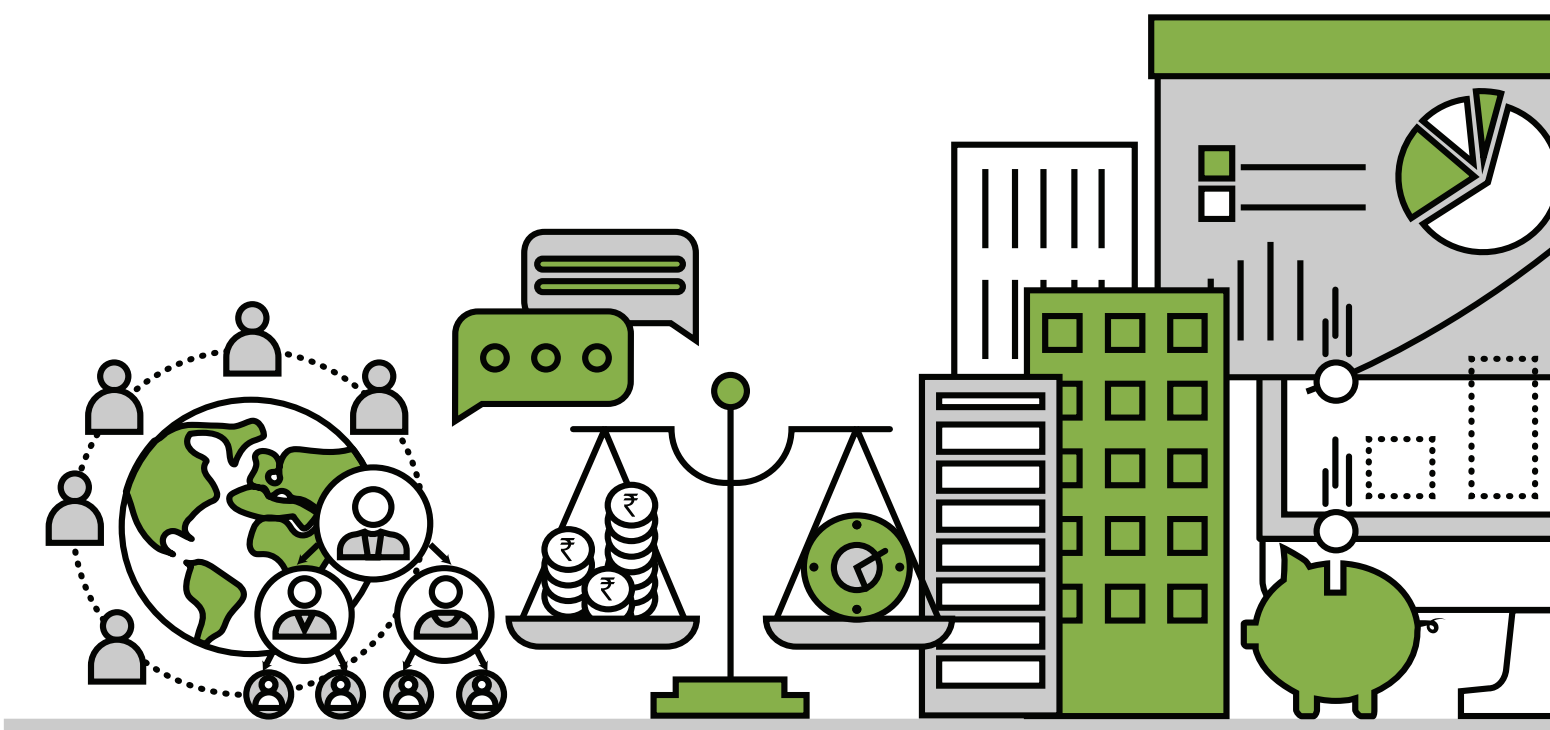




Time to take the bull by the horns Now is as good a time as any

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The pace of change in the banking sector has left banks grappling with multiple fraud-related challenges. While financial crime appears to be a major concern for banks as the number of incidents and value of fraud rises, there appears to be a certain lag in the implementation of fraud risk management measures. The recently released Central Vigilance Commission (CVC) analysis¹ of the top 100 frauds observed across Indian banks reveal certain lapses in control, that facilitated the perpetration of these frauds, key/some of which include:

- 01 Inadequate amount of due diligence and focus on an intelligence gathering mechanism;
- 02 Lack of oversight by line managers or senior management;
- 03 Inadequate monitoring mechanism including early warning signals.

