How banking frauds can be nipped in the bud

The Nirav Modi case has once again cast the spotlight on the dark corners of the Indian banking universe. The details of what exactly went wrong are still trickling into the public domain, yet the information available till now suggests that there was a failure at different levels—internal controls, corporate governance and weak regulatory capabilities. The authorities should not let this crisis go waste, but use it as an opportunity to minimize the risk of such frauds in the future.

Here are some ideas that could be considered.

First, the basic line of defence against fraud is the internal controls in a bank. Most banking regulation across the world works on this principle. India is no exception. Technology should be seen as a game changer. It can reduce the chances of human connivance, and can be used to detect outlier lending or guarantees. A good technology system should make it impossible—or at least extremely difficult—for individual employees to bypass controls, as seems to have happened in the Punjab National Bank case. Most importantly, bank boards, and especially the audit committees, must have clear responsibilities.

Second, as Charan Singh and others at the Indian Institute of Management, Bangalore have suggested in a 2016 paper, *Frauds In The Indian Banking Industry*, banks can also set up a special fraud monitoring agency, with officials specially trained to detect incipient frauds. Banks can also choose to appoint one member of the board to oversee fraud risk management. In other words, banks need to focus more on frauds in order to maximize the chances of detecting them at an early stage. This will also require banks to improve their human resource management policies, and be ready to pay the big bucks needed to hire experts trained in fraud detection.

Third, as the above-mentioned paper noted, the role of third parties such as chartered accountants, auditors, and advocates who figure in bank frauds should also be examined with a tough eye. In fact, the regulator should revisit the role of auditors both in the case of borrowers and lenders. They will need to design stringent systems where auditors are not able to get away with fraudulent financial statements. However, to make this happen, it will also be necessary that investigations are conducted in a given time frame.

Fourth, even while we have argued earlier in this editorial that the internal controls in a bank should be the first line of defence against fraud, there is no doubt at all that banking regulators need to be a backstop. The Reserve Bank of India (RBI) has said it had earlier warned banks about frauds, it clearly did not nip them in the bud. The Indian central bank will have to build capabilities, both in terms of designing rules and making sure that they are effectively implemented. It will be a delicate balancing act, since over-regulation could scare bankers off any sort of lending, hardly what the doctor ordered for a growing economy. For now, the RBI has done well to constitute an expert committee to look into the rising incidence of frauds, among other things, in the banking system.

Fifth, in order to make the banking system more efficient, the government should actively pursue the idea of privatizing public sector banks (PSBs), as the required reforms will go the distance only when banks are free of political and bureaucratic control. It is not our case that fraud does not take place in private financial institutions—think Barings—but public sector banks seem to be more prone to frauds. Public sector banks have always been marred by poor governance—also reflected in their stock market valuations—and both high levels of non-performing assets and the recent fraud are consequences of inept governance.

Sixth, Jayant Verma of the Indian Institute of Management at Ahmedabad has a radical take on the use of technology to reduce fraud. He said in a recent blog post that blockchain technology could be used to make banking transactions more transparent. This would mean that every link in the chain can be scrutinized publicly. Verma feels that lifting the veil of secrecy from banking transactions should not be a big worry since we are already in an age when borrowers disclose a lot of information in public statements, while mutual funds provide detailed disclosures about their bond portfolios.

India needs a safe and efficient banking system to service the needs of a growing economy. The government and RBI would do well to use the current opportunity to strengthen the banking system. They should also worry in case citizen anger is replaced by panic about the safety of their deposits—especially in a radically networked age when misinformation spreads like wildfire.

What can the government and RBI do to reduce the chances of fraud in banks? Tell us at views@livemint.com

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