

Fraud, forgery and Vigilance in Banking Sector

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Abstract- 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 and have become indispensable in a modern society. Banks play a critical role in economic development of a nation. The increase in banking operations is now accompanied by an increase in frauds in the banking sector. In this paper the first chapter deals with an introduction to banking and related frauds. The second chapter focuses on Fraud and Forgery, subsequently the Next Chapter deal with Fraud and Forgeries in Banking sector with relevant legal provisions. The fourth chapter deals with measures for prevention and detection of such discrepancies, followed by the vigilance in banking sector and the fifth chapter deals with Legal regime available to control the menace of banking frauds followed by the conclusion.

KEYWORDS: Banking-nationalization-fraud-forgery-losses- bank employees-crime-Indian Penal Code, 1860-Rangarajan Committee Report

INTRODUCTION

Banking system occupies a significant place in a nation's economy. A banking institution is crucial and indispensable in a modern society. It plays a pivotal role in economic development of a nation and forms the core of the money market in an advanced country. Banking industry in India has traversed a long way to accomplish its present stature. It has undergone a major structural transformation after the nationalization of 14 major commercial banks in

1969 and 6 more on 15 April 1980. The Indian banking system is indeed unique and perhaps has no parallels in the banking history of any country in the world.¹

The Indian Banking system performs a crucial role in economic development of India through saving-investment.²Banks 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 competitiveness based lending in the context of India's economic liberalization policies and the process of linking with the global economy.

While the operations of the bank have become increasingly important, banking frauds in banks have also increased and fraudsters are becoming more and more sophisticated and ingenious. In a bid to keep pace with the changing times, the banking sector has diversified its business manifold. The old philosophy of class banking has been replaced by the modern concept of mass banking. The challenge in management of social responsibility with that of economic viability has also increased.³

¹Apoorva Yadav and Juhi Malviya "Banking Fraud - Prevention and Control" <http://ezinearticles.com/?Banking-Fraud---Prevention-and-Control&id=772623>(March 30, 2011).

²SUNDHARAM AND VARSHNEY, BANKING THEORY LAW AND PRACTICE 1.64 (17th ed, 2006).

³Apoorva *supra* note 1.

FRAUD

Fraud is defined as "any behavior by which one person intends to gain a dishonest advantage over another". 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.⁴

Fraud is defined u/s 421 of the Indian Penal Code and u/s 17 of the Indian Contract Act. Thus essential elements of frauds are:

1. There must be a representation and assertion;
2. It must relate to a fact;
3. It must be with the knowledge that it is false or without belief in its truth; and
4. It must induce another to act upon the assertion in question or to do or not to do certain act.

Financial fraud is not an offence in spite of the fact that the banks and financial institutions suffer heavily in frauds committed by the borrowers, more often than not, in collusion with the employees of the banks and financial institutions. In the last decade, instances of 'scam' have gone up. People, banks and financial institutions have suffered losses of thousand of crores. The situation is becoming explosive and can lead to anarchy at any time unless 'scam' is legally contained. Financial fraud is a very sensitive issue. It affects the public faith in the system structure. The whole banking system is predominantly based on public faith. Market systems are structured in a society to ensure public confidence. Repeated market failure, undetected frauds in financial institutions and collusion of employees in financial fraud cause frustration in the public, which is a challenge to any good governance.⁵

Bank fraud is the use of fraudulent means to obtain money, assets, or other property owned or held by a financial institution. In many instances, bank fraud is a criminal offense. While the specific elements of a particular

banking fraud law vary between jurisdictions, the term bank fraud applies to actions that employ a scheme or artifice, as opposed to bank robbery or theft. For this reason, bank fraud is sometimes considered a white-collar crime.⁶

BANK FRAUDS

Losses sustained by banks as a result of frauds exceed the losses due to robbery, dacoity, burglary and theft-all put together. Unauthorized credit facilities are extended for illegal gratification such as case credit allowed against pledge of goods, hypothecation of goods against bills or against book debts. Common modus operandi are, pledging of spurious goods, in letting the value of goods, hypothecating goods to more than one bank, fraudulent removal of goods with the knowledge and connivance of in negligence of bank staff, pledging of goods belonging to a third party.⁷