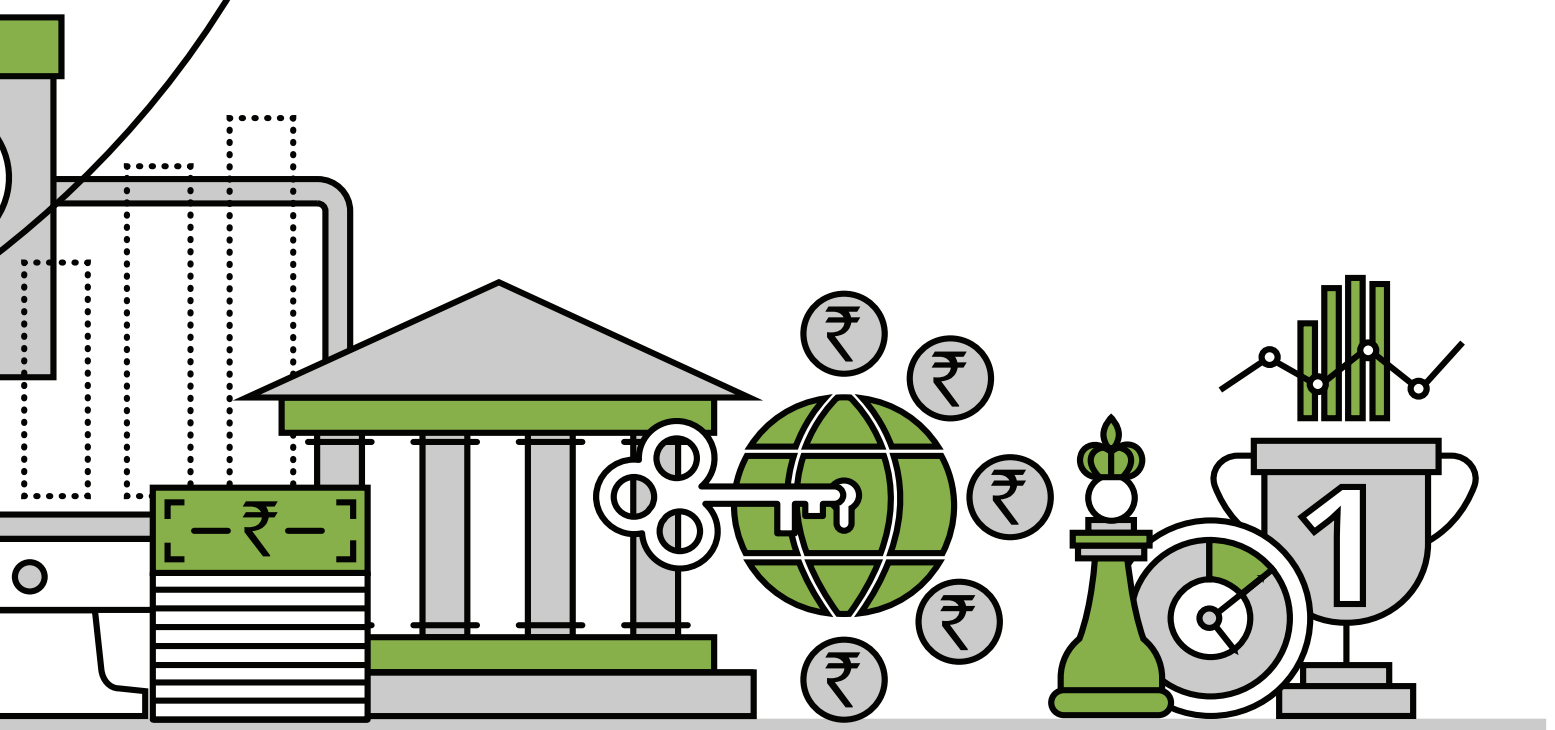
The Deloitte India Banking fraud survey (currently in its third edition and across its previous two editions) has also highlighted the aforementioned control lapses and, additionally, has identified key focus areas to improve fraud risk management at banks. While banks have and continue to make a significant effort in investing in fraud risk management processes and controls, their resources are clearly being tested and stretched. In our experience, bank employees are operating in a performance linked compensation system wherein meeting business targets is essential for their career progression. In light of the pressure to meet these targets,

