# Law and Policy Relating to Bank Fraud and its Prevention and Control

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**ABSTRACT:**

Banking fraud is a critical issue before the Country. But the pace of development for an effective mechanism to fight it is negligible. Banking frauds affect the modern quality of life and imposes a detrimental effect on the national growth. A number of strategies can be developed by both the Reserve Bank of India and Government of India to curb the menace of Banking Frauds. However, these strategies can only be effective if they strengthen the development of a more effective banking system in fact, within the banking system fraud is one of the areas which need immediate urgent attention. Indian Penal Code, 1860 does not recognize Banking Fraud as a separate offence. Different provisions of the Indian Penal Code, 1860 are attracted depending upon the facts of each case of Banking Frauds. This shows that till now, there is no independent legislation to deal with Banking Frauds exclusively and comprehensively. In general, Banking Frauds constitute white collar crime committed by unscrupulous persons smartly taking undue advantage of loopholes existing in the current banking system as well as in procedure. In the absence of independent legislation to address Banking Fraud, the umbrella penal legislation in India i.e. the Indian Penal Code provides diverse provisions to redress this conspicuous issue. It is crystal clear that Banking Fraud is an activity which is a combination of various elements of civil and criminal ingredient, which adversely affect the interest of public, public money and state exchequer. Keeping in view the above stated the paper is an attempt to highlight the law and policy regarding bank fraud. The author will prove scientifically with some cases that there is existing legislative gap which need to be filled. At the end of paper certain suggestions are provided as well.

**"Offences Related To Banking Activities Are Not Only Confined To Banks But Have A Harmful Impact On Their Customers And Society At Large"[1]**

## I. INTRODUCTION

Fraud is a worldwide phenomenon that affects all sectors of the economy. It is an act of deceiving illegally in order to make money or obtain goods[2].A banking institution is an indispensable industry in the modern society. It is the blood vascular system of our economy[3]. Banks are the engines that drive the operations in the financial sector, which is vital for the economy. With the nationalization of banks in 1969, they also have emerged as engines for social change. After Independence, the banks have passed through three stages. They have moved from the character based lending to ideology based lending to today's competitiveness based lending in the context of India's economic liberalization policies and the process of linking with the global economy[4].

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[1] http://articles.economictimes.indiatimes.com/2013-10-14/news/43027531_1_offences-bank-employee-moralturpitude
[2] Mohan Lai Bhasin, "Cheque Frauds in Indian Banking", Journal of Professional Banker. Sept. (2007), p. 45 , Hyderabad
[3] B Manoharan. "Prevention of Frauds in Public Sector Banks", Journal of Professional Banker. Sept. (2007), p. 17, Hyderabad
[4] B. R Sharma., R.P Nainta."77/e Principles of Banking Law and Negotiable Instruments Act". (2006), p. 120, Allahabad Law Agency, Faridbad, Haryana

While the operations of the bank have become increasingly significant, there is also an occupation hazard. There is a Tamil proverb, which says that a man who collects honey will always be tempted to lick his fingers. Banks are, all the time dealing with money, a temptation should therefore be very high. Oscar Wilde said that the thief was an artist and the policeman was only a critic. There are many people who are unscrupulous and are able to perpetrate a fraud. The bank should devise systems and procedures in such a way that the scope for such clever and unscrupulous people is reduced.