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

1. Active involvement of the staff-both supervisor and clerical either independent of external elements or in connivance with outsiders.
2. Failure on the part of the bank staff to follow meticulously laid down instructions and guidelines.
3. External elements perpetuating frauds on banks by forgeries or manipulations of cheques, drafts and other instruments.
4. There has been a growing collusion between business, top banks 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.⁸

Frauds are committed in the banks in various departments by employees and by the outsiders with the connivance of the bank employees. Each bank has prescribed the systems and procedures for the holding of banking transactions, but frauds are committed due to

⁴ WILLIAM BLAIR AND RICHARD BRENT, BANKS AND FINANCIAL CRIMES (1st ed 2008).

⁵ The Report of the Expert Committee on Legal Aspects of Bank Frauds.

⁶ http://en.wikipedia.org/wiki/Bank_fraud

⁷ Apoorva *supra* note 1.

⁸ *Id.*

loopholes in the system, non compliance of the procedures, ineffective supervision and control of the working of the branches. It is not easily possible to identify the fraudulent person. The intricate procedures also help the culprit escape altogether many times the matter is kept pending so long , that the gravity of the offence is reduced. Sometimes the frauds come to the notice, years after they are perpetrated.⁹

The Reserve Bank of India had set-up a high level committee in 1992 which was headed by Mr. A. Ghosh, the then Dy. Governor Reserve Bank of India to inquire into various aspects relating to frauds malpractice in banks.¹⁰ The committee had noticed/observed three major causes for perpetration of fraud as given hereunder:

1. Laxity in observance of the laid down system and procedures by operational and supervising staff.
2. Over confidence reposed in the clients who indulged in breach of trust.
3. Unscrupulous clients by taking advantages of the laxity in observance of established, time tested safeguards also committed frauds.

TYPES OF FRAUD

KITE-FLYING OPERATIONS

In terms of bankers and accountants, the word “Kite” means that a depositor is passing worthless cheques between banks with no assets behind them. The person doing so to create a false balance on which he may then withdraw cash and skip from the city. Kite flying operation or kiting is the most expensive type of fraud in banks. The kite flying operations is difficult to detect as it may occur in old and well established accounts. Sometimes the kiter has no intention to defraud the bank, as a small business man may turn to kiting for funding to avoid his creditors in temporary financial

difficulty. Sometimes it is difficult to distinguish between kiting and good fund management.¹¹

FORGERY

Section 463 Of the Indian Penal Code

A person who makes any false documents with intent to cause damage or injury commits forgery. A document is a matter expressed or described upon any substance by means of letters, figures or marks, intended to be used, or which may be used, as evidence of that matter. It is immaterial by what means or upon what substance the letters, figures or marks are made. The offence of forgery will be committed, when the false document, it is not necessary that there must be writing or contain the signature or facsimile of any person. A document may be made false by wiping out the signatures, which gives it validity. In forgery the making of the document should be with a fraudulent or dishonest intention. The intention to defraud is different from the intention to cause a wrongful gain or loss. While an intention to cause a wrongful gain or loss of property is necessary for a dishonest act, though intended to deceive, may not be connected with the wrongful gain or wrongful loss of property, though it must involve the causing of injury. If there is an intention to obtain an advantage by deceit, there is a fraud. An action may be fraudulent though it may not be dishonest.¹²

The offence of forgery is complete, if the act is complete, if the act is committed with the intention to cause damage or injury to the public or a person. It is not necessary whether damage or injury or fraud is actually caused or not. A man may commit forgery with the intention to defraud, though there may not be any person who could be defrauded by the act. There may be intention to defraud without the power or opportunity to defraud. The document may be falsely made to support any claim or title. The claim is not restricted to the claim to property. It may be a claim to anything as for example to a claim to the custody of a child as the claimant's

⁹ M L TANNAN, TANNAN'S BANKING LAW AND PRACTICE 1108 (21st ed, 2007)

¹⁰ S.R MYNENI LAW OF BANKING 348(1st ed, 2008).

