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(VIGILANCE DIVISION)

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SUB: CVC ANALYSES OF 100 TOP BANK FRAUDS – IDENTIFIES - LOOP HOLES - SUGGESTS SYSTEMIC IMPROVEMENTS

A copy of "Analysis of Bank Frauds" & "Press Release" received from Central Vigilance Commission (CVC) on the above subject is forwarded herewith for information and guidance.

(Arvind Kumar Kadyan)
Chief Vigilance Officer

Encl: As Above

To :

- ES to CMD
- ES to All Directors
- All Divisional Heads/Branch Managers

CENTRAL VIGILANCE COMMISSION

CVC ANALYSES 100 TOP BANK FRAUDS – IDENTIFIES LOOP HOLES-SUGGESTS SYSTEMIC IMPROVEMENTS

DT. 16.10.2018

PRESS RELEASE

Central Vigilance Commission (CVC) has reviewed and analyzed Top 100 Bank Frauds, as on 2017.

Sharing the details Dr. T.M. Bhasin, Vigilance Commissioner, CVC informed that the Commission has sub divided the study into 13 sectors comprising of Gems and Jewellery, Manufacturing, Agro sector, Media, Aviation, Service Sector, Discounting of cheques and bills, Trading sector, IT Sector, Exports sector, Fixed deposits and Demand Loan etc.

Dr. Bhasin said that as a conscious decision and with a view to maintaining discreteness, the names of borrower accounts/entities and the names of the Banks have not been disclosed in the report. However, steps are being taken for all encompassing actions such as investigation by the Premier investigative agencies, fixing staff accountability and recovery measures, etc. for effective action.

Dr. Bhasin said that the modus operandi of these loans has been thoroughly analysed and various loopholes/lapses have been identified. Based on the findings, various industry specific suggestions for systemic improvement have been given in the final report, which have also been sent to Deptt. of Financial Services (DFS)and RBI, in order to plug the loopholes observed by the Commission. The measures suggested include strengthening of SOPs, monitoring system and also highlighting the role of controlling offices, so as examine the aspect of quality of business.

Dr. T.M. Bhasin said that this analytical study was initiated by the Commission as a Preventive Vigilance measure so as to minimize the occurrence of such type frauds in future. RBI has also confirmed to the Commission that inputs given by CVC are very useful and shall be used for systemic improvements to mitigate the risks. Dr. Bhasin said that the intention of the Commission is to bring about awareness among the field functionaries by enhancing their knowledge towards the existing lapses, so that the frauds of similar nature do not recur. These studies have been done by the Commission as a preventive Vigilance tool by utilizing its vast experience of handling various cases of frauds and Staff accountability related matters.

A copy of the Analysis of Top 100 Bank Frauds by CVC is also being uploaded on CVC website for ready reference.

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Analysis of Bank Frauds
By
Central Vigilance Commission
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Gem & Jewellery Sector

The cases of frauds perpetrated by three companies in this sector have been analysed. The companies were in business of the Diamonds & Jewellery. The companies had adopted a business model by which they imported gold/gem through foreign Banks/private parties against SBLC/LC/ Cash Credit for value addition and production of Jewellery for export to its customers located aboard. The Companies availed credit facilities from the banks under consortium arrangement led by one of the banks.

Modus operandi:

- The companies deliberately inflated the valuation of diamonds with the malafide intention to avail higher credit facilities from the lenders and also to indicate the security coverage available with the lenders.

- Export bills which remained unpaid on due date were purchased by the consortium Banks. Simultaneously, the disruption of the cash flow led to the devolvement of SBLCs and outstanding of cash credit remained unpaid.

- The group of the companies informed that as their receivable were not being realized in time due to financial difficulties of the foreign buyers; they could not meet the SBLC (Standby Letter of Credit) commitment on time.

- The details of receivable/debtors submitted by the companies to the bank in order to avail credit facilities appeared to be manipulated, false and fabricated.

- The companies acted cleverly to avail entire pre-shipment as Standby Letter of credit instead of packing credit loans, for which consortium succumbed to their innovative funding ideas. The companies also resorted to availing post-shipment finance by discounting "Export Bills" from one of the member banks, while pre-shipment finance was obtained from another member bank by way of SBLC, leading to double financing.

Loopholes/Lapses:

❖ Due diligence report on borrowers were not obtained before submitting the sanction/ renewal proposal. While recommending the proposal for enhancement in limits, quantum of export was focused to get the limit enhanced. However comforts like LC/SBLC were not insisted to ensure timely payments of exports whereas imports were on the basis of SBLC.