A sound banking system should possess three basic characteristics to protect depositor's interest and public faith. These are (i) a fraud free culture, (ii) a time tested Best Practice Code, and (iii) an in house immediate grievance remedial system. All these conditions are their missing or extremely weak in India. Section 5(b) of the Banking Regulation Act, 1949 defines banking. According to it “banking means the accepting, for the purpose of lending or investment of deposits of money from the public, repayable on demand or otherwise, and withdrawable by cheque, draft, order or otherwise." But if his money has fraudulently been drawn from the bank, the latter is under strict obligation to pay the depositor. The bank therefore has to ensure, at all times, that the money of the depositors is not drawn fraudulently. Time has come when the security aspects of the banks have to be dealt with on priority basis.[5]

## II. Fraud: Meaning and Definition

Fraud is a dishonest act, by which one person gains or intends to gain over another person. In other words, fraud is an act or omission which is intended to cause wrongful gain to one person and wrongful loss to the other, either by way of concealment of facts or otherwise Fraud is defined as ‘the use of one's occupation for personal enrichment through deliberate misuses or misapplication of the employing organizations resources or assets.8 This sort of occupational fraud results from the misconduct of employees, managers or executives.9 The term ‘fraud’ has not been defined in the Indian penal code directly. However, sections dealing with Cheating (sec.415 to sec.420), Concealment (sec.421 to sec. 424), Forgery (sec.463 to sec. 477A), Counterfeiting (sec.489A to sec.489E), Misappropriation (sec.403 to sec.404) and Breach of Trust (sec. 405 to sec. 409) cover the same adequately. The term ‘fraud’ has been defined in section 17 of the Indian contract Act follows:

“Fraud” means and includes any of the following acts committed by a party to a

Contract, or with his connivance or by his agent, with intent to deceive another party

Thereto or his agent, or to induce him to enter into the contract:

i. The suggestion, as a fact of that which is not true or by one who does not believe it to be true;

[5] Banking Regulation Act, 1949, Section 5(b).

ii. The active concealment of a fact by one having knowledge or belief of the fact;

iii. A promise made without any intention of performing it;

iv. Any other act fitted to deceive; and

v. Any such act or omission as the law specially declares to be fraudulent.

However, mere silence as to the facts likely to affect the willingness of a Person into a contract is not fraud unless there is a duty to speak or his Silence is, itself, equivalent to speech[6]

**Essential Elements of Frauds**

In the above statement of law, four essential elements stand out clearly as follows:

i. There must be a representation or assertion;

ii. It must relate to a fact;

iii. It must be with the knowledge that it is false or without belief in its truth; and

iv. It must induce another to act upon the assertion in question or to do or not to do certain act.[7]

In Derry v. Peek, Case[8] Lord Herschell observed "Fraud" means a false statement made Knowingly or without belief in its truth, or recklessly careless, whether it be true or false. The fraudulent misrepresentation is a false statement which is made by a person who does not believe it to be true.

## III. Bank Fraud: Meaning and Concept

**(i) General**

Fraud is a dishonest act and behavior by which one person gains or intends to gain an advantage over another person. The gain may accure to the person himself or to someone else. Fraud causes lose to the victim, directly or indirectly. In earthly terms bank frauds include all sort of misappropriations, embezzlements, manipulations, of negotiable instruments (cheques, drafts, hundies, bills or statements of accounts, securities,etc). Frauds also include misrepresentations, cheating, thefts, undue favours and irregularities.[9]

**(ii) Meaning and Concept**

A bank fraud is a deliberate act of omission or commission by any person carried out in the course of a banking transaction or in the books of accounts maintained manually or under computer system in bank, resulting into wrongful gain to any person for a temporary or otherwise, with or without any monitory loss to the bank.

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[6] Sec. 17 of Indian Contract Act, 1872

[7] *Ibid*

[8] Derry v. Peek, (1889) 14 AC 337 : 5 TLR625.

[9] B.R. Sharma, "Bank Frauds Prevention & Detection", (2009), p. 3, Universal Law Publishing Co. New Delhi

Losses sustained by banks as a result of frauds are the losses due to robbery, dacoity, burglary and theft-all put together. Unauthorized credit facilitate are extended for illegal gratification such as cash credit allowed against pledge of goods, hypothecation of goods against bills or against book debts. Common modus operandi are, pledging of spurious goods, inflating the value of goods, hypothecating goods to more than one bank, fraudulent removal of goods with the knowledge and connivance of or negligence of bank staff, pledging of goods belonging to a third party. Goods hypothecated to a bank are found to contain obsolete stocks packed in between good stocks and cases of shortage in weight are not uncommon.

