

# **FINANCIAL FRAUDS IN INDIA: A CASE STUDY OF THE EFFICACY OF BANKING SYSTEM IN INDIA**



**Dissertation submitted in partial fulfilment of the requirement  
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Corporate and Commercial Laws**

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## **DECLARATION**

I, T.S. NITHIN hereby declare that the Dissertation work titled” **FINANCIAL FRAUDS IN INDIA: A CASE STUDY OF THE EFFICACY OF BANKING SYSTEM IN INDIA**” is an original work done by my me under the supervision of Dr. Harshita N Kulkarni, School of Law, Governance and Public Policy, Chanakya University, Bangalore.

I further declare that to the best of my knowledge this LL.M. Dissertation does not contain any part which has been submitted for the award of any degree either in this University or in any other Institutions without proper citations. It is further declared that all the sources of information used in the dissertation have been duly acknowledged. I understand that the dissertation may be electronically checked for plagiarism by anti-plagiarism software to assess the originality of the submitted work.

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## **CERTIFICATE**

This is to certify that the dissertation titled “**FINANCIAL FRAUDS IN INDIA: A CASE STUDY OF THE EFFICACY OF BANKING SYSTEM IN INDIA**” submitted by **T.S. NITHIN**, bearing Registration Number 24PG00015, in partial fulfilment of the requirements for the award of the Master of Laws (LL.M.) Corporate and Commercial Laws, at Chanakya University, Bengaluru, is an original work carried out under my guidance and supervision.

I certify that this is a Bonafide work of T.S. NITHIN

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# CHAPTER 1

## INTRODUCTION

### 1.1 Introductory

Fraud in the Indian economy, especially in its huge and complicated banking system, has become a big problem. In India, there have been more financial scams involving businesses and the government in the last few years. Everyone falls for these scams, from people not paying back their loans and moving money to hacking and insider trade. They all make people lose faith in the financial system. The problems with Yes Bank's collapse and Nirav Modi's involvement in the Punjab National Bank (PNB) scam have shown that India's banking industry has problems with ethics, operations, and rules.

For economic growth and financial safety, the Indian banking business is very important. Internal controls, risk assessment, and governmental tracking have all been called into question by the return of financial crime. These disasters entail huge financial losses and damage the credibility of the institutions involved, undermining investor confidence and harming the economy. Digitalisation and the spread of financial services to rural and semi-urban areas have made scam more likely, so everyone needs to come up with a strong and flexible reaction.

This case study examines how well Indian banks prevent, identify, and manage financial fraud. It will delve into the systemic issues that contribute to such crimes, assess the existing legal and regulatory frameworks, and evaluate the response mechanisms adopted by banks and authorities. The report seeks to identify gaps and suggest ways to improve financial governance, accountability, and depositor and investor protection in India's developing financial sector.

### 1.2 Statement of the Problem

- i. The rise in financial scams in India's banking sector over the past few years has hurt both public and private bodies. Notwithstanding regulatory bodies, contemporary technology, and stringent compliance regulations, large-scale frauds such as the Punjab National Bank affair, Yes Bank crisis, and IL&FS collapse have

shown shortcomings in detecting fraud, handling risk, and institutional accountability. These events have caused significant financial losses and eroded public faith in banks.

- ii. Fraudsters now have more chances to make money because banking operations are getting more complicated and digital transfers are growing quickly. But the legal and political systems that are already in place often fail to react quickly and effectively. This brings up important questions about how well the Indian banking system stops, finds, and handles financial scams.
- iii. Because of this, it is important to look into the root reasons, judge how well institutions are responding, look into major fraud cases, and find ways to make the system stronger. The goal of this study is to answer these worries and help make India's banking industry stronger and more open.

### **1.3 Objectives of the Research**

1. To understand the types, evolution, and impact of financial frauds in the Indian banking system.
2. To examine the role of regulatory institutions and laws in preventing and responding to financial frauds.
3. To analyze major financial fraud cases in India and identify gaps in fraud detection and management.
4. To provide suggestions for strengthening the Indian banking system against future financial frauds.

### **1.4 Hypothesis of the study**

- i. **H1:** There is a significant relationship between the rise in financial frauds and weaknesses in the Indian banking regulatory system.
- ii. **H2:** Digitalization has contributed both positively and negatively to the occurrence and detection of financial frauds in Indian banks.
- iii. **H3:** Institutional and legal responses in India are not fully effective in preventing and managing large-scale financial frauds.

- iv. **H4:** Financial scams in the Indian banking sector are less likely to happen again because they are caught quickly and strictly enforced.

### **1.5 Literature review**

**Yusuf et.al (2016) “A Conceptual Study on Islamic Corporate Governance Model in Curtailing Bank’s Fraud”** evaluated the effect of Islamic corporate governance on banking fraud of small Islamic banks in Nigeria during June 2016 to July-2016, using conventional sampling method and 5-Point Likert scale including dependent and independent variables. Researchers used various variables such as Financial Fraud, Islamic Corporate Governance, Rationalization, Capability, Opportunity and Pressure. According to the report, the pilot study's statistics provide indications of logical normalcy<sup>1</sup>.

**Adetoso et.al (2016) “Fraud control and fraud prevention in Nigeria banking industry”** looked at how to control and stop theft in a certain area of Nigeria's banking system. First-hand information was used for this study. In order to gather information, 150 workers from five Nigerian business banks were given a worksheet to fill out. Controlling fraud was the dependent variable, and stopping fraud was the independent variable. They used many types of statistics, like regression analysis, P-value, Durbin Watson, the standard test level, F-test, and T-test. The study says that the three main types of fraud in the financial business are defalcation, forgeries, and theft and embezzlement. The research found a substantial association between managerial control and whistleblowing at selected institutions. They concluded that Whistleblowing policy is an effective tool that can be used in reducing fraud in the commercial bank of Nigeria<sup>2</sup>. They recommended that Management control, Whistle Blowing policy and framework of the new policy as a tool for reducing the banking fraud.