¹¹ M L TANNAN, TANNAN'S BANKING LAW AND PRACTICE(23rd ed, 2010).

¹² *Id.*

child. A claim to be admitted in an institution under reservation.¹³

Forgery is punishable under Section 463 of the Indian Penal Code. Both the prevention and detection of frauds through forgery are important for a bank. Forgery of signatures is the most frequent fraud in banking business. It is now considered synonymous with bank frauds. The bank should take special care when the instrument has been presented either bearer or order; in case a bank pays forged instrument he would be liable for the loss to the genuine customer.

FRAUD PRONE DEPARTMENTS OF BANKS

The following are the potential fraud prone areas in Banking Sector.

Savings Bank Accounts

Saving bank accounts are prone to various frauds since it is a popular type of accounts. The frauds committed against such accounts include producing forged cheques, wherein the signature of depositors may be forged or the specimen signatures of the depositors may be changed, particularly after the death of depositors. Also dormant accounts may be operated by dishonest persons with or without collusion of bank employees. Further there could be unauthorized withdrawals from customer's accounts by employee of the bank maintaining the savings ledger.

Current Account Fraud

Current Accounts also face frauds in form of the fraudster opening accounts in the names of limited companies or firms by unauthorized persons. It also includes the presentation and payment of cheques bearing forged signatures. Another prevalent fraud is breach of trust by the employees of the companies or firms possessing cheque leaves duly signed by the authorized signatures. Apart from this the fraudulent alteration of the amount of the cheques and getting it paid either at the counter or through

¹³TANNAN *supra* note 9, at 1109.

another bank is yet another misuse of power or responsibility conferred on employees.¹⁴

Credit cards-Unscrupulous persons steal credit cards and spend on merchandise unauthorized.¹⁵

Book Keeping Department-these frauds are mainly due to lack of effective supervision, non reconciliation of accounts, absence of regular rotation of staff, negligence of controlling office to scrutinize the returns received from branches. An internal control system must be used to control it.¹⁶

Other frauds include fraud by staff members, frauds in purchased bills, the remittance department.

FRAUDS-PREVENTION AND DETECTION

A close study of any fraud in bank reveals many common basic features. There may have been negligence or dishonesty at some stage, on part of one or more of the bank employees. One of them may have colluded with the borrower. The bank 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 interest 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.¹⁷

Bank frauds are the failure of the banker. It does not mean that the external frauds do not defraud banks. But if the banker is upright and knows his job, the task of defrauder will become extremely difficult, if not possible.¹⁸

In order to have uniformity in reporting cases of frauds, RBI considered the question of classification of bank frauds on the basis of the provisions of the IPC. Given below are the Provisions and their Remedial measures that can be taken.

¹⁴ Apoorva *supra* note 1.

¹⁵ TANNAN *supra* note 9, at 1122 .

¹⁶ *Id at* 1124.

¹⁷ SN GUPTA, BANKING LAW 433(4th ed, 2005).

¹⁸ TANNAN *supra* note 11, at 1109.

Cheating can be prevented by paying more attention to identity, genuineness, verification of particulars in respect of various instruments as well as persons involved in encashment or dealing with the property of the bank. All these matters must be thoroughly cross-checked. It is punishable under Section 415 of the Indian Penal Code

Criminal misappropriation of property -Section 403 IPC

Criminal misappropriation of property, presuppose the custody or control of funds or property, so subjected, with that of the person committing such frauds. Preventive measures, for this class of fraud should be taken at the level the custody or control of the funds or property of the bank generally vests. Such a measure should be sufficient, it is extended to these persons who are actually handling or having actual custody or control of the fund or movable properties of the bank.

Criminal breach of trust (Section 405, IPC)

This type of crime is usually committed by the employees or any member of the bank. Therefore proper care should be taken from the initial step when a person comes to the bank. Care needs to be taken at the time of recruitment in bank as well. There should be some vigilance on the employees, but not in such a manner so as to hamper their relation with the bank.