Frauds in deposit accounts take place by opening of bogus accounts, forging signatures of introducers and collecting through such accounts stolen or forged cheques or bank drafts. Frauds are also committed in the area of granting overdraft facility in the current accounts of customers. A large number of frauds have been committed through bank drafts, mail transfers and telegraphic transfers.[10]

An analysis made of cases brings out broadly, the undermentioned four major elements responsible for the commission of frauds in banks.

a) Active involvement of the staff-both supervisory and clerical either independent of external elements or in connivance with outsiders.

b) Failure on the part of the bank staff to follow meticulously laid down instructions and guidelines.

c) External elements perpetrating frauds on banks by forgeries or manipulations of cheques, drafts and other instruments.

d) There has been a growing collusion between businessmen, top bank executives, civil servants and politicians in power to defraud the banks, by getting the rules bent, regulations flouted and banking norms thrown to the winds.

**(iii) Components of Fraud**

There are two important components in any fraud committed by an employee of a bank himself or in collusion with a borrower. They are firstly, the intention which is subjective; and secondly the opportunity which is objective. Conditions must be created in a bank that the person who intends perpetrating a fraud does not get the opportunity to commit it.

## IV. Fraud Prevention and Detection

A close study of any fraud in a bank reveals many common basic features. There may have been negligence or dishonesty at some stage, On the part of one or more of the bank employees. One of them may have colluded

[10] S.K. Ghosh, "Indian Banking. Crime and Security in Indian Banks". (1990), pp. 31-33.

with the borrower. The bank of official may have been putting up with the borrower's sharp Practices for a personal gain. The proper care which was expected of the staff, as custodians of banks interests may not have been taken. The bank's rules and procedures laid down in the Manual instructions and the circulars, may not have been observed or may have been deliberately ignored. In all such cases, the result would be more or less the same, a fraud and consequent loss of money and prestige. It should, however, be conceded that in spite of all the possible safeguards and precautions that human ingenuity can desire, there may still be a wily customer who may have the upper hand in the battle of wits and succeed in cheating a bank[11].

Bank frauds are the failure of the banker. It does mean that the external frauds do not defraud banks. But if the banker is upright and knows is job, the task of the defaulter will become extremely difficult, if not possible.

## Prevention of Frauds

The following are the ways by which frauds can be averted:

**(i) Recruitment and Selection**

The right type of persons with necessary qualifications and aptitudes should be recruited. Selection of officers should be carefully made on the basis of qualifications, experience, performance, efficiency and reputation. Adequate training to staff at all levels should be provided.

**(ii) Private Lives of Staff**

The private lives of staff should be watched, difficult though it may be. A member of the staff who is a habitual borrower or lives beyond his means can be one who may ultimately let the bank down.

**(iii) No Undue Reliance**

No undue reliance should be placed on bank's staff. Explanations should not be too readily accepted. So that vested interests are not created, agents, clerical staff and officers should be transferred periodically from branch to branch

**(iv) Basic Honesty**

No bank official should think of accepting presents and bribes from the borrowers in the belief that everything is safe and nothing would go wrong. The financial position and dealings of a borrower who invites bank officials too often for drinks and dinners or sends them presents should be closely watched.

**(v) Routine**

The bank's system, routine and procedures should be meticulously followed. The manual of instructions and the

[11] H.L. Bedi and V.K. Hardikar, “practical Banking (Advances)" (1982), p. 472

circulars are the outcome of wide experience of men and matters, which the head office has acquired over a long period.

**(vi) Supervision and Audit**

The checking of books and registers should be done regularly by the authorized officer. The godowns should be inspected without notice. Audit of bank branch is must.

