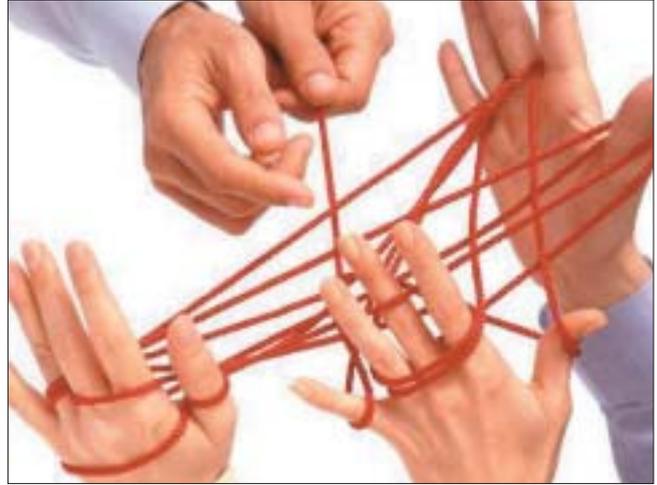


Vigilance and Fraud share a peculiar relationship. Whichever works faster and better makes the difference. In the case of frauds in the financial sector, there is no limit as to how bad things can get. Maladies in any organisation are more due to non-adherence of internal control mechanism rather than the absence of it. This article explains how.



Fraud Detection and Audit in Banks

—RS Raghavan

Corporate and business entities, more specifically financial institutions like banks, are one of the most sought after targets of fraudsters. This is because these organizations deal in hot money, the ownership of which, on the face of it, is difficult to establish.

This article deals with frauds and not with errors and genuine judgemental mistakes. The distinguishing factor between the former and the latter is whether such an action is intentional or unintentional. Fraud is intentional and involves deliberate concealment of facts whereas the latter is unintentional and in generic terms be referred to as a mistake.

Fraud is considered as a white-collar crime. In a most common modus operandi of committing the fraud the fraudster studies the pro-

cedures and processes adopted by a commercial entity for putting financial and funds transactions, ascertains the loopholes in the systems and then exploits it to the advantage in such a way that it does not come to light immediately. However, it is only a question of

time before it is detected.

In a business entity, fraud-prevention measures have to be part of a continuous and dynamic process as well as a long journey to be covered by any commercial organisation. Business environment is changing at an extremely fast pace and the rate of change is continuing to accelerate.

Vigilance and Fraud share a very peculiar relationship. Whichever works faster makes the difference. In the case of frauds in the financial sector, there is no limit as to how bad things can get. Nevertheless, every incident of fraud is a crisis situation that provides an opportunity to find innovative ways of handling it now besides preventing it later.

The financial sector reforms, reflected in Liberalisation, Privatisation and Globalisation (LPG) facilitates unhindered mobility of products, services and consequently

When a fraud is detected, punishment for the culprit and the reward for the detector should go hand in hand. Similar to the Risk Rating and Credit Rating system in vogue in the financial market, the inception of a Vigilance Rating system are not far off.

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the funds. Thus, in the financial sector there is an urgent need to put in place foolproof systems and procedures, governance and professional ethics so as to ensure smooth functioning of business entities that are prone to fraud. The engine of change is the evolution of the market economy abetted by unimaginable advances in technology, communication, and uncontrollable flow of information, capital and commerce across the globe.

In the matter of preventing fraud, internal audit has an advantage over the external audit in the sense that it has an understanding of how the system works so as to initiate quick steps. Internal audit would be privy to the dynamics of decision-making and the process behind them in an organization. A vigilant internal audit team would be able to bring in the requisite transparency and through this, proper accountability.

Maladies in any organisation are more due to non-adherence of internal control mechanism rather than the absence of it. When a fraud is detected, punishment for the culprit and the reward for the detector should go hand in hand. Similar to the Risk Rating and Credit Rating system in vogue in the financial market, the days of developing a Vigilance Rating system are not far off. This involves monitoring the business actions and creation of a related database so as to use it as a tool to monitor the frauds.

Computerised Banking Environment

Though the main activities of a banking company involve collection of deposits from those who want to save, and deployment of funds to those who are in need of it, the functions of banking has crossed

such boundaries owing to financial sector reforms. This has given wider scope for number of scams and frauds in the field of finance.