**Adeniyi et.al (2016) “Examination of Fraud in the Nigerian Banking Sector and its Prevention ”** They looked into scams in the Nigerian banking sector from 1995 to 2014 using the ex post facto research design for secondary research and the random

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<sup>1</sup> Yusuf AD, ‘Moderating Role of Islamic Corporate Governance Between Pressure, Opportunity, Rationalization , Capability and Banking Fraud in Kano State Nigeria Ali D . Yusuf’ 1

<sup>2</sup> Idris S and Babangida MA, ‘Whistleblowing Policy and Fraud Prevention in Nigeria’ (2021) 1 UMYU Journal of Accounting and Finance Research 113

sample method and cross-sectional survey design for primary research. Employees and management teams from 16 DMBs, 5 audit firms, and the Central Bank of Nigeria's zonal office were studied. She used regression analysis in her investigation. Fraud prevalence did not affect Nigerian banks' expected loss, with a P-value of 0.972, more than 0.05. The study showed that Nigerian banks' fraud amounts predict their collapse. The study recommended using forensic auditors in Nigerian banks to avoid fraud.

**Gitau & Samson et.al (2016) “Effect of financial fraud on the performance of commercial banks: a case study of tier 1 banks in nakuru town, kenya”** looked into what happens to business banks when people write fake checks, send fake bills and payments, make fake loans, or move money. The type of research used in the study was descriptive<sup>3</sup>. The researchers have used correlation analysis, regression analysis, multiple regression analysis and ANOVA, F –Test using SPSS software. The data for this research were gathered from the original source by administering a questionnaire to fifty respondents from 11 Kenyan banks. This study used data that was already out there. The yearly records of the Central Bank of Kenya were used to get secondary data. While the yearly liquidity ratio, annual fraud loss, cheque fraud, invoice and payment fraud, lending, and money laundering were independent variables, ROA was a dependent variable. According to the analysis, the bank's return on assets was favourably influenced by fraud loss and liquidity ratios<sup>4</sup>. The study recommended that the financial department should work with other departments.

**Gudup et.al (2016) “The study of frauds and safety in e-banking”** studied frauds and safety in E-banking. The study found that 65% of all scams were linked to technology and advanced theft. There was both first-hand and second-hand material used in the study. We used a questionnaire to get first-hand information, and newspapers, bank records, and the internet to get second-hand information. The author has selected area of customers having internet banking, ATM & credit cards of selected from Nanded District. The study concluded that Bank should develop high security and safety features for E-banking transactions

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<sup>3</sup> Funmi PA and others, ‘Bank Fraud and Its Effect on Nigerian Economy-a Study of Selected Quoted Banks’ (2018) 6 European Journal of Accounting, Auditing and Finance Research 104 <[www.eajournals.org](http://www.eajournals.org)>

<sup>4</sup> Madugba J and others, ‘Effect of Electronic Banking on Financial Performance of Deposit Money Banks in Nigeria’ (2021) 16 Banks and Bank Systems 71

**Enofe et.al (2017) “Bank Fraud and Preventive Measures in Nigeria: An Empirical Review”** evaluated a strong internal control system & good corporate governance on banking sector fraud prevention in Nigeria during the year 2015, using random sampling method and 4-Point Likert scale including dependent and independent variables<sup>5</sup>. The writers employed primary data and questionnaires to acquire information. Data was collected from 15 NSE-listed commercial banks in December 2015. Bank fraud prevention was a dependent variable, whereas control systems, company governance, and banking ethics were independent variables. Researchers employed the Regression Model with Ordinary Least Squares and different statistical approaches such as co-efficient, standard error, T-statistics, and probability to conduct the study. According to the research, avoiding financial fraud was made easier by sound company governance, a robust internal control system, and sound banking practices. According to research, in order to avoid fraud, mistakes, and misappropriations, financial institutions should create and implement a rigorous and efficient set of criteria<sup>6</sup>

**Verma et.al (2017) “Impact of frauds on the performance of Indian public sector banks: An empirical analysis”** examined how scams affect Indian public sector bank profitability. RBI secondary data was utilized for the research<sup>7</sup>. Her study focused on 26 public-sector banks. Research was done 2005–2015. The researchers looked at Return on Assets, Return on Equity, and Return on Investment as dependent factors along with the intensity and frequency of theft. Statistical tools like least square regression, correlation matrix, descriptive statistics, F test, and R<sup>2</sup> were used by the experts. They found that the number and intensity of frauds had a big effect on how much money Indian public sector banks made.

**Rohilla et al. (2017) “State-wise Assessment of Banking Frauds in India: A Study of Trends in 21st Century”** From 2007 to 2016, ten years, they looked into state-specific crime trends in India's public sector banks. Primary and secondary data were

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<sup>5</sup> Ben OC, Patrick EA and Caleb AJ, ‘Investigating the Impact of Corporate Governance on Banks ’ Performance in Nigeria : A Field Experiment’ (2015) 1 98

<sup>6</sup> Jensen M, Meservy T and Nunamaker J, ‘Automated Kinesic Analysis for Deception Detection’ [2010] Proceedings of the Credibility Assessment and Information Quality in Government and Business Symposium Credibility Assessment and Information Quality in Government and Business Symposium 31

<sup>7</sup> Sharma D and Verma R, ‘Impact of Frauds on the Performance of Indian Public Sector Banks: An Empirical Analysis’ (2017) 6 SAARJ Journal on Banking & Insurance Research 25

used in the study. Information Rights, Lok Sabha, Rajya Sabha Starred and unstarred questions provide most of the data, while RBI circulars, media stories, publications, and ASSOCHAM and Deloitte polls provide secondary data. The researcher picked 32 Indian states to investigate financial fraud. The researcher analysed using descriptive statistics and graphs. The survey found a rise in Indian financial scams. The report found that Maharashtra, West Bengal, Chandigarh, and Gujarat had the highest fraud rates in India. Given the state of the Indian economy, the government and RBI have supported a strong cyber security policy and legislative framework for banks. The RBI should take the required efforts to raise consumer awareness about scams<sup>8</sup>.

