle several components required to identify EWS.

RBI circular issued on 7 May on loan frauds provides a new component in the framework for fraud risk management.

Framework directs Bank's focus to prevent, detect and reporting to RBI of fraud in loan portfolio with accounts above exposure of INR 50 crore.

RBI requires banks to monitor Early Warning Signals (EWS), evaluate if the account is appropriate to be Red flagged and thereafter conduct investigation to assess the facts and appropriately report the case to the authorities.

1. http://timesofindia.indiatimes.com/business/india-business/Bank-credit-growth-lowest-in-18-years-as-companies-borrow-less/articleshow/46939402.cms; https://www.rbi.org.in/Scripts/BS_PressReleaseDisplay.aspx?prid=33706
2. https://rbi.org.in/Scripts/BS_SpeechesView.aspx?Id=955
3. https://www.rbi.org.in/scripts/NotificationUser.aspx?Id=1665&Mode=0

New structure

Our analysis of the EWS and investigative experience indicate that banks may need to extend due diligence procedures and have illustrated measures that can be adopted to identify signals for further evaluation. (See picture). Historically, the focus on borrower analysis has been tilted towards books, records and bank transaction analysis. However, these operate in conjunction with data gathering through market intelligence and regular public domain checks to provide better insights into loan account operations. In this manner, potential red flags can be appropriately identified. Our experience of conducting various investigations indicates that typically, capability within the credit monitoring team to perform adequate and enhanced background checks and gather market intelligence on prospective borrowers is lacking. This area will require further emphasis in the pre-sanction stage.

01

Bank statement analysis

- Promoter cash contribution analysis
- Fund tracing - inward and outward
- Payment and credit history
- Interest coverage and payment
- Multiple bank account operations
- Huge cash withdrawal

02

Review of books and records

- Financial statement analysis
- Insurance and security coverage
- Project cost benchmarking
- LC/BG structure and operations
- Debtors and creditors turnover
- Complex entity structure
- Qualified internal and external audit reports

03

Public domain checks

- Litigation and disputes analysis
- Adverse media reports
- Related and associate entity identification
- Validation of ROC information with financials
- Inadequate public discloures
- Regulatory/trade sanctions

04

Market and intelligence field visit

- Enforcement action on borrowers
- Frequency project profile change
- Physical verification access not available
- Frequent management changes
- Borrower and competition analysis
- Inter-connected entities and relationship identification

Source: KPMG analysis

With regulatory developments like Companies Act (especially Section 177), entities with borrowings above INR50 crore from Banks and public financial institutions are required to have a vigil mechanism to report frauds. To leverage on this provision of the Companies Act, the banks could mandate borrowers to have a vigil mechanism as a pre-condition to sanctioning high value loans, as well as request periodic declaration by borrowers to monitor them.

RBI has also emphasised the need for a whistle blower policy to be set up within a bank to empower employees to report fraudulent activities. Our experience indicates that whistleblowers are normally apprehensive about passing on information within the internal set-ups. Typically an independent third-party whistleblower facility reinforces confidence amongst employees to speak up.

The Circular emphasises on the role of auditors and reporting obligations of the top management and audit committees. It indicates that audit teams, as part of routine transactions reviews, may now be looking closely at high value loans for existence of any EWS and effectiveness of the new reporting structures.

Approach by banks

RBI has defined the broad process to be followed by the banks and provided an emphasis on time limit of completing the exercise within six months, subsequent to which staff accountability is to be determined. RBI has recommended that external help can be considered by way of Forensic Experts for investigation and Forensic investigation is a key tool for appropriate evaluation and categorisation of loan accounts.

Requirements	Sole lender	Consortium
EWS evaluation	Fraud monitoring Group	On individual bank level ('reporting bank')
Timeline for RFA classification	Within a month from EWS identification	Reporting bank to request a joint lender meeting which is to be held within 15 days of request by the reporting bank
Classification	Forensic reviews to help a bank determine whether the account is fraudulent or not	Account to be categorised as fraud if consensus by joint lenders. Else, if 60% of lenders agree, a Forensic review to be commissioned and to be completed in 3 months
Remedial and Investigations	Within 6 months from reporting of an account as, RFA	
Reporting	Reporting to Special Committee of the Board for monitoring and follow ups of Fraud (SCBF) and reporting to RBI	RBI reporting and complaint to CBI on behalf of all banks in consortium

Our experience indicates that valuable evidence is at times diluted due to delays and non-coordinated efforts of various agencies/ institutions involved in the process. It is expected that staff accountability assessment from a criminal or internal inquiry perspective should operate in parallel and various banks should set up a point of contact for coordination with authorities.

Strict measure in place to avoid recurrence

RBI has brought in penal provisions on borrowers that could be serve as deterrents, and has also taken away some leeway or negotiation powers from the banks:

- Borrowers who become fraudsters will be 'debarred' for a period of five years from the date of full payment of the defrauded account and if the full payment is not made, then the promoters and whole time directors would not have access to the financial system at large for borrowing funds for any future purpose.
- Restructuring or new facilities cannot be given to RFAs
- Compromise settlement only allowed if criminal complaint continued.

Road ahead

Setting up of a central fraud registry is a welcome move, in addition, a statement of intent that the CBI may have a nodal officer/department to handle bank complaints on fraud cases could bring in synergies. The litmus test may be the swiftness of these actions and providing an operating structure for these intentions.

Further, in addition to ramping up capability to perform detailed financial and transaction reviews, banks may be required to invest in building expertise to gather market information and conduct regular intrusive public domain checks to identify EWS. Given the volume of business and the threshold of INR50 crore for monitoring, in our view, to be able to effectively implement the regulatory requirements, the credit monitoring teams may require ongoing investments in training, technology and tools. Fraud prevention is the first step to create a healthy portfolio of accounts, and EWS and RFA mechanism would assist in improving the quality of banks' earnings and assets.

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