The basic purpose of computerising and mechanisation of more and more business is to contain the occurrence of frauds due to manual intervention, besides improving overall efficiency for ensuring better customer service. But, over dependence on the staff of computer vendors and laxity coupled with lack of IT knowledge paved way for occurrence of frauds. Some of the frauds and the modus operandi of the same are summarized below:

- ❑ Significant exposure of the banking activities to the employee of a software vendor, while later is providing the maintenance service.
- ❑ At the time of half-yearly crediting of interest in the huge operative savings bank account, substantial amount may be credited by inflating interest paid on deposit account by erasing genuine debits/fraudulent credits in the relative accounts.
- ❑ Misappropriation of cash received at Single Window counter due to the absence of scroll/control mechanism, normally.
- ❑ Even after years of computerisation, important functions like password secrecy, maintenance, printing of reports, exceptional reporting, checking of the output/reports, monitoring system generated entries, etc. are not performed as per the laid down guidelines.

Alert Signals

Normally certain alert signals are thrown by the system if the environ-

ment is fraud-prone, and it is better to capture and catch them so that at least the impact is minimized, if not brought to nil. Some such signals are detailed herein below:

- Scrutinise various reports such as Internal Inspection, Concurrent Audit, Statutory Audit, Long Form Audit, Branch Audit, Supervisory/Regulatory inspection, etc., meant to throw light on the weakness in the system and vulnerable areas and ensure that the shortcomings are duly attended to/rectified.
- Deep probing of any abnormality of movement, transactions, data immediately before it



becomes too late for any action.

- Non-rotation of jobs and some gaining roots in to the functioning of certain business oriented functional departments.
- No individual is bigger than the institution and while keeping faith on people working on the systems there should be no relaxation and compromise on the systems and procedures.

Window of opportunity for perpetration of fraud

In banking sector, frauds are perpetrated basically by three classes of people: (1) Employees, (2) Customers and (3) outsiders or



strangers. It is a common knowledge that no fraud can take place without a window of opportunity for the same.

Let us examine the window of opportunity and the environment because of which fraud takes place in banks.

- ✎ Banks, particularly the public sector ones, have to handle huge rush of customers during the first week or 10 days in a month. With long queues and rush indiscipline, there is a tendency to overlook certain procedural aspects and overall control systems get automatically relaxed.
- ✎ Creation/storage of surrogate specimen signatures in some of

wrongful change of control parameters and modification of defining vital input fields such as interest rate, commission, charges, etc. thereby misleading the entire system to pick up the wrong inputs to the detriment of the bank's interest.

- ✎ Non-adherence to the 'Know Your Customer' norms would pave way for customer of doubtful integrity to get an entry into the financial world. Hence, whose account is getting opened plays an important role in the matter of operations in the account?
- ✎ Many frauds come to light only when the customer concerned brings the same to the notice of the bank.
- ✎ Milking infrequently operated or inoperative accounts with significant balance or close successive operations for deposit and withdrawal.

ness target in Retail Lending, banks woo the middle class customers to indulge in more than the normal standard of living suiting their known means, resulting in over-debt situation giving room for fraudulent transactions and relaxations in the basic covenants in lending.

- ✎ In the recent past, even respectable people have duped banks by producing fake Title Deeds and multiple mortgages.
- ✎ Obtention of 'No Objection Certificate' from other bank is a normal and routine procedure in banks while extending credit to certain customer and in this regard the NOC issued in favour of one bank may be fraudulently manipulated as if it is issued in favour of different banks thereby misleading the bank.
- ✎ Absence of timely and periodical inspection is one vital area

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the benami/fraudster's/collateral security in the system with an intention to pass fraudulent financial transactions.

- ✎ With large scale of computerisation, ordinary bank employees and customers are under the impression that mere computerisation is sufficient security, not fully appreciating the attendant vulnerabilities.
- ✎ Gaining access to operating systems, database systems, application software by unauthorised persons would make a number of business and administrative areas fraud-prone.
- ✎ Through improper access to control system thereby allowing

- ✎ Pigmy/daily deposit collectors from small vendors and household sectors for the reason that the control exercised by banks on these is not adequate.
- ✎ Improper appraiser of Jewels pledged to banks with the connivance of the Jewel Appraiser.
- ✎ A common thread running through fraudulent transactions is forging of cheques/drafts/Credit Advice/instrument of funds transfer and in credit areas through fake security documents, besides the basic intention to commit and put through a fraudulent transaction.
- ✎ In the enthusiasm to reach busi-

ness being exploited by the unscrupulous borrowers to their advantage and lack of supervision/monitoring.

- ✎ Habitually not tallying/reconciling certain sensitive accounts like Clearing Adjustment, Branch Adjustment, Instrument paid at par, Interest Paid on Deposit, Clearing Suspense, Dividend Warrant, suspense payments/receipts, etc. is a dangerous signal as these are very fertile for fraud indulgence particularly with the connivance of employees/insiders.
- ✎ Delay in the reporting of frauds by the staff members to the

In the past one and a half decade India has seen a number of scams relating to financial deal in general and capital market in particular as could be noticed from the alleged deals of Harshad Mehta, M S Shoes, CRB, Ketan Parekh, etc.

higher authorities, outside agencies such as police, CBI, etc.