**K S L N S Subrahmanyam et.al (2019) “Financial Frauds on Financial Performance of Banking Industry”** The Indian economy has grown because of work done in many places. Indian banks play a big role in the economy, and they're also becoming more important to economies around the world. Since then, the ability of the banks that were taken over by the government to stay in business has gone up and down a lot. Indian banks have to follow certain rules, but those rules need to be changed so that the Banking Regulation Act is always followed. These rules come from the Reserve Bank of India and are changed by the government when they need to be. The banking industry has been hit hard by financial disasters, losses, and bills over the last 20 years. This is because it is easy for loans to be approved and the repayment rate is low. That was because of scams and other bad behavior for some reason. Both the government and the people of the country have to pay more money because of this. This study paper looks at the reasons behind financial fraud and makes the necessary suggestions to get rid of fraud and build strong and effective control systems.

**Sagar Sharma et.al (2024) “Analyzing cybercrimes and cyber security landscape in the banking sector of india”** Since the start of COVID-19, all back-end and front-end activities in the banking industry have been done digitally. With the release of new technologies, cyberattacks are happening more and more often. Since most banks are now online, there are risks like ransomware, fake scams, privacy issues, and more. There aren't enough strong security measures in place for both online and mobile services, and computer dangers are becoming more widespread. Cybercriminals are

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<sup>8</sup> Scott WR, ‘Unpacking Institutional Arguments/The New Institutionalism in Organizational Analysis. Ed. Walter Powell, W and Paul DiMaggio’ (1991) 1 RBI Monthly Bulletin 1

always looking for ways to make money in the banking industry. This paper talks about how bad hacking is for Indian banks, how cyber security is set up to stop cyber risks, and what can be done to keep Indian banks safe. Websites like news sites, government websites, articles, and research papers were used to get secondary data for the study. Another use is to look at examples of cybercrimes that have cost a lot of money in the past few years. To make things safer, this paper will look at steps that financial companies, banks, and people can take to deal with hacks that can be stopped.

**Sadhana Tiwar et.al (2022) “Assessment of Association between Financial Fraud Cases in reference to Transaction Volume & E-Auditing”** When the Indian economy was opened up in 1991, the banking business grew and got a lot better. Some issues with fairness, money issues, and corporate governance come up in the banking business, even though it is mostly well controlled and run. There have been a lot more banking actions since e-banking became popular. Also, it has sped up and made customer service easy. The study says that cyber theft costs money, and the money lost can belong to either the bank or the customer. Among other things, it could hurt the bank's name. It tries to find a link between the amount of fraud, the growth of e-auditing, and the number of deals that happen every year. The study looked at information from 12 years, from 2009–10 to 2020–21. To look at the link between the above factors, linear regression and analysis of variance were used. The study found that every year there are fewer fraud cases, even though there are more deals, which makes fraud more possible. Even though there are security problems with electronic banking in India, the expert came to the conclusion that it has made banks run more efficiently. Based on these data, the researcher says that, among other things, the Reserve Bank of India should make sure that different electronic banking networks have the right security measures in place, look over the BVN system, and teach people how to use electronic banking.

**Udeh et.al (2018) “Fraud in Nigerian Banking Sector”** examined how fraud affects Nigerian bank earnings, assets, and deposits. Ex post facto research was used. All analysis used secondary data from 2006–2015. The figures came from NDIC annual reports. The survey sampled 24 Nigerian Stock Exchange-listed banks. The researchers used descriptive analysis, OLS, and regression analysis for this study. They utilised bank profit, assets, and deposits as dependent variables, with fraud as an independent

variable. The research found that fraud has a detrimental influence on Nigeria's banking industry. Research suggests that profit and fraud are negatively correlated, although crime and assets of banks and deposits are positively correlated. They advised that the bank use more stringent procedures in their personnel recruiting and internal control actions to minimise the risks connected with an expanding amount of deposits<sup>9</sup>.

**Upadhyay et.al (2018) “Banking scams in india”** This article examines Indian bank scandals' importance. Bank fraud falls into three types, according to the survey: Internet banking, ATM, credit, debit, and identity fraud<sup>10</sup>. Fraud may be classed into three types: fraud by insiders, fraud by outsiders, and both. The study also discussed the main frauds in India. The research concluded that NFRA is an independent regulator of the auditing profession.<sup>11</sup>.

**Jorge Bernard et.al (2019) “Impact of Frauds on the Indian Banking Sector”** looked into how fraud affected the Indian banking industry. The study found that banks are having a harder time making money because of more bank scams and assets that aren't being used. Records from 2013 to 2018 were used for the whole study. When they looked into it, they found that most of the theft in Indian banks involves borrowing. In this study, they used regression analysis. It was thought by the writers that a rise in theft would lead to a rise in NPA and a drop in profits. In India's banking business, loans are the main target of scams. They found that the banking system had a number of problems and that court processes were taking too long. They said that theft had a big effect on the Indian banking sector's ability to make money and on the amount of bad loans (NPAs).

**Sadhana Tiwari et.al (2022) “Assessment of Association between Financial Fraud Cases in reference to Transaction Volume & E-Auditing”** The banking industry has grown and gotten better a lot since 1991, when the Indian economy was opened up. There are some problems with fair standards, financial hardship, and corporate governance in the banking business, even though it is mostly well regulated and

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<sup>9</sup> Udeh SN and Ugwu JI, 'Fraud in Nigerian Banking Sector' (2018) 8 International Journal of Academic Research in Business and Social Sciences 585

<sup>10</sup> Mehta A, 'Impact of Technological Advancements on Banking Frauds: A Case Study of Indian Banks' (2024) 7 International Journal of Research in Finance and Management 261

<sup>11</sup> Aashima A, Mohanty B and Kedia N, 'Evaluating the Significance of Forensic Accounting in Fraud Detection in the Indian Banking Sector: A Systematic Literature Review' (2023) 19 Gurukul Business Review 145

managed. With the rise of e-banking, there have been a lot more banking activities. In addition, it has made customer service easier and faster. The study says that cyber theft costs money, and the money lost can belong to either the bank or the customer. Among other things, it could hurt the bank's name. It tries to find a link between the amount of fraud, the growth of e-auditing, and the number of deals that happen every year. The study looked at information from 12 years, from 2009–10 to 2020–21. To look at the link between the above factors, linear regression and analysis of variance were used. The study found that every year there are fewer fraud cases, even though there are more deals, which makes fraud more possible. Even though there are security problems with electronic banking in India, the expert came to the conclusion that it has made banks run more efficiently. Based on these data, the researcher says that, among other things, the Reserve Bank of India should make sure that different electronic banking networks have the right security measures in place, look over the BVN system, and teach people how to use electronic banking<sup>12</sup>.