compliance aspects - such as undertaking adequate due diligence or repeat validation of KYC documentation - can take a back seat. Banks therefore need to re-look at their performance metrics and include compliance and fraud prevention as essential aspects of an employee's career path.

In our experience, some of the control mechanisms currently being used by banks are better suited only to take action on NPAs (non-performing assets) post their identification, and are not designed to be preventive in nature to detect early warning signs/signals of financial stress in borrower accounts. For instance, the CVC report identifies limited due diligence on borrowers and lack of monitoring on the usage of funds disbursed as a recurring cause for frauds across sectors. As part of their due diligence process, banks currently tend to request for limited details/documentation pertaining to conflicting relationships, despite the knowledge that several fraud schemes rely on diverting money through related party transactions or shell companies. Other issues that we have come across include inflated project costs, inflated value of fixed assets, asset ripping, unaccounted sales, money/loan routed to group companies, inflation of working capital constituents, to name a few.



1. Source: <http://www.cvc.gov.in/sites/default/files/new1111.pdf>



Although organisations can never eliminate the risk of fraud entirely, it is important to have controls that can effectively detect as well as prevent fraud. To achieve better controls, banks should ideally identify existing control gaps and figure out how to plug them. In our view, the following are some good practices that may be considered while setting up new controls:

01

Due diligence at the pre-sanction stage

Loan misrepresentation cannot be detected by a review of the supporting loan documentation alone. Loan applications offer a lot of detailed information that can be cross-referenced across the public domain to trace any missing information and identify any non-reported relationships. However, third-party originators (brokers) are aware of how an application must appear in order to get approved, and can use that to their advantage. The only way to obtain a complete picture of a borrower's current situation is to review every section of the application independently. A comprehensive due diligence mechanism can therefore go a long way.

02

Carrying out background checks

A background check can help assess the integrity, reputation and accuracy of the assertions made by the individual/company concerned. This could include an assessment of the business practices of the potential business partners/dealers or suppliers as well as of the company you are planning to provide a loan/facility to. These checks can help identify conflict of interests/other business interests and past issues, if any.

03

Continuous monitoring

Banks also need to be vigilant from a fraud perspective at the time of annual review of accounts. Assessment of annual reports (including financial statements, stock audit reports, etc.) can help identify trends, profitability, concentration of debtors/creditors and other such issues. Obtaining market intelligence about the client from vendors/competitors, monitoring the adherence to covenants, and identifying anomalies in nature and dealings with key third-parties should all be part of the process.

04

End use monitoring

Having invested in a project and/or providing continued financial support, banks need to understand and evaluate the progress on how the loan is being utilised. In quite a few sectors, the CVC report points to the inability of banks to understand the business proposals submitted by the applicant and therefore a relative laxity in monitoring end use of funds. In our experience, it is important to make sure that loans are constantly monitored to help identify instances of diversion of money for non-business plan related activities, recognise red flags in cases of siphoning of funds, and to make sure that funds are utilised for the purposes intended according to the agreed upon sanction terms.

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