**(vii) Unscrupulous Parties**

The bank should be careful in accepting new customers, particularly borrowers. The customer, who has been noticed to follow undesirable practices or is known to have committed a fraud, should be avoided. It is good for the bank to follow the maxim, “once bitten, twice shy.[12]

**(viii) Danger Signals**

Particular attention must be paid to the accounts wherein the debt balance usually remains very near the sanctioned limit or the drawing limit. When the borrowers cheques start bouncing with reasons like, “exceeds arrangement” or “effect not cleared present again” or when there is a very poor turnover in the account and securities charged, start bank officers have to the watchful.

**(ix) Vigilance**

Vigilance means alertness or watchfulness. This is a mental state and applicable to rank and file. Vigilance is an integral part of the managerial function. The preventive vigilance should ensure that:

a) The business is planned and conducted with proper system and procedures keeping in view corporate vision.

b) Transactions are properly authorized and appraised.

c) Assets safeguarded and liabilities controlled; minimize the risk of losses arising out of irregularities, fraud.

d) Accountability and records provide complete, accurate and timely information.

e) Finally, the bank officer’s eyes and ears have to be everywhere. They cannot afford to be lethargic, complacent or negligent in the discharge of their duties.

## Detection of Frauds

Despite all the care and vigilance, there may still be some frauds, though their number, periodicity and intensity may be considerably reduced. Just as vigilance is very important in the prevention of frauds, calm behavior and

[12] R.P. Nainta, "Bankine System. Fraud and Leml Control” t (2005), p. 57, Deep & Deep Publication New Delhi

attitude are a must in the detection of a fraud. The officer should in no circumstances lose his temper and presence of mind when confronted with difficult situation. The following procedure would be very helpful if taken into consideration.[13]

i. All relevant data-papers, documents, etc. should be promptly collected. Original vouchers or other papers forming the basis of the investigation should be kept under lock and key.

ii. All persons in the bank who may be knowing something about the time, place and modus operandi of the fraud should be examined and their statements should be recorded.

iii. The probable order of events should thereafter be reconstructed by the officer, in his own mind. The next man, if competent honest, and capable of keeping secrets, should be taken into confidence.

iv. It is always advisable to keep the central office informed about fraud and further developments in regard thereto.

## V. RISK IN BANKING SECTOR

Banks have to face many types of risks. A successful bank is one that has the ability to mitigate these risks and create significant returns on consistent basis. Mitigation of risk can be done only on the basis of proper identification of risks, the reason for their arise and what damages can caused by this risk. The major types of risks faced by every bank are credit risks, market risks, operational risks, moral hazards, liquidity risks, business risks and systematic risks. In its bi-annual Financial Stability Report (FSR) released on June 30, 2018 the Reserve Bank of India (RBI) warned that the banking sector is under severe stress, with mounting bad loans and an increase in bank fraud, among other issues. All this, the RBI says, could drag down India‘s economy. In March, 2018, the average bad loans of PSBs stood at 75% of their net worth. These bad loans are squeezing banks profitability and capital positions, threatening the health of India‘s biggest banks.[14]

There are three categories of frauds, namely technology related, KYC related and advances related. Although the number of technology related frauds is the highest among the three, the highest amount comes from advances related frauds. Moreover, the latter involves multiple banks mostly from public sector. There is an urgent need to strictly monitor banks and other financial services institutions so as to ensure that proper corporate governance checks and balances are in place. The board of directors and senior management need to be made more responsible. Exchange of information needs improvement to impress financial discipline. Internal systems and control should be able to identify fraudulent activities and raise timely red flags. Delays in reporting these activities should be minimized as it gives the fraudster enough time to erase her trail making it

[13] Ibid

[14] H.L. Bedi, V.K. Hardikar, “practical Banking (Advances)" (1982), p. 472

difficult for investigative agencies to find convincing proofs. The law should ensure that perpetrators are dealt with strictly and are barred from accessing banking and other financial facilities once convicted of a fraud. RBI has issued various guidelines to deal with these malpractices for all of banking and financial services industry to follow.