**Dr. C. Mallesha (2020) “Cyber-crime and cyber security in Indian banking sector”**

In India today, there are a lot more cybercrimes like Trojan attacks, e-mail bombings, information theft, system hacking, data hacking, and so on. Even though businesses use a lot of different tools, hacking has been on the rise in recent years. Crimesters can do a lot of different types of cybercrime because people use computers and the internet more and more in their daily lives. In this case, people and businesses should take some safety precautions when they use the internet, since it is a big threat to hacking. The point of the study is to show the various types of theft that happen in the banking business and how these hacks impact banks. Some ideas have been put forward to stop hacking, and this study talks about some basic computer security problems.

**Pannir Selvam Ramila Rajaleximi et.al (2018) “Feature Selection using Optimized Multiple Rank Score Model for Credit Scoring”**

Finding and stopping fraud is quickly becoming the most important task for all financial service businesses and agencies. Most banks use a customer's credit past to figure out if they are creditworthy by giving them a credit score, which is a number or data value. A training sample will be used to build a credit score model, and then an analysis process will be given to each

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<sup>12</sup> Neha S and Dhiraj S, ‘An Empirical Study on Banking Frauds in India- with a Special Reference to Role of Employee Awareness in Banking Frauds.’ (2017) 3 International Journal Of Business Management 2055

customer to predict their credit score. For any credit score model, this means that lenders get different pieces of information about the customer from different outside sources. It's possible that the data received includes factors that aren't important and won't help you make any decisions. They may also slow down the model's overall performance. So, feature selection is a must if you want to get rid of characteristics that aren't important for any collection, but especially for credit score. The main point of this study is to find out how well the multiple rank score model works for the attribute selection process. The better cutting formula is used in the suggested method to collect data, and it does a better job of picking the quality trait for the credit score model below. There was an experiment done, and the results showed that the suggested method is more accurate and works better than the current single rank techniques.

## **1.6 Research methodology**

The research methodology examines financial fraud in India, focussing on the banking sector's efficacy in fighting it. This section discusses the design, data sources, analytical tools, and reasoning for using a secondary data-based case study technique.

As the number and amount of frauds in India's banking sector rise, it is important to do a full study based on real-life cases, how the law works, and how institutions respond. The study is an experiment, so it only uses secondary data from reliable sources, such as papers from the Ministry of Finance, the Reserve Bank of India (RBI), and the Comptroller and Auditor General (CAG). It also uses well-documented case studies of big fraud cases.

This technique is intended to give a thorough knowledge of the underlying causes of financial fraud, uncover system flaws, and assess the effectiveness and limitations of present preventative procedures in the Indian banking system. The combination of qualitative content analysis and case study investigation allows for a full and context-rich assessment of how financial fraud occurs and how efficiently it is addressed.

### **1.6.1. Research Design**

The trends, causes, and effects of financial crime in India's banking sector are all looked into in this qualitative and experimental study that uses only secondary data. It uses both a detailed and an analytical method to look at different types of banking fraud and

structural reactions such as risk management, legal enforcement, internal controls, and governmental review. The study draws on government documents, regulatory reports, academic research, official bank disclosures, and case studies of major fraud incidents such as the Nirav Modi–PNB scam, Harshad Mehta case, and Yes Bank crisis.

Multiple case studies are used to provide deeper insights, selected based on their scale, systemic impact, and regulatory shortcomings. Analytical methods include trend and comparative analysis to uncover recurring vulnerabilities, and a regulatory review to assess the effectiveness of current oversight mechanisms. All information used is from credible and publicly accessible sources, with proper citations, ensuring ethical research practices without involving any private or sensitive data.

### **1.7 Limitations of the Study**

There are some problems with the study because it only used secondary data sources like reports, papers, and case records that had already been released. This dependence may affect the depth, accuracy, and completeness of the findings, especially when compared to studies involving primary data or insider insights. Additionally, access to confidential documents such as internal audit reports and fraud investigation files is restricted, limiting a more thorough examination of internal control failures. A further constraint is the time lag associated with data released by regulatory bodies like the RBI or the Ministry of Finance, which may prevent the study from capturing the most recent developments or regulatory responses. The inclusion of media reports introduces the potential for bias or selective coverage, affecting the objectivity of certain interpretations. Also, the case study method gives detailed information, but it makes it hard to apply the results to the whole banking industry. Lastly, the study is geographically confined to the Indian banking system, excluding comparative perspectives from global practices that could enhance the analysis.

## CHAPTER 2

### BANKING OPERATIONS AND THE RISING INCIDENCE OF FINANCIAL FRAUDS IN THE BANKING SECTOR

#### 2.1 Introduction

Because of changes in the financial sector, more competition within the industry, new technologies, more competition around the world, banks' constantly changing strategic goals, and the constantly changing strategic goals of their current and future competitors, the Indian banking industry is being restructured. There are a lot of important jobs in the banking field, and banks run those jobs. White-collar crimes that are done by well-liked, decent people are called scams. It leads to bigger financial losses. The present day society values recognize the social status of citizens in terms of possession of wealth and means of acquiring the wealth are of secondary importance. In addition there is absence of guilt-feeling also. It is said that there is close relation between tax evasion, inflation and black money. It is possible to detect a fraudulent/forged document but to identify the author is rather difficult. Recent years have seen a rise in the total number of banks, which has resulted in a rise in fraud. Bank frauds are far more easy and lucrative and falsification of financial documents is on the increase everywhere<sup>13</sup>.

