New framework to combat frauds: A good follow-up

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One of the villains in the Indian growth story is the poor state of capitalization of India's public sector banks (PSBs). Most government majority-owned PSBs are among India's largest banks and also have the largest exposure to stressed assets and sectors. Continued exposure to delinquent borrowers and fraudulent practices by borrowers of the PSBs has contributed to the declining credit quality of the loans made by the PSBs.

To improve the PSBs' situation, the Reserve Bank of India (RBI) has taken steps such as introducing higher provisioning for restructured assets and guidelines for formation of a joint lenders forum to "work out" potentially stressed borrowers before they become non-performing assets. The RBI has also introduced changes to the prescriptions on wilful defaulters to make it more difficult for delinquent borrowers to access the credit markets. These measures apply not only to PSBs but to the banking sector in general (including Indian branches of foreign banks).

Following up on these measures, the RBI issued a circular on 7 May prescribing a framework to identify and deal with fraudulent accounts, and to develop appropriate risk control measures for such accounts. The framework, based on the recommendations of an RBI internal working group, seeks to direct the attention of banks to early detection and prevention of fraud, and prompt reporting to the RBI and any investigating agencies of any instance of fraud, without overly affecting the "normal conduct of business" and "risk taking ability" of banks.

The framework observes that detecting fraudulent bank accounts currently takes an "unusually long time" and that banks tend to report fraud only on exhaustion of all chances of recovery. The framework also notes that the tracking of early warning signals should not be considered as an additional task, but rather must be "integrated with the credit monitoring process in the bank so that it becomes a continuous activity and also acts as a trigger for any possible credit impairment in the loan accounts".

The framework contemplates "red flagging" of accounts on the basis of "early warning signals". While the framework provides an indicative list of such signals – income tax raids, frequent change in the scope of project undertaken by the borrower, frequent invoking of bank guarantees issued on behalf of the borrower, etc. – banks can include further signals based on their experience.

The list of early warning signals appears comprehensive but is bereft of qualitative criteria. For instance, reduction in the promoter's stake is not necessarily an indicator of fraudulent practice. Similarly, "substantial related-party transactions" are common in closely held groups and may not be indicators of fraudulent practice.

The threshold for application of the early warning signals is ₹500 million (US$7.8 million). All such accounts that are red flagged must also be reported to the Central Repository of Information on Large Credits. For accounts below ₹500 million, banks have the discretion to determine the mode for identification of fraud.

Unusually, the framework appears to be a hybrid mix of both prescriptions and principles. Along with detailed provisions relating to red flagging, the framework sets out the following principles: (a) empowerment of bank staff to report fraudulent activity coupled with a whistle-blowing policy that protects whistleblowers and ensures against fear of victimization; (b) auditors reporting instances of fraud to the bank's audit committee; (c) bank's acquiring "market intelligence" and gathering information from the public domain on potential borrowers as part of the pre-sanction appraisal process; and (d) tracking market developments relating to major clients, and continuous monitoring and vigilance at the time of annual review of loan accounts.

To encourage banks to report fraudulent accounts, the framework also contemplates provisioning over four quarters (rather than with immediate effect), for accounts reported as fraudulent, subject to there being no delay in reporting. In case of any delay in such reporting, the reporting bank will have to make provisions with immediate effect.

The framework prescribes that borrowers that default on their loan obligations and are reported as fraudulent will be debarred from obtaining financial assistance from banks and non-banking institutions for five years from the date of full payment of the "defrauded amount". The framework also contemplates the establishment of a central registry on fraudulent accounts that can be accessed by banks.

The issuance of the framework is a good follow-up to the measures already introduced by the RBI such as the joint lenders forum. This is particularly important considering the repeated warnings of international rating agencies on the declining asset quality of Indian banks and the stressed state of infrastructure sector borrowings. Provisions such as the creation of a central registry are far-sighted and welcome moves, and will certainly provide a fillip to the RBI's efforts to leave no stone unturned to inculcate discipline in banks and to improve their asset quality.

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