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RBI Master Directions on fraud risk management

July 2024

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In July 2024, the Reserve bank of India (RBI) issued Master Directions on fraud risk management applicable to regulated entities including Banks, AIFIs, NBFCs, and cooperative banks (“regulated entities”).

The directions aim to increase the overall roles and responsibilities of boards in fraud risk management, enhance internal control frameworks, and ensure compliance with principles of natural justice. They are also expected to have a significant impact on various stakeholders in the entire lending ecosystem, including borrowers, external auditors, judicial system, etc.

Impact on regulated entities

Boards of these regulated entities are mandated to formulate and approve the Fraud Risk Management Policy. Under this policy, they need to form multiple committees helmed by the board to oversee effective and efficient implementation of the policy. This increased accountability aims to improve both the implementation and subsequent oversight of the Fraud Risk Management Policy.

Furthermore, these directions mandate improvement in early warning signals (EWS) and red flag accounts (RFA). These include mandatory integration of EWS with core banking solutions (CBS) and operational systems, mandatory establishment of data analytics and market intelligence units to continuously monitor financial transactions, and implementation of EWS for non-credit-related transactions. These will be critical in increasing the efficiency of prevention and early detection of frauds.

Finally, the directions emphasis principles of natural justice, in line with a notable Supreme Court* ruling from 2023. This ensures that entities and individuals have a fair opportunity to respond before being labeled as frauds. However, its impact on effective closure of the assessment of RFAs would be note-worthy considering the various nuances involved in forensic audits, availability of data, operational efficiency etc. Furthermore, these additional opportunities could affect the recoverability of the facilities in confirmed fraudulent accounts, since fraudsters would potentially have more time to dispose of their assets.

Impact on borrowers

The flip side of the principles of natural justice of Master Directions also means that borrowers must now be prepared to respond quickly to any allegations or clarifications raised by regulated entities at various stages of monitoring and investigations. For instance, while enhancements in EWS and RFAs are likely to prevent and detect fraudulent transactions, they would also lead to significantly high instances of triggering of EWS and suspicious transactions, requiring prompt responses from borrowers for timely closure.

Furthermore, the directions mandate regulated entities to conduct timely internal or external audits for all RFAs. In cases where audits remain incomplete due to lack of information or non-cooperation from borrowers, the directions mandate regulated entities to close investigations and classify accounts as “Fraud” or otherwise based on available information. Hence, it is imperative for borrowers to be prepared to maintain relevant documentation and respond diligently to allegations. This is likely to lead to better governance and better financial controls.

Borrowers would therefore need to enhance their internal processes and possibly set up a response mechanism to ensure prompt responses to regulated entities and to avoid disruptions in banking operations.

Impact on external forensic auditors

External Forensic Auditor’s reports are pivotal in issuing show-cause notices before declaration of fraud or wilful defaulters. Therefore, it is crucial for external forensic auditors to draft reports that are forensically and legally sound and capable of withstanding scrutiny in legal proceedings.

Impact on judicial proceedings

Considering the application of principles of natural justice, many cases that would have been erroneously declared as “Fraud” may now get resolved before entering judicial systems. This could reduce the burden on the system and quicken the process of justice. However, frivolous defences against potential actions by lenders against borrowers could delay the resolution process, as lenders may now have to deal with creative counter arguments from borrowers before taking any coercive actions against them.

Points to ponder upon

It will be worthwhile to see whether there will be any substantial changes made by lenders in the operating procedures and policies while dealing with instances where forensic audit reports have indicated "Red Flags" or "potential frauds". Some points that lenders could be faced with could be sharing of the information relied upon by the lenders for the purpose of declaring fraud, opportunity for personal hearings to borrowers, presence of external legal counsels of borrowers in personal hearings, time limit provided to borrowers to respond to allegations of fraud, diversion, siphoning off of funds, opportunity to cross examine forensic audit report and consideration of independent forensic audit reports obtained proactively by the borrowers themselves.

*Judgement of the Hon’ble Supreme Court dated March 27, 2023 on Civil Appeal No.7300 of 2022 in the matter of State Bank of India & Ors Vs. Rajesh Agarwal and Ors. and connected matters, read with the Order dated May 12, 2023 passed by the Hon’ble Supreme Court in Misc. Application. No.810 of 2023.

Key takeaways of the Master Directions

The key takeaways of the Master Directions are as follows:

Comprehensive

The Directions have a wider coverage and are applicable to all banking companies, foreign banks, AIFIs, NBFCs, cooperative banks including regional rural banks, payment banks, foreign banks, etc.

Governance

Boards of banks and institutions would be responsible to:

- Formulate a policy on fraud risk management with the following key elements:
  - Separate roles and responsibilities of board/board committees and senior management of the bank
  - Principles of natural justice, thereby issuing SCN and provide reasonable time of at least 21 days before issuing a well-reasoned order and reporting any persons/entities as fraud.
- Constitute a "Special Committee of the Board for Monitoring and Follow-up of cases of Fraud" (SCBMF) to oversee the effectiveness of Fraud Risk Management and periodically review fraud cases to identify root causes and suggest mitigating measures.

Prevention

- EWS framework
  - EWS framework would form a part of Fraud Risk Management Policy and would be overseen by a board-level committee such as Risk Management Committee or any other committee of similar functions.
  - The EWS Framework should have a wider coverage to not just include Credit Facilities/ Loan Accounts but also to include other banking/non-credit related transactions.
  - All the institutions need to upgrade/put in place the EWS framework within six months from issuance of the directions.
- Other preventive measures
  - Mandatory setting up of Data Analytics and Market Intelligence units to continuously monitor financial and non-financial transactions.
  - Add "Right to audit" in the loan agreements to enable audits in suspicious/RFAs through external or internal auditors.
  - Accountability clauses for wilful malpractice/ negligence to be added in the agreements with third-party service providers.
  - Debarment of persons/entities (including associated entities) classified and reported as fraud by banks from raising of funds financial entities regulated by RBI, for a period of five years from the date of full repayment.
  - Institutions shall initiate and complete the examination of staff accountability in all fraud cases in a time-bound manner.

Reporting of fraud cases

- Reporting to law enforcement agencies
  - The Directions now require institutions to report fraud to law enforcement agencies (earlier police/CBI)
- Reporting to RBI
  - The Directions provide for wider list of categories to choose from while reporting fraud monitoring returns (FMRs).
  - Banks are now additionally required to report payment system related disputed/suspected or attempted fraudulent transactions to Central Payments Fraud Information Registry (CPFIR), maintained by the RBI.

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