#### 2.2 Definition:

Defining key terms like fraud, financial fraud, and forensic accounting is crucial for establishing a clear understanding of the concepts in the study of banking frauds. These definitions ensure that everyone involved shares a common understanding, enabling accurate analysis and stronger conclusions. It provides clarity, context, and structure to the research, helping to communicate findings more effectively.

##### 2.2.1 Definition of Fraud:

Under Section 17 of the Indian Contract Act 1872

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<sup>13</sup> Bhasin ML, 'The Fight against Bank Frauds : Current Scenario and Future Challenges' (2016) 31 Ciencia e Tecnica Vitivinicola 56

“Section 17 of Indian Contract Act defines fraud as follows:”

- i. *“The suggestion as fact of that which is not true by anyone who does not believe it to be true.*
- ii. *The active concealment of a fact by one having knowledge or belief of the fact.*
- iii. *A promise made without any intention of performing it.*
- iv. *Any other act fitted to deceive.*
- v. *Any such act or omission as the law specially declares to be fraudulent.”*

There is fraud in the business of a company or body corporate if someone does something, doesn't do something, hides a fact, or abuses their position to trick, get an unfair advantage, or hurt the interests of the company, its shareholders, creditors, or anyone else, even if there is no moral gain or loss. This is what the Companies Act, 2013 says. People get "wrongful gain" when they illegally get something they don't have the right to, and they lose "wrongful loss" when they illegally lose something they have the right to (Study on Forensic Accounting and Fraud Detection, 2017).

### **2.2.2 Definition of Financial Fraud**

Financial fraud is any of the following things that a person, someone working for them, or someone with their knowledge does when they deal with a bank, other financial company, or any other organization that holds public funds;

- i. The suggestion, as a fact, of that which is not true, by one who does not believe it to be true
- ii. The active concealment of a fact by one having knowledge or belief of the fact
- iii. A promise made without any intention of performing it;
- iv. any other act fitted to deceive;
- v. any such act or omission as the law specially declares to be fraudulent”

### **2.2.3 Definition of Bank fraud**

When it comes to banks, what does "fraud" mean? Changes to the books of accounts, fraudulently cashing in negotiable instruments, handling securities promised or hypothecated to banks without permission, bank workers taking money,

misappropriating funds, cash theft, and other things like these are all examples of fraud. In fact, a list could not include all the different types of scams. The words cover all the things that people don't do that break trust, lie, or abuse their power <sup>14</sup>.

Frauds may be purposeful or accidental and done by:

- i. The bank staff themselves,
- ii. Bank employees conspiring with consumers or outsiders.

#### **2.2.4 Definition of Forensic Accounting**

“Forensic accounting is the field that comes from combining skills in accounting, reporting, and investigation. It looks at and makes sense of financial data. It uses accounting techniques to find and gather physical proof, generally to help find and prosecute criminals who have done things like fraud or theft.” (Study on forensic accounting and fraud detection, 2017) <sup>15</sup>.

#### **2.2.5 Definition of Forensic Investigation**

“To get proof, people look at papers and talk to other people, which is also known as forensic audit. As part of an investigation, forensic accounting looks at financial records of people or businesses to try to find proof that can be used in court.” (Study on forensic accounting and fraud detection, 2017)

#### **2.2.6 Definition of Forgery**

"Section 463 of the Indian Penal Code says that someone is guilty of forgery if they make a fake document or part of a document to hurt someone or the public, to support a claim or title, to get someone to give up property or sign a contract, or to make fraud happen or know that fraud could happen."

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<sup>14</sup> Jalan D, ‘The Report of the Expert Committee on Legal Aspects of Bank Frauds Chairman, Committee on Legal Aspects of Bank Frauds Reserve Bank of India Submission of the Report of the Committee on Legal Aspects of Bank Frauds’

<sup>15</sup> The Institute of Chartered Accountants of India (Set up by an Act of Parliament) New Delhi. (2017). *Study on Forensic Accounting and Fraud Detection*. [www.icai.org/http://cit.icai.org](http://cit.icai.org)

### **2.2.7 Definition of Scams**

A scam can be defined as a clever and dishonest way to make money and can occur in practically any area of human activity<sup>16</sup>. Viewed in strictly legal terms, scams are generally offshoots of crimes. Scams are classified depending upon the nature of the crime. For instance, cheating, fraud, violation of fiscal laws. Because they are different from other crimes in a number of ways, scams: Especially when it comes to money, scams usually involve tricking the system. Often, they go unnoticed for a long time, and it's also possible that a lot of scams that have already been done are never found. Since scams involve manipulation of the system, collusion of the regulatory authorities has generally been observed in the majority of them. Moreover, scams, in order to qualify as such, entail widespread complicity and large sums of money. Previously, scams surfaced in 'closed economies', activated by the principal of 'self-reliance', and countless instances of such scams can be cited. In India the license, quota, or permit raj, which was prevalent for many years, spawned the maximum number of scams in the 'closed economic set-up'. Now that economic liberalization is the mantra, a soft attitude coupled with increased economic activity has also created a potential for the occurrence of scams.

### **2.3 Types of Bank Fraud**

- i. Check Kiting: This is when someone writes a check that isn't worth the amount of money on it. Because banks need some time to figure out that a cheque is fake, this can happen.
- ii. Check Fraud: This is a very common crime in which stolen checks or fake signatures are used to steal money from other people.
- iii. Accounting Fraud: Some businesses lie about their finances to hide a problem. They do this by making up records that make the business look better than it really is. This can help them get loans or other ways to get money.
- iv. Letter of Credit Fraud: A letter of credit is a paper that lets someone borrow money and give you credit, generally with some time to pay it back. Letters of credit are most often used in foreign trade, where someone wants to buy something from another country but needs to borrow money to do so. Criminals sometimes try to

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<sup>16</sup> Farrell G and Pease K, *Repeat Victimisation*, vol 12 (2013)

trick banks with fake letters of credit by showing proof that the goods have been shipped when they haven't.

