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Fraud Risk Management System in Rural Financial Institutions

Introduction

The banking sector is susceptible to fraud due to the nature of its operations involving a large number of customers and the volume of transactions performed across multiple channels. The Reserve Bank of India (RBI) has defined fraud as a deliberate act of omission or commission by any person, carried out during a banking transaction, resulting in a wrongful gain to any person, with or without any monetary loss to the bank.

Trends of Fraud in Rural Financial Institutions (RFIs)

The number of frauds in the Regional Rural Banks (RRBs) and Rural Co-operative Banks are on a rise since FY 2015-16. From FY 2015-16 to FY 2022-23, there were 2119 frauds involving ₹ 2051 crore reported by RRBs and RCBs. In FY 22-23, public sector banks reported 3405 fraud cases involving ₹ 21,125 crore. The corresponding data for RFIs are 365 frauds involving ₹ 447 crore. Though the number of frauds and amount involved appears very insignificant in comparison to public sector banks, frauds occurring in RFIs have wider ramifications as the clientele of these banks are rural households, who are mostly farmers. As per our data, the maximum number of frauds were reported by District Central Co-operative Banks (DCCBs) followed by Regional Rural Banks (RRBs) and State Co-operative Banks (StCBs). Eighty-eight percent of these frauds were committed either by staff or in connivance with staff.

Central Fraud Monitoring Cell (CFMC) and its functions

The Central Fraud Monitoring Cell was set up at the Department of Supervision, Head office in 2018 to enable RFIs to develop an effective fraud risk management system to prevent, detect, and report fraud in time. The CFMC also analyses the root cause of frauds reported by supervised entities and issues cautionary advice to the supervised entities when the modus operandi of the fraud is ingenious, to prevent and detect frauds of similar type in the future. The CFMC monitors the frauds reported by supervised entities through various MIS till the frauds are closed with due approval from NABARD.

Fraud Vulnerability Index (VINFRA)

VINFRA is a self-assessment tool developed by NABARD to evaluate a bank's fraud risk management capabilities. The analysis of VINFRA (as submitted by the SEs) highlighted top 5 areas in which SEs have inadequate systems, as shown below: -

Sl. No.	Areas	% of SEs
1	Absence of system of Early Warning Signals and Red Flagging of Accounts	54%
2	Non-conduct of IS Audit	40%
3	Non- Availability of Fraud Insurance cover	40%
4	Proper Resolution of Fraud Cases	37%
5	Board-approved Fraud Risk Management Policy	34%

Modus Operandi of Frauds in RFIs

i. The fraud in loans and advances was committed through fraudulent documents on collateral, forged KYC documents, over-valuation, and by opening ghost loan accounts against fixed deposits. Poor appraisal system and monitoring mechanism is also responsible for frauds in loans and advances in RFIs.
ii. Fraud was committed by PACS by including fake members in Normal Credit Limit statements based on forged documents.
iii. Similarly, fraud in SHGs occurred by including bogus members based on forged KYC.
iv. Fraud on the deposit accounts transpired through fraudulent withdrawal by the cashier after issuing a fake counter receipt.
v. Frauds were also committed internally by siphoning off the bank's funds by passing fraudulent entries in general ledgers.

Why such frauds could not be prevented?

i. Lack of oversight by senior management on deviations from existing processes indicating weak internal checks and control. For e.g. - The perpetrators (mostly internal staff) disabled the SMS alert or changed the registered mobile numbers of the customer and thus fraudulently sanctioned and disbursed loans or made fraudulent withdrawals.
ii. Weak customer due diligence – no system of verification of the customers in case of new deposit accounts or loan applications.

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iii. Lack of tools to identify potential red flags.
iv. Low financial literacy among customers of these SEs also aggravates the situation. The customers do not opt for the SMS/email alerts facility to save the service charges.

Impact of Fraud in Supervised Entities

i. In case of frauds above ₹ 1 crore, the 'Internal Checks and Control' parameter of the bank may be considered as weak for the purpose of assessing compliance to Sec 22 (3)(b) of BR Act, 1949 (AACS)
ii. For non-compliance with the fraud guidelines issued by NABARD, RBI can levy monetary penalty on the SE. Baroda Gujarat Gramin Bank, Tamil Nadu StCB, Gondia DCCB, Mahbubnagar DCCB were imposed monetary penalty by RBI mainly for non-reporting and delayed reporting of frauds to NABARD.

How can we minimize fraud in RFIs?

Preventing fraud in RFIs requires a multi-pronged approach and each stakeholder needs to play its role responsibly.

i. Role of NABARD Regional Offices

- Regional Offices need to act promptly on receiving the fraud auto-alert from the bank in ENSURE. Conduct the quick study/portfolio inspection and send the report to CFMC, DoS, Head Office.
- Follow up with the banks to comply with the Action Points to be taken by the bank to contain the risk of fraud in the future, post-detection of a fraud.
- Conduct half-yearly and annual reviews of frauds for effective monitoring of frauds.

ii. Role of Inspecting Officer during on-site Inspection

- In the Inspection Reports, Inspecting Officers generally provide information on when a particular fraud was detected, total outstanding fraud in a bank, the presence of a fraud risk policy, and the constitution of a special committee of the board to review fraud.
- Apart from the above, IOs are encouraged to provide comprehensive and detailed information to ensure clarity, accuracy, and accountability. For e.g. –
  i. Provide a clear and concise overview of the fraudulent activity detected during the inspection (nature of the fraud)
  ii. Assess the impact of the fraud on the bank's operations, financial health, reputation, and stakeholders.
  iii. Identify the root cause and contributing factors that facilitated the occurrence of the fraud.
  iv. Support comments with relevant documentation, evidence, and supporting data obtained during the inspection process.

iii. Role of Supervised Entities

- Comply with NABARD guidelines in letter and spirit.
- Adopt a robust Fraud risk identification, prevention, detection and fraud reporting, and mitigation framework. The 'Four eyes principle' must be followed in all sensitive areas without compromise.
- Utilise the information received from the Credit Bureaus
- Bring in a culture of vigilance, strong internal control, and compliance as Fraud is a criminal offense.
- Use technology like fraud filter system to lock login in sleep mode and use forecasting models based on historical data to reduce false positives.
- Practice safe cyber security hygiene like biometric authentication and dynamic factor-based authentication to prevent unauthorized logins to CBS.
- Sensitize employees and customers about frauds including cyber frauds.
- Adopt adequate safeguards while availing Third-Party Service Providers like gold appraisers or lawyers for verification of title deeds.

Conclusion

Though RFIs are regulated and supervised, fraud cannot be eliminated. Therefore, the need of the hour is to build resilience through good governance and robust risk management practices. Aspects like strengthening of KYC system in the SE, strong whistle blower policy and use of technology must be prioritized to prevent and detect frauds in time.

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