

BANKING FRAUDS, IPC & FRAUD

PREVENTION

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Banks are an essential part of the Indian economy. After the nationalization of banks in 1969, they have also emerged as vehicles of social change. As the banks always deal with money, temptation is high for some of those associated with banks to find out loopholes in the system to make personal gains fraudulently.

According to N.Vittal, Ex-Central Vigilance Commissioner, our system encourage corruption/fraud due to the following factors-

- (a) Scarcity of goods and services.
- (b) Lack of transparency
- (c) Delay and red tape.
- (d) Cushions of safety that have been built for the corrupt on the principle that everybody is innocent till proved guilty.
- (e) Tribalism and the tendency to shield the corrupt.

What is Fraud?

The term “fraud” as such has not been defined in the Indian Penal Code (In short, IPC). But IPC defines and prescribes punishment for various acts that may lead to commission of fraud. According to Tomlin’s Law Dictionary, Fraud is deceit in grants and conveyances of land, bargains and sale of goods etc. to the damage of another person, which may be either by the suppression of the truth or suggestion of a falsehood. According to section 17 of the Indian Contract Act, it means certain acts committed by a party to a contract or by his agent with the intent to deceive another party or to induce him to enter into contract.

The Reserve Bank of India has classified frauds into the following categories for the purpose of uniformity of reporting by the banks to the RBI and in keeping with the provision of the IPC-

- (a) Misappropriation and criminal breach of trust.
- (b) Forging of documents and instruments and manipulation of the books of accounts.
- (c) Negligence and cash shortages.
- (d) Cheating.
- (e) Irregularities in extension of credit facilities against illegal gratification.
- (f) Cases of frauds not covered above.

It is pertinent to note here that the cases of theft, burglary and dacoity are not covered in any of the above classification but have to be reported separately to the RBI.

IPC and Banking Frauds

Perpetrators of frauds in banking transactions are liable to be prosecuted under the criminal law of the country for which adequate provisions of punishment have been prescribed under the Indian Penal Code, 1860. Some of the important provisions of the IPC in this regard are discussed hereunder-

- (a) Section 403 of IPC-Dishonest misappropriation of property:** According to this provision, whoever dishonestly misappropriates or convert to his own use, any movable property, shall be punished with imprisonment for a term which may extend to two years or with fine or with both. For example, A takes B's property in good faith believing that the property belongs to himself. A is not guilty of misappropriation. But even after discovering his mistake, A dishonestly misappropriates the property to his own use, he is guilty of an offence under this section.

Explanation 1 to the section states that a dishonest misappropriation for the time being only is a misappropriation within the meaning of this section.

For example, A finds a property and takes it with the intention of restoring it to the owner, A is not guilty of offence. But if he appropriates it for his own use without using reasonable means to discover the owner, he is guilty of the offence.

- (b) Section 405 of IPC-Criminal breach of trust:** According to this provision, anybody entrusted with the property dishonestly misappropriates or converts to his own use or dishonestly uses or disposes of that property in violation of any

direction of law prescribing the mode in which such trust is to be discharged, or of any legal contract, which he has made touching the discharging of such trust, commits criminal breach of trust.

For example, A, an executor of a will, dishonestly disobeys the law which directs him to divide the property according to the Will and appropriate the same to his own use, A has committed criminal breach of trust.

Section 406 prescribes punishment for criminal breach of trust which is imprisonment extending to three years or fine or both. Section 409 of IPC prescribes higher imprisonment of upto ten years in respect of criminal breach of trust by a public servant or by a banker or merchant or agent.

- (c) **Section 415 of IPC –Cheating** : According to this provision, whoever, by deceiving any person, fraudulently or dishonestly induces the person so deceived to deliver any property, to any person, or to consent that any person shall retain any property or intentionally induces the person so deceived to do or omit to do anything which he would not do or omit, if he were not so deceived, and which act or omission causes or is likely to cause damage or harm to that person in body, reputation or property, commits cheating.

Examples:

- (a) A, by falsely pretending to be in civil service, intentionally deceives B and thus dishonestly induces B to let him have on credit goods for which he does not mean to pay, A cheats.
- (b) A, by putting a counterfeit mark on an article, intentionally deceives B into a belief that this article was made by a certain celebrated manufacturer, and thus dishonestly induces B to buy and pay for the article, A cheats.

- (d) **Section 463-Forgery** : It is defined as- “ Whoever makes any false document or false electronic record or, part of a document, or electronic record, with intent to cause damage or injury, to the public or to any person, or to support any claim or title, or to cause any person to part with property, or to enter into express or implied contract, or with intent to commit fraud or that fraud may be committed, commits forgery”.

The Madras High Court in *AIR 1968 Mad 349* held that in order to constitute an offence under this section, the document must be false and it must have been made dishonestly or fraudulently and it must have been made with one of the intentions specified in section 463. In *AIR 1979 SC 1890*, Supreme Court held that mere presenting a lottery ticket to the state authority which later on was detected as a forged one does not by itself amount to forgery. The knowledge of forged document is a necessary requirement.

Section 465 prescribes a punishment for forgery which is imprisonment for a term which may extend to two years or with fine or with both.

- (e) **Section 489-A – Counterfeiting of currency notes:** This section provides that whoever counterfeits, or knowingly performs any part of the process of counterfeiting, any currency note or bank note, shall be punished for **imprisonment for life**, or with imprisonment of either description for a term which may extend to ten years, and shall also be liable to fine.