- v. The second type of fraud is payment card fraud, which is when dishonest things are done with a debit or credit card.
- vi. Phishing and Internet Fraud: Phishing is a type of internet fraud in which someone sends a lot of annoying emails at once. This can be done by making fake websites, getting people's personal information without their permission, or just writing a lot of emails quickly.
- vii. OTP Fraud: OTP codes are used to communicate securely between two people. Someone could change the code so that the money goes to a different account, which could be used to commit fraud.
- viii. Counterfeit Securities: You can use fake papers, which look like securities, as collateral to get a loan from a bank. This means the papers might not be real or have anything to do with the real thing.
- ix. ix. Forged Document Fraud: People can get loans or protection from banks by using fake papers.
- x. x. Fraudulent Money Laundering: This is when someone tries to hide where the money really comes from so they can get an unfair edge.
- xi. If someone breaks into a bank's computer to steal money or information, this is called bank theft. They can do this by destroying or getting into the machine or by spreading malware.
- xii. Wire transfer fraud: Banks quickly and easily send money to each other through wire transfer networks. People can try to use fake papers to get money sent to an account in another country, which makes it easy for scam to happen.
- xiii. Fraudulent loan applications: People can hide their credit past or money problems in a number of ways by giving false information on loan applications. Some people do this by telling lies about their past, while others change their financial records to look better. It's also possible for businesses to lie about their income in order to get a dangerous loan.
- xiv. xiv. Identity theft: This is when someone gets a credit card or loan using your name and number or other personal information that you give them.
- xv. Loan Fraud: Someone commits loan fraud when they borrow money that they can't pay back. People who don't have a good credit background or have too much credit card debt often get this.

- xvi. Banks trust thieves who use the business they own to get loans. This is called bill discounting scam. As if they were real customers, the crook sends small amounts of money to the business every day. When the bank starts to believe the con artist, he or she asks the bank to begin paying the company for bills that the con artist will later get from real customers. The con artist can keep the bank's money and not have to pay the bills<sup>17</sup>.

#### **2.4 Three Elements of Fraud Detection**

- i. Theft: Theft is defined as any form taking of cash, inventory, information, or other assets. Theft can occur by manual, on a computer, over the phone<sup>18</sup>.
- ii. Concealment: It refers to the procedures made by the perpetrator to conceal the fraud from others. Changing financial documents, miscounting cash or inventory, or destroying evidence are all forms of deception.
- iii. Conversion: Selling the stolen property or converting it into cash, then using the funds for purchases, is part of it.

#### **2.5 Classification of Frauds:**

- i. Misappropriation and criminal breach of trust.
- ii. Negligence and cash shortages.
- iii. Unauthorized credit facilities extended for reward or for illegal gratification.
- iv. Cheating and forgery.
- v. Irregularities in Foreign Exchange transactions.
- vi. Fraudulent encashment through forged instruments, manipulation of books of account or through fictitious accounts and conversion of property.
- vii. Any other type of fraud<sup>19</sup>.

#### **2.6 Reasons for occurrence of frauds**

- i. Non-adherence to systems and procedure.
- ii. Atmosphere of laxity/missiveness.

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<sup>17</sup> The Institute of Chartered Accountants of India (Set up by an Act of Parliament) New Delhi. (2017). *Study on Forensic Accounting and Fraud Detection*. [www.icaai.org/http://cit.icaai](http://cit.icaai.org).

<sup>18</sup> Huang SY and others, 'Fraud Detection Using Fraud Triangle Risk Factors' (2017) 19 Information Systems Frontiers 1343 <<http://dx.doi.org/10.1007/s10796-016-9647-9>>

<sup>19</sup> Laleh N and Abdollahi Azgomi M, 'A Taxonomy of Frauds and Fraud Detection Techniques' (2009) 31 Communications in Computer and Information Science 256

- iii. Lack of supervision/control.
- iv. Resort to unauthorized practices.
  - 1) Shortcuts in following procedure.
  - 2) Deviation from laid down instructions<sup>20</sup>.

## 2.7 Fraud Triangle

A model called the "fraud triangle" shows the things that can cause people to commit fraud. It has three parts that work together to make people act dishonestly.

- i. Perceived Pressure
  - ii. Perceived opportunity
  - iii. Rationalization
1. Incentives or pressure: People in management may be given incentives or put under pressure to commit fraud. This can happen when someone's, a division's, or the company's success has a big impact on pay or promotion, for example. Some people may want to change the results or put pressure on others to do so. Investors, banks, or other sources of money may also put pressure on businesses if they have high demands of them. Some danger factors can help you figure out if and how strong these forces or rewards are. People who figure out how risky an organization is look at a number of different risk factors. This is because risk factors could cause important lies to be told.
  2. Thoughts or reasons: Some people are more likely to commit scams than others. If all other factors stay the same, a person's willingness to commit theft relies on their personal situation as well as their morals. Ethical behaviour is influenced by both a person's character and outside factors, like not knowing if they will have a job after being laid off or being in a hostile work setting where no one gets a raise. This group of risk factors is usually the least observable or measured, and a lot of them are hard for an inspector to find out any other way. Attitude and rationalisation are mainly caused by the organization's culture, the people who work there, and how they connect with each other<sup>21</sup>.

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<sup>20</sup> Khanna A and Arora B, 'A Study to Investigate the Reasons for Bank Frauds and the Implementation of Preventive Security Controls in Indian Banking Industry' (2009) 4 International Journal of Business Science and Applied Management 1

<sup>21</sup> Language IE, Asma C and Narimene D, 'The Impact of Racism on the Individual Psyche: Inner Conflict in Richard Wright ' s Native Son'

3. Chances: There are times when managers or other staff members may have chances to commit theft. When there are chances to cheat, people who might not usually want to do so may be tempted to do so. There must be a way to commit fraud, and the person doing the scam must think that they can get away with it. There may also be opportunities built into the way a business is run, its size, or its organization.

## 2.8 Fraud Diamond

Wolf and Herman son's idea of the scam triangle now has four factors: "capability" is the fourth one. A lot of scams would not have happened if the right person didn't have the right skills to carry out the details of the scam. According to the scam Diamond theory, all three are needed, but "Capability" is the most important one for making a scam chance happen<sup>22</sup>.<sup>23</sup>

## 2.9 Fraud Pentagon

Fraudsters nowadays are more independent, knowledgeable, and connected than 1950s crooks. Few would dispute that the previous 60 years have seen enormous cultural transformations<sup>24</sup>. Howarth Crowe's Scam The Pentagon adds an employee's skill and conceit to each of the three fraud triangle scenarios.