## VI. Preventive and Curative Measures vis-a-vis Modern Areas of Fraud

21st Century has witnessed a tremendous change in almost all the walks of life. Technology has promised unprecedented development to the mankind and provided computerization as a fountain of new age wisdom and delivered a flood of new quick and efficient banking services. But this facility also created risks in various banking activities which need well defined and timely precautionary measures. Computer automation providing innumerable services are subject to certain security/precautionary measures against its inbuilt flaws and RBI to explaining the activities suggests the preventive Vigilance steps to be taken to minimize such risks. The precautions to be adopted to avoid/minimize occurrence of computer related frauds involve to a large extent in molding attitudes of the persons engaged in computer field's attitudes needing thorough Overhauls are outlined below[15]:

a) Easy to get away and cannot get caught.

b) Stealing a little from big company would not hurt.

c) Everybody else is stealing, why not me.

d) Computer security is not a priority.

e) Computer will take care of everything-no checking is required.

f) Lack of input control - output verification.

g) Lack of evidence.

h) Lack of access control-audit trails.

i) Lack of dual checks in sensitive and high-value transactions.

j) Long serving trusted operators/supervisors/Managers.

## VII. Computer Related Frauds

To provide efficient and fast service, most of the branches of the banks except the ones in the rural and remote areas have been computerized. Not many frauds relating to computers have yet been reported so far as computerization in the Indian banks is of recent origin. But in the western countries where virtually everything

[15] S.K. Ghosh, "Indian Banking. Crime and Security in Indian Banks". (1990), pp. 31-33.

is computerized, a large number of cyber crimes in the banking sector are reported on a regular basis. There is a need to analyse the nature of such crimes so that appropriate preventive measures may be devised. Normally following types of frauds are committed-

a) Spy software is devised by the cyber criminals to crack the passwords. They enter into the computer system of the banks and manipulate the data to transfer the money from other's accounts.

b) Computer virus is created by the mischief mongers who find way into the computer system by way of e-mails. These viruses destroy the data stored in the computers and slow down the entire computer system. It is sometimes alleged that the manufacturers of anti-virus software themselves create virus so that their product may be sold in the market.

c) Hackers are computer experts who steal the passwords and access the classified information stored in the computer system. They do not even fear to "raid" the government departments including military establishments to carryout their nefarious design to destroy and mutilate the date stored in the computer systems. Such acts are committed normally not for any material gain but to derive mental satisfaction out of other's sufferings.

d) Wire tapping is a crime committed by tapping the wire of the ATMs of the banks to withdraw money out of other person's account. The fraudster, in this case, attaches a wireless microphone to the telephone line connecting the ATM with the bank's computer and records signals through wire tapping while a customer is using the ATM. These signals are later on utilized for withdrawing money.

The Government of India enacted the Information Technology Act, 2000 to provide for punishment and penalties in respect of frauds committed in respect of computers. Section 43 of the said Act provides for hefty damages up to rupees ten lakhs payable by the offender to the person affected in case there are unauthorized acts committed in respect of another person's computer system like access, downloads or taking copies of the information or data stored, introduction of computer contaminant or computer virus, damages to the computer or its system etc. Further, the said Act also provides for punishment with imprisonment upto three years for tampering with computer source documents and for hacking the computer systems.

## VIII. CONCLUSION

From the preceding discussion it is clear that banking fraud is a critical issue before the Country. But the pace of development for an effective mechanism to fight it is negligible. Banking frauds affect the modern quality of life and imposes a detrimental effect on the national growth. A number of strategies can be developed by both the Reserve Bank of India and Government of India to curb the menace of Banking Frauds. However, these strategies can only be effective if they strengthen the development of a more effective banking system in fact, within the banking system fraud is one of the areas which need immediate urgent attention.

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