Syllabus subtopic: Indian Economy and issues relating to planning, mobilization of resources, growth, development and employment.

Prelims and Mains focus: Why rising incidence of bank frauds is a cause of concern for RBI, the Centre and people with savings and deposits in these banks.

News: The finance minister informed Parliament last month that state-run banks reported frauds of over ₹95,760 crore in April-September.

Are frauds rising at state-owned banks?

Public sector banks (PSBs) reported frauds of over ₹95,760 crore from April to September this year. According to the Reserve Bank of India’s latest annual report, all banks, including PSBs, reported frauds involving losses of ₹71,542.93 crore over the 12-month period of FY19. RBI data shows that the bulk of the frauds relate to loans and take place at PSBs. The incidence and cost of frauds is increasing year after year, posing threats to the financial stability and eroding the credibility of PSBs, auditors, credit rating agencies and the regulator RBI, as well as the trust of savers and depositors.

Why is the incidence of fraud increasing?

Studies have shown that fraudsters, big and small, are able to take undue advantage of a number of well-documented weaknesses in the system. The central bank has an early warning signals system but, as had happened in the Nirav Modi case, PSBs do not always take advantage of it. Former RBI governor Urjit Patel made a presentation at Stanford University in June that showed most of the frauds are related to loans and occur due to poor operational risk management and ineffective internal audits at state-owned banks. These banks apply little risk analysis or due diligence.

Are frauds related to non-performing assets (NPAs)?)

A 2016 study by the Indian Institute of Management, Bangalore, found a correlation between rising frauds and NPAs, which indicates lack of requisite standards of corporate governance, leading to more instances of loan defaults involving over ₹1 crore. The study said this is suggestive of collusion between corporate entities and top PSB officials.
Why do frauds take place more at PSBs?

The study found that big loan advance frauds happen as bank officials collude with borrowers and sometimes even with officials of third parties such as advocates and chartered accountants. Post loan sanction, the monitoring is weaker than at private banks due to lack of expertise and modern tech resources. Officers retire before they can be booked for fraud. Weak selection process and lower pay than at private banks are among key reasons. PSB staff are not offered appropriate incentives to prevent or detect frauds early.

What should be done to prevent frauds?

There is little deterrence for fraudsters as conviction rates are low due to the lack of specialized financial sleuths. PSBs should set up an internal rating agency for stringent evaluation of big-ticket projects before sanctioning loans. Banks must evaluate projects on the basis of the business model and not get influenced by the brand name or creditworthiness of the parent firm. Strict punitive steps for bank staff and others who collude with fraudsters can help.