1. Competence: It broadens the scope of opportunity to include a person's capacity to go over internal limitations and deal with the circumstance in a societal manner.
2. Arrogance: The perpetrator's arrogance and greed make him think company rules don't apply to him.

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<sup>22</sup> Ezugwu OB, Okoye EI and Amaechi EP, 'Application of Fraud Box-Key Model in the Determination of Fraud Risk Factors' (2017) 99 Journal of Global Accounting <[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3125237](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3125237)>[https://www.researchgate.net/profile/Emmanuel-Okoye-4/publication/323219703\\_APPLICATION\\_OF\\_FRAUD\\_BOX-KEY\\_MODEL\\_IN\\_THE\\_DETERMINATION\\_OF\\_FRAUD\\_RISK\\_FACTORS\\_EVIDENCE\\_FROM\\_BANKS\\_IN\\_NIGERIA/links/5a86](https://www.researchgate.net/profile/Emmanuel-Okoye-4/publication/323219703_APPLICATION_OF_FRAUD_BOX-KEY_MODEL_IN_THE_DETERMINATION_OF_FRAUD_RISK_FACTORS_EVIDENCE_FROM_BANKS_IN_NIGERIA/links/5a86)>

<sup>23</sup> Dana R. Hermanson, PhD and David T. Wolfe, CPA, The Fraud Diamond, <https://www.cpajournal.com/2024/06/10/the-fraud-diamond/>

<sup>24</sup> Gbegi D. and Adebisi J., 'The New Fraud Diamond Model- How Can It Help Forensic Accountants in Fraud Investigation in Nigeria?' (2013) 1 European Journal of Accounting Auditing and Finance Research 129

## **2.10 Types of Investigations**

1. Asset misappropriation: The most prevalent fraud include those involving embezzlement, and this category includes a wide range of fraud kinds. Theft of cash is a typical characteristic. For instance, asset abuse, inventory fraud, fraudulent payouts, and cash theft.
2. Corruption: Conflicts of interest, bribery, and extortion are all examples of corruption fraud. According to a research, corruption is connected to one-third of fraudulent transactions.

In a conflict of interest scam, the scammer uses their power to get something for themselves that hurts the company. Even though the scammer might not make any money, they are still getting something out of it. For example, a boss might agree to pay for the expenses of a worker who is also a friend in order to keep the friendship alive, even if the costs aren't necessary.

- i. Bribery is when someone tries to influence a situation by giving money or anything else of value.
  - ii. Extortion, unlike bribery, involves demanding money rather than offering it in exchange for a desired goal.
3. Financial statement fraud: False financial reporting is fraud that creates a fake financial statement. It may entail systematic accounting record manipulation and financial statement omissions of transactions, balances, and disclosures.

## **2.11 Techniques and tools of forensic audit**

In the context of investigating financial fraud in the Indian banking sector, forensic auditors employ a variety of analytical tools and techniques to uncover irregularities, assess systemic weaknesses, and detect hidden fraudulent activities. The following methods are particularly relevant to the current study:

### **i. Ratio Analysis**

Ratio analysis is one of the most important tools used to find strange trends in financial records that could mean fraud. By evaluating key financial ratios such as debt-equity, return on assets, or current ratios over time, auditors can detect inconsistencies or red

flags that warrant deeper scrutiny. In this study, ratio analysis helps highlight unusual financial behavior within banks affected by fraud cases.

## **ii. Benchmarking**

Benchmarking involves comparing financial performance across different time periods, cost centers, or business units with industry standards or peer institutions. This method helps identify outliers and deviations from expected norms. In the present context, benchmarking assists in pinpointing underperforming or suspicious divisions within banks that may be involved in fraudulent activities.

## **iii. System Analysis**

System analysis is used to examine internal banking systems and processes to identify vulnerabilities or flaws that may allow fraudulent actions to occur. This is especially relevant in understanding how weak internal controls or outdated processes may have contributed to major financial frauds like the PNB-Nirav Modi fraud.

## **iv. Specialist Software**

Advanced forensic tools and data analytics software, such as data-matching and anomaly detection programs, are essential for large-scale fraud detection. These tools can automatically sift through vast datasets to uncover inconsistencies or duplications. In this study, such tools could be applied to analyze audit trails, transaction logs, and communication records to detect collusion or manipulation.

## **v. Mathematical Modelling**

Bedford's Law is a useful tool for finding fraud. It is a mathematical model that predicts how often digits will appear in naturally occurring datasets. When used on financial data, differences from predicted digit ranges can show that numbers have been changed or are fake. This method is an unbiased and statistically sound way to check big data sets for possible theft<sup>25</sup>.

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<sup>25</sup> Ewa U and others, 'Evaluation of Forensic Accounting Techniques in Fraud Prevention/Detection in the Banking Sector in Nigeria' (2020) 2020 Article in International Journal of Finance and Accounting 56 <<http://journal.sapub.org/ijfa>>

## 2.12 Impact of frauds on Banks

- i. Financial loss- 100% provision against frauds
- ii. Loss of image/goodwill of the Bank and the branch
- iii. Diversion of attention of Top Management
- iv. Drop in morale and
- v. Loss of trust within the team members<sup>26</sup>

In India, there are several governmental as well as non-governmental organizations, which are dealing with Fraud Detection.

- i. (ED) Enforcement Directorate
- ii. CBI (Central Bureau of Investigation)
- iii. SFIO (Serious Fraud Investigation Officer)
- iv. India Financial Intelligence Unit.