- The entire group of existing buyers companies was controlled by a single person. No credit assessment was done for these customers. There was no evidence for proof of delivery of the goods to customers. Later on, the investigating agency have raised the issue regarding proof of delivery of sales of gold and diamond jeweller to foreign companies.

- In the absence of any effective mechanism to monitor the movement of discounted Export bill proceeds towards liquidation of SBLCs across member banks, the companies manipulatively diverted and round tripped the funds to their related/ shell companies.

- Consortium Mechanism under the leadership of lead bank broadly failed to check and monitor the transactions. The exchange of information was more a ceremonial formality rather than to sift the data. The lead bank did not share the areas of concern. They did not take note of warning signals mentioned in the business rating reports. The lead bank did not exchange the information in meetings to alert other member banks at early stages.

- It is evident that Bullion Trade and Merchant Trading were not genuine transactions carried out in the ordinary course of the business. The losses were deliberately booked through related party transactions to siphon off/ divert the funds availed from the consortium thus committing default in making payment/ repayment thereof. The high value transactions were made without the specific approval of the consortium.

Systemic Improvement:

- There should be control of financers on movement of stocks. Genuineness of buyers should have been verified to ascertain whether buyer is capable of such a huge buying.

- Banks should have exercised due diligence on the buyers and have executed a tripartite agreement with the buyers & exporters to remit proceeds to bank account of the companies in India. Confidential Report (CR) on all foreign buyers should have been obtained/ analyzed.

- Gem & Jewellery Sector credit facilities to these companies increased manifold within a short span of time in an effort by the banks to increase their credit dispensation. There should have been some segment related limits on such type of credit exposures.

- There were frequent attempts by fraudsters to fabricate documents and avail finance from banks. Heightened awareness of loopholes, consequences of bypassing procedural aspects and check points for evaluating genuineness of various essential documents was very much necessary. These points should be the learning lesson for future.

- It should be ensured that appropriate accountability is fixed in the chain of command including sanctioning authority in the event of such frauds instead of fixing entire responsibility on lower functionaries.

- Investigation should be done to find out the trail of diversion so as to find as to where the money has gone whether any money has been remitted /parked aboard.

- Bank must immediately delist such third party valuers, Chartered Accountants/Chartered Engineers, Advocates etc. who have questionable credentials/have been negligent in their professional duties or have caused financial loss to the bank by their willful acts of omission/commission/dishonesty. A periodical review of all empanelled professionals should to be ensured by banks for weeding out undesirable third party service providers.

- In such cases of frauds the concerned banks should get forensic audit done and concerted efforts should be made by banks to get back the money lost.

- Jewellery sector units may also be asked to furnish a monthly declaration to its lender Banks declaring details of all transactions /financial agreement/ contract entered into by its subsidiaries with their business associates.

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Trading Sector

The cases of frauds perpetrated by three companies in this sector have been analysed. The companies were in business of trading in coal, pulses and agro commodities, and aluminum foil rolls. The companies had adopted a business model by which they imported goods from foreign banks/private parties against SBLC/LC/ Cash Credit for trading in domestic market. The Companies availed credit facilities from the banks under consortium arrangement led by one of the banks.

Modus operandi:

- The company had diverted a substantial amount of fund to related parties/ associate concerns. The creditors had not been deducted for the purpose of calculation of drawing power. The scrutiny of purchases and sales of the company revealed that there were many cases where the same party was the customer as well as the supplier.
- The Company violated accounting principles and misutilised funds for other purposes. Funds were utilized towards purchase of real estate in the name of the director and his relatives.
- The other Company submitted the documents with the bills drawn under the letters of credit issued/opened on behalf of the borrowers which were fabricated and the underlying transactions were not real merchant trade transactions. The letter of credit mechanism/ RTGS facility for kite flying transactions involving unconnected parties were grossly misused by the borrowers.
- When the bills drawn under the letters of Credit (LC), opened on behalf of the company, started devolving, the bills were met by creating overdrafts in the accounts as fund was not provided by the company.
- In case of another company, the credit facilities were given by the banks to the borrower for the purpose of manufacturing and exporting of aluminum foil containers, its lids and covers. However, the company instead of utilizing the funds for which the credit were granted, utilized the same for granting loans for the other entities without any security or documents and that too in the sectors which were not even remotely related to the core business activity of the company.
- The Company resorted to falsification of the account by manipulating the position of LCs/ Buyers credit outstanding in the monthly stock statement thereby overstating the drawing power in the cash credit account.
- The company's debts increased substantially during a particular period. The funds were utilized for investments mainly by way of loans and advances, the returns of which were not immediately forthcoming.