Major types of Bank Frauds and preventive measures

Deposit Account Frauds: Following types of frauds are normally committed-

- (a) Value of cheque deposited is inflated by inserting numbers.
- (b) Nature of cheque is altered by deleting words. For example, crossed cheques are made bearer cheques.
- (c) Name of the payee in the cheque/draft is altered and money is withdrawn by the fraudster.
- (d) A dormant account is fraudulently operated by forging signature.
- (e) Collections of the Mini Deposit Account are not deposited with the bank and misappropriated by the agent.

Following preventive measures may be resorted to-

- (i) The cheques/drafts should be examined under strong light and preferably under ultra violet lamp. In case of material alterations, it will be noticed that the surface of the document is not uniform, there are stains visible,

background printing is disturbed, different inks have been used, handwriting is not uniform and flow of writing is disturbed.

- (ii) There should be surprise checks on cashier's cash and the cashiers should be rotated at frequent intervals.
- (iii) Cash handling operations and book keeping operations should be divorced.
- (iv) Balancing of day books should be done every day in the evening.
- (v) Bank statements should be issued and pass books updated at frequent intervals. The customers should be asked to confirm their balances appearing in the bank statements /pass books.

Frauds relating to loans and advances: Following types of frauds are generally committed-

- (a) A large number of loans advanced under the priority sector lending schemes turn NPAs because either the loans are taken by ineligible persons or used for some social or consumption purpose rather than utilizing it for agricultural operations.
- (b) Proper appraisal of the project for which loan is advanced is not done by the staff for a consideration.
- (c) Collaterals lodged with the bank are inadequate or valueless.
- (d) Value of Hypothecated /pledged stocks is inflated.
- (e) Goods pledged with the bank are removed with the connivance of the bank staff.
- (f) Hypothecated stock is sold but the godown is set on fire to show loss of stock due to fire.
- (g) False title deeds of immovable property lodged with the bank.
- (h) Duplicate title deeds lodged with several banks simultaneously.

Suggested preventive measures are-

- (i) There should be random and regular checking of the pledged and hypothecated goods. The personnel deployed for the purpose should be

men of proved integrity and honesty and such persons should be subjected to frequent rotation.

- (ii) Trained personnel should scrutinize loan applications and check the quantity and value of goods pledged/hypothecated.
- (iii) Project should be properly appraised. Factory site should be inspected before sanction of loan. It is preferable to disburse loan by way of direct payment to the supplier of plant and machinery to ensure that loan is not diverted for any other purpose.
- (iv) Verification of title of the immovable property should be done by obtaining proper search report from the empanelled lawyer of the bank.
- (v) Where loan is advanced against hypothecation of vehicles, lien of the bank should be registered with the RTO office.
- (vi) The hypothecated/pledged goods should be insured jointly with the borrower for fire and burglary.

Frauds relating to purchase Bills

Such frauds are committed normally in the following manner-

- (a) Fraudster discounts the bogus or stolen railway receipts.
- (b) False bills are drawn on sister concerns for the purpose of discounting.
- (c) Bills are inflated in collusion with the supplier.
- (d) Payment is obtained before the bill is presented by the bank for encashment.
- (e) Worthless goods are dispatched and bills discounted on the strength of despatch papers.

Suggested preventive measures:

- (i) Only the transport receipts of the approved transport concerns should be accepted.
- (ii) Normally bills of sister/associate concerns should not be accepted for discounting.

- (iii) The bank should inform the concerned transport company of its charge over the goods so that the borrower may not take delivery of goods without the production of transport receipt.
- (iv) In case of an unknown drawee, a report should be obtained from the banker of the drawee about its bonafide and creditworthiness.
- (v) In case bills are returned unpaid, the amount should be realized from the borrower without delay.

Frauds relating to computers

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 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 are 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 are created by the mischief mongers which find way into the computer system by way of e-mails. These virus 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 upto 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.

Report of the Sub-Group on banking sector frauds

A meeting of the Sub-group constituted by the high level group on frauds in the banking sector was held on 14.12.2001. The group deliberated on the issues like internal control mechanism in banks, inspection & Audit, rationalization of control returns, internal house keeping, delegation of powers, credit related frauds. It suggested, interalia the following measures-

- (a) There is need for periodical review of systems and procedures at certain intervals, say, once a year.
- (b) The main threat to the health of the public sector banks is from high value frauds which mainly relate to advances and foreign exchange operations and also on account of delayed reconciliation of high value inter branch transactions/suspense accounts. It requires special attention of top management.
- (c) There has been proliferation of returns and statements as a result of which, their purpose and importance are often lost sight of. It is desirable to reduce the number

and revise the formats to make them meaningful for scrutiny and monitoring of large value transactions.

- (d) The reconciliation department at the head office should ensure that reconciliation is upto date.
- (e) There has been higher delegation of discretionary powers due to increased volume of business. All exercise of such powers should be reported immediately to the higher authority. Non-submission or late submission of returns should be viewed seriously.
- (f) Normally there is delay in reporting of fraud cases to RBI because of time consumed in preliminary investigation. A time limit not exceeding fifteen days for completion of preliminary investigation and reporting the case to RBI should be set.

As regards audit and inspection, the group observed that the banks have a system of internal inspection and concurrent audit, verification audit, snap audit etc. But these have not been proved to be as effective as expected for early detection of frauds. Substantial loss is caused by the time fraud is detected. The group suggested that the banks should have a competent cadre of inspecting officials who should conduct concurrent audit and internal inspection of branches. The role of Chartered Accountants as concurrent auditors should be to supplement and not supplant the regular internal checks.