Falsification of accounts (Section 477A)

Proper diligence is required while filling of forms and accounts. The accounts should be checked regularly and there must be a proper vigilance system to avoid falsification of accounts

Criminal conspiracy (Section 120 A, IPC)

In the case of *State of Andhra Pradesh v. IBS Prasad Rao and Other*, the accused, who were clerks in a cooperative Central Bank were all convicted of the offences of cheating under Section 420 read along with Section 120 A. all the four accused had conspired together to defraud the bank by making false demand drafts and receipt vouchers.

Offences relating to currency notes and banks notes (Section 489 A-489E, IPC)

These sections provide for the protection of currency-notes and bank notes from forgery. The offences under section include counterfeiting currency notes or banks, selling, buying or using as genuine, forged or counterfeit currency notes or bank notes with the knowledge that they are forged or counterfeit. Possession of forged or counterfeit currency notes or bank-notes, knowing or counterfeit and intending to use the same as genuine. Making or passing instruments or materials for forging or counterfeiting currency notes or banks. Making or using documents resembling currency-notes or bank notes.

Most of the above provisions are Cognizable Offences under Section 2(c) of the Code of Criminal Procedure, 1973.

VIGILANCE IN BANKS

With the financial sector reforms, the banks have to work in competition with foreign banks and private sector banks. To survive in the era of competition, the public sector banks have to launch aggressive retail banking, due to which the business of these banks is increasing day by day. The focus of the banks has been shifted from socio banking to profitability. With the advantages of increase in business, many disadvantages have been noticed in the public sector banks. Some officers and staff members have started to take advantage of the liberalization and enhanced delegated powers to branches. Majority of the frauds are committed by the criminals with the connivance of the bank staff.¹⁹ Therefore banking system has introduced vigilance system under three categories- Preventive, Detective and Punitive.

LEGAL REGIME TO CONTROL FRAUDS

The consecutive Rangarajan Committees set the tone for computerization in India. While the first committee drew the blue print in 1983-84 for the mechanization and computerization in banking industry, the second committee set up in 1989

¹⁹ TANNAN *supra* note 9, at 1125.

paved the way for integrated use of telecommunications and computers for applying technological breakthroughs in banking sector. However, with the spread of banking and banks, frauds have been on a constant increase. It could be a natural corollary to increase in the number of customers who are using banks these days. Further the Twenty-ninth Report of the Law Commission had dealt some categories of crimes one of which is "offences calculated to prevent and obstruct the economic development of the country and endanger its economic health." The most important feature of such offences is that ordinarily they do not involve an individual direct victim. They are punishable because they harm the whole society. Thus it is important that sufficient efforts should be taken in this regard. There are also crimes as defined and punishable under the general criminal law of the country as laid down in the Indian Penal Code. For instance, breach of trust, cheating, fraudulent deeds, forgery, violations of trademarks, bribery and other offences relating to weights and measures and food adulteration are Penal Code crimes irrespective of the fact as to who commits them.

CONCLUSION

The fact that crime has shifted from almost solely individual perpetrators, to white-collar crimes on an ever increasing scale has not yet been taken into account in many legal systems. White-collar crimes include frauds committed by unscrupulous persons deftly advantage of loopholes existing in systems and procedures. The ideal situation is one there is no fraud, but taking ground realities of the nation's environment and human nature's fragility, an institution should always like to keep the overreach of frauds at the minimum occurrence level.

There is a dire need of security in the banking sector. Security implies sense of safety and of freedom from danger or anxiety. In the banking and financial sectors, the introduction of electronic technology for transactions,

settlement of accounts, book-keeping and all other related functions is now an imperative. Increasingly, whether we like it or not, all banking transactions are going to be electronic. There exists a new kind of threat in cyber world. Writers are referring it as "Salami Attack" under this a special software is used for transferring the amount from the account of the individual. Hence the culprits of such crimes should be found quickly and should be given strict punishment. Moreover there is requirement of more number of IT professionals who will help in finding a solution against all these security threats.

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