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- During Investigation, some unusual transactions were observed in the account of another company. Funds were diverted to finance various sister concerns/associates dealing in various areas of business ranging from real estate development to gambling business (breeding price bulls and race horses).

Loopholes/Lapses:

- The Company dealt with many related parties including subsidiaries/associates including their key management. The gross amount receivable from the related parties was much higher while amount payable was much less.

- The bills which remained unrealized from the associate concerns reflected funds which had already gone out of working capital cycle for long since in many cases there were cross transactions of sales and purchases from the same party i.e the same party was the buyer as well as the supplier on different occasions.

- The Company had not made transactions in accordance with RBI guidelines on merchant trade. In the case of LC opened, it was noticed that major transactions had taken place in a bank with 2 parties with same address where they had acted as customers as well as suppliers.

- The Company had routed transactions from banks outside the consortium to keep the business going as devolvement had taken place in majority of banks. The 60% sale of the company had such cases where records of delivery/ movement of goods had not been maintained.

- The promoters in connivance with their Chartered Accountants had submitted doctored financial papers for getting finance from different banks. The Chartered Accountants wrongly certified the balance sheets for three years from 2007-08 to 2009-10 overstating the profits /understating the losses.

- The bills drawn under LCs opened by the bank were suspected to be accommodation bills for the purpose of raising finance. The method adopted by the company revealed that the underlying transactions were not real merchant trade transactions and were only kite flying transactions.

- During investigation, it was observed that there were major diversion of funds from the borrower company's cash credit account to personal SB and CD accounts of the promoter directors and other unrelated accounts.

- The company was consistently showing inflated sales, stock holding levels and trade debtors. Book debts statement was given with assumed and artificial figures. Names of debtors were not mentioned by the company.

- Out of loans & advances sanctioned, a substantial amount of loan was free of interest by the company extended to various entities. Loans were extended in accounts, wherein no movement of receipt or payment was observed during a particular period.

- The Company had advanced loans various companies engaged in trading of bullion. Out of these advances, a large amount had been adjusted against expenses not directly attributable to company's business.

- On review of stock statement submitted to the lead bank, it was observed that the scrap was included as stock in monthly statements. Hence, stock statements were inflated.

- As per the monthly stock & statement submitted to the Bank, it was observed that creditors had substantially decreased as compared to creditors as reported in the previous month.

Systemic Improvement:

- ✓ End use of fund disbursed should be monitored and due diligence procedures should be applied to identify instances of utilization of funds for purposes not related to the business of the client.

- ✓ Even in the cases where the funds were disbursed for the purpose of working capital, its end use should be verified so as to avoid diversion of funds. Confirmation may be obtained from the customer on the utilization of funds.

- ✓ Periodic balance confirmation from top five suppliers/ buyers (creditors/ debtors) should be obtained/ ensured in stock audits and should be analyzed as a part of stock statement.

- ✓ Banks should have a fool-proof system of checking and confirming whether the company is actually working on the contracts and whether the contracts are genuinely business based.

- ✓ Corporate governance in banks in the present form is a matter of concern and has to be strengthened. Housekeeping and internal control of banks have to be strengthened.

- ✓ Multiple banking arrangements in large value financing have done more harm than good to banks. This type of arrangement enabled corporate to secure multiple finances from various banks far in excess of their requirements. Funds raised are easily diverted through company's accounts with various banks in the absence of effective exchange of information between the banks. There is a need to review the multiple banking arrangements.

- ✓ Realization of receivables and payment to creditors are required to be monitored. In case transactions routed through the accounts with consortium members do not tally with corresponding movement reflected in the stock statements, Concurrent Auditors to monitor the transactions need to be appointed by the member banks.

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- ✓ The debtors' position of the borrowers should be closely monitored. It should be a part of the Stock Audit and Inspection and audit report. Controller should critically go into on the quality of business booked by branches and sudden spurt, if any, observed in business growth should be thoroughly investigated.

- ✓ Operating officials are being equipped with inputs on Forensic Audit areas and to understand the complex business models especially transactions through Associates concerns/ wholly owned joint ventures.

- ✓ Bank must immediately delist such as third party valuers, Chartered Accountants/ Chartered engineers, Advocates etc. who have questionable credentials have been negligent in their professional duties or have caused financial loss to the bank by their willful acts of omission/commission/dishonesty. A periodical review of all empanelled professionals should to be ensured by banks for weeding out undesirable third party service providers.

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Export Business Sector

The cases of frauds perpetrated by four companies in this sector have been analysed. The companies were engaged in exporting cotton bales, cotton & synthetic yarn, agro/engineering goods and readymade garments to China, Dubai, Singapore and other countries. The Companies availed credit facilities from the banks under consortium arrangement led by one of the banks.