- ✎ Laxity in exercising control over inventory of security items such as DDs and cheque-books.
- ✎ In the credit card business, the tendency of fraudulently transacting the business is on the increasing trend. The magnetic strip details are transferred into a device by fraudsters in collusion with unscrupulous merchant establishments for duplication of cards to be put into use fraudulently.
- ✎ Skimming and counterfeiting of global credit cards.

The above are just illustrative and definitely not exhaustive, as the nature and occurrence of fraud differ with the change in time and technology advancement.

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As every one knows, owing to lack of proper governance, financial system has been used as a conduit/pies for the unhealthy activities. Consequently, these irregularities in securities and banking transactions speak on both financial and moral values. Banking sector provides a payment and settlement system to the economy and has vital linkages to the other important real sectors. Though the financial sector is providing only supportive ser-

Occurrence of frauds

Some of the large value frauds that occurred in Indian banking environment revealed that the following led to the occurrence of frauds.

- Opening fictitious account for crediting proceeds of forged/unauthorised cheque for withdrawal immediately.
- Allowing frequent over-drawing in the current or operative limits and not reporting to the higher authorities and not getting it regularised.
- Availing loans on the strength of forged documents/title deeds
- After availing loans, the proceeds of the asset procured out of the loan not being deposited back to the bank or being routed through other banks for siphoning the funds.
- Release of the securities in an unauthorised manner before ensuring liquidation of direct or indirect liability of a borrower/guarantor.
- Encashment of forged/stolen instruments such as cheque, demand draft, Credit Advice, etc.
- Entertaining accommodation of Bill of Exchange transactions and wrongful encashment of loan proceeds through unauthorised withdrawal.

vice, it is a very vital sector serving as a lubricant to the business and economic cycle.

Fraud preventive measures

It is important to ensure that suitable preventive measures are put in place to avoid or at least minimize fraud in the computerised environment in Banks to which situation only the banks are moving into. Some of these are listed below:

- ☞ Proper security in the computer systems can be achieved by exercising series of regulations such as 'physical access controls', 'logical access controls' and environment controls, etc., This is because, perpetration of fraud in computerised environment happens mainly by breaking any one or more or all of these Access Control Mechanisms.
- ☞ Full adherence to all the security and control standards prescribed.
- ☞ Branches should be careful while issuing chequebooks on the basis of authorisation letters to avoid fraudulent usage of the same. Proper verification is required
- ☞ Implementation of segregation of duties, roles and responsibilities in the computerised environment. Job rotation among the staff and avilment of leave by the employees should be ensured.
- ☞ No one should have complete access to the entire operating cycle of any financial transactions and it should necessary pass through more than two or three officials. That is, four-eye principle should be adopted.
- ☞ Checking and balancing of books should never be entrusted to the same person at any point of time.
- ☞ Newly opened accounts needs to

be put under close watch for any unusual and large volume of transactions.

- ☞ Stipulated audit exercises such as credit audit, legal audit, stock audit, current asset audit should invariably be completed with different set of people.
- ☞ Exercise of delegated powers by the functionaries should be subjected to perusal/scrutiny by the controlling/next higher authority.
- ☞ Periodical audit and inspection of the computerised systems and application software with regard to capability of meeting the security standards. Examine the vulnerable areas of fraud as commented in the Systems Audit Report for regular compliance, checking, verification and ensuring.
- ☞ Mandatory Maker-Checker con-

cept in one-way or the other for all the transactions, with proper job rotation and delegation of duties.

- ☞ Based on the tenet of sub-ordinate to superior, peer-to-peer, supervisor to Executive, a strong supervisory checking and verification mechanism should be put in place.
- ☞ Exceptional transaction statement should be checked and verified by the Branch Head, on daily basis without fail and corrective action be taken immediately.

It is always important and better to prevent fraud than to spend lot of resources to detect them.

Conclusion

In the words of Mahatma Gandhi, there is enough in the world for every one's need, but not for one's greed.

Law by itself cannot put a full stop to corruption and fraud.

According to the prevailing guidelines, cases of fraud of the value of below Rs 1.00 cr would be handed over to the local police. However, reference of such cases to Central Bureau of Investigation (CBI) would be necessary only if a bank official is suspected to be involved. Other cases would be referred to CBI The Banking Securities and Fraud Cell at Delhi, Mumbai, Bangalore and Kolkata would handle information/compliance of amount of alleged bank frauds in excess of Rs. 5 crore. If the amount of the alleged fraud ranges between Rs. 1 crore to Rs. 5 crore, the information would be handled/investigated by the branch of CBI having territorial jurisdiction over the area. ■

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