Modus operandi:

- Bank was discounting the export bills of the company against LCs from prime banks of the buyer. The payment/acceptance of bills was delayed. On the request of the company bank had extended the due date of bills.

- As per information gathered from Custom authorities, export had not taken place against most of the bills. Goods produced for exports against packing credit (PC) were also not available. It appeared that either goods were not produced against PC or disposed off locally and funds were siphoned off.

- The Customs authorities had informed that exports did not take place in 200 cases out of the pending 203 bills, as these consignments did not relate to any exports.

- Another company availed multiple loans from different banks/ institutions for acquisition of the same set of equipments from the same suppliers at almost similar estimated cost.

- Completion of projects was confirmed to respective banks/institutions by submitting false/ fabricated certificates from Chartered Accountants and false status reports. Term loans were not accounted for in the year of their receipt/payment.

- The cash inflows and out flows were dealt with outside the books of accounts and not reflected in the audited balance sheets of the company during respective years.

- One other company had given the same export orders to various banks in consortium and availed packing credit facility. The company did not submit the export documents to the same bank from whom the packing credit was availed.

- The Company submitted contract documents to member bank for availing the credit facilities. The company had obtained export packing credit disbursement from another bank against the same contract document.

- The list of book debtors submitted by the party showed that most of the debtors were foreign buyers. In the backdrop of payment received from third parties and the bills

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getting returned, earlier the company had stated that the goods were sold to alternate buyers as the original buyers were renegotiating the price after dispatch of consignments.

- In respect of the creditors for suppliers, full details of such suppliers were not available. The investigating officer stated that the creditors for the supply were fabricated in order to artificially boost the purchase, sale and receivable.

- The borrower companies cheated the bank by submitting fake and forged export bills for purchase/discount which were drawn in nonexistent overseas buyers.

Loopholes/Lapses:

❖ The bank had discounted the bills against the terms of the sanction without ensuring acceptance of bills and confirmation of due date for payment from LC issuing bank. The bank did not obtain GR form of shipping bills verified/issued by custom authorities.

❖ There were several apparent major discrepancies in set of bills submitted for discounting which should have aroused suspicion about genuineness of bills. Due date of bills extended at the request of the company without ensuring acceptance of bills, analyzing reasons for non acceptance of bills and delay in acceptance of bills.

❖ The Chartered Accountants including Statutory Auditors tended to collude and conspired to be a party in submitting false, fabricated and misleading financial statements and certificate to the institutions/banks with the only intention of obtaining disbursement of the financial assistance.

❖ The company had managed affair of the company based on false and fabricated books of accounts to ensure easy and smooth flow of credit without any restraint by way of term loan from financial institutions for funding cash losses.

❖ The proceeds of packing credits & FBPs credited to the account were withdrawn on the same day in clearing suggesting improper end use and diversion of loan proceeds.

❖ The export transaction undertaken by the company was suspect considering the fact that within a span of less than 3 months the utilization of the limit was to the brim under PC and negotiation of bills under LC.

❖ Realization proceeds of export bills credited to current account of the company which was subsequently withdrawn by the company when bank packing credit was outstanding.

❖ Credit report of all associates/ sister concerns was not obtained from their banker as per terms of sanction. Periodical inspection for packing credit disbursement to ensure end use was not carried out.

Systemic Improvement:

✓ Monitoring of systems and MIS generation has to be strengthened. Housekeeping and internal control of banks also have to be strengthened.

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- ✓ There are lacunae in bank's credit and risk management policies. Proper mechanism to be devised for review of the policies of the bank and to keep it updated as per change of environments.

- ✓ Multiple banking arrangements in large value financing have done more harm than good to banks. This type of arrangement enabled corporate to secure multiple finances from various banks far in excess of their requirements. Funds raised are easily diverted through company's accounts with various banks in the absence of effective exchange of information between the banks. There is a need to review the multiple banking arrangements.

- ✓ There should be no over confidence on the borrowers based on their stature. Bank's top management should take considered decision on the merits of the proposal irrespective of the reputation of the company.

- ✓ Fraud monitoring in financial services should be a specialized area and a specialized cadre may be created to monitor and investigate such cases. The skill gaps in banks should be addressed through proper training.

- ✓ Management of fraud risk in large value advances need a comprehensive approach. It requires being changes in mindsets, fine tuning of work progress and human resources skills. Banks need to have a system of real time information sharing among them. To deal the fraud effectively, there has to be better support from enforcement agencies coupled with strong legislative.