## 2.13 Development of banking institutions in India

Banks are the backbone of the economy and are the oldest intercessors in the financial systems across the world, providing a structured environment for resource mobilization and distribution of such resources through credit, to almost all the sectors of an economy<sup>27</sup>. According to RBI Financial Stability Reports, India's banking sector has the most assets in its financial system and is crucial to economic stability. A trustworthy banking system guarantees investors and borrowers have access to capital. Money and banks Companies have been around for a very long time. In fact, Chana Kya's Arthashastra talks about things like loans and investments that are used in business. The Bank of Hindustan opened in 1770, and the Bank of Bombay opened in 1720. These were the first banks in India as it is today. With royal approval, 71 Presidential Banks of Bengal, Bombay, and Madras were set up in Calcutta, Bombay, and Madras from the start of the 1800s to the middle of the decade. Indian-owned cooperative and joint stock banks were set up at the same time as government banks.

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<sup>26</sup> Lal Bhasin Visiting Professor M, 'An Empirical Study Of Frauds In The Banks Introduction' (2015) 4 European Journal of Business and Social Sciences 1 <<http://ssrn.com/abstract=2703640>URL:<http://www.ejbss.com/recent.aspx-Electroniccopyavailableat:https://ssrn.com/abstract=2703640>Electroniccopyavailableat:<http://ssrn.com/abstract=2703640>>

<sup>27</sup> Taru GAPB, 'Gap Bodhi Taru Banking Systems In Ancient India : A Historical Overview' 57

The Joint Stock Indian Banks were mostly involved in supporting foreign trade, while the Cooperative Banks served the needs of the middle class in cities. When the Presidency Banks united in 1921, the Imperial Bank of India was born. When the government took it over in 1955, it changed its name to the State Bank of India. Imperial Bank was a business bank and a state bank before the Reserve Bank of India was made. It lent money to both the government and other banks<sup>28</sup>. However, the functions of issue and control of currency were not entrusted to The Imperial Bank and were performed by the Government. By the early twenties of the last century, central banking and commercial banking were regarded as distinct forms of business and it was believed that both the functions could not be appropriately performed by the same bank. The Reserve Bank of India Act, 1934 was passed in 1935 to establish the RBI after many local banks failed during the Great Depression. Initially, RBI was not the exclusive regulator of banking activity; commercial banks were established and supervised under the Companies Act<sup>29</sup>.

The RBI is now in charge of making sure that Indian banks follow the Banking Control Act, 1949. This law used to be called the Banking Companies Act. This was India's first regulatory measure. It gave the RBI broad supervisory powers over commercial banks, such as protecting customers' interests, reviewing and inspecting banks' books of accounts, and keeping an eye on when new banks and branches open. The Deposit Insurance Corporation Act of 1961 made the Deposit Insurance Corporation of India. Its job is to help people trust banks more<sup>30</sup>. This facilitated higher deposit deployment which provided the impetus for economic growth. This did not assist rural people since financial services were concentrated in cities. The government nationalised 14 banks in 1964 and 6 in 1980 to balance urban and rural banking services and distribute economic power. These initiatives balanced banking services nationwide but did not help rural small-scale farmers and merchants.

To mitigate the gaps, a separate banking structure was set up in 1976, known as Regional Rural Banks. As the banking system spread across both urban and rural areas,

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<sup>28</sup> Gauba R, 'The Indian Banking Industry : Evolution, Transformation The Road Ahead' (2012) 5 Pacific Business Review International 85

<sup>29</sup> Deolalkar GH, 'The Indian Banking Sector On the Road to Progress' [2010] Rising to the Challenge in Asia: A Study of Financial Markets 59

<sup>30</sup> Sardana V and Shukla A, 'Deposit Insurance Coverage Limit: How Much Is Enough? Evidence From India' (2020) 4 Indian Journal of Finance and Banking 66

the informal or unorganized sector declined, benefitting small farmers and traders and improving the economy. However, nationalization of banks also stifled the growth of the banking industry as banks became governmental instruments with no incentives to making profits. There was no competition and innovation in the banking industry as banks operated in a standardized atmosphere with strict compliances of interest rates, credit flows, high liquidity ratios and investments in Government and priority sectors.<sup>31</sup> In turn, this made people spend less and work less in the banking sector, which made the sector less efficient and less profitable overall. Concerns about the honesty of the banking system as a whole were raised by weak and badly handled internal controls, the lack of standard disclosure rules, and the failure to properly verify customers. All of these problems made already bad banking services even worse. The Government realizing the need for modernizing banking operations to internationally acceptable standards, introduced a number of reforms, however, most of them proved inadequate to address the growing problems in banking services.

Mr. M. Narasimham led a Committee on the Financial System in 1991 to look at India's financial system, especially commercial banking, and come up with ways to bring it up to date so it could meet world banking standards<sup>32</sup>. The Committee concluded that directed investments and directed credit programs were the main reasons why banks and other financial institutions were failing. The Report further found that the quality of Loan Portfolios had deteriorated, impeding the growth of Banking and Financial Institutions 'income and capital funds. The Report attributed the decline to improper accounting and disclosure procedures followed by these institutions, which more often than not, did not indicate the actual financial health of the organizations; improper internal controls; underutilization of resources in rural and over expansion in urban branches. The Committee believed that Banks and Financial Institutions needed autonomy and flexibility to implement Financial Sector Reforms. This would raise financial sector profitability and efficiency and benefit the economy. The Committee's proposals encompassed directed loans and investments, operational and functional autonomy, bank regulation, audits, and internal controls, laying the groundwork for

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<sup>31</sup> Claessens S, 'Competition in the Financial Sector: Overview of Competition Policies, IMF Working Paper, WP/09/45, March 2009' 1

<sup>32</sup> Shukla S, 'Analysis of Banking System Performance of Select Global Economies with That of India – During and after the Global Financial' (2014) 11 *Procedia Economics and Finance* 383 <[http://dx.doi.org/10.1016/S2212-5671\(14\)00206-8](http://dx.doi.org/10.1016/S2212-5671(14)00206-8)>

broad banking sector changes. Despite resistance, the Government adopted most Committee recommendations. Measures included:

Lowering of Statutory Liquidity Ratio (SLR) and Cash Reserve Ratio (CRR).

- i. Interest Rate Deregulation.
- ii. Implementation of Basel Committee Report-based Bank of International Standards (BIS) Capital Adequacy Standards.
- iii. Implementing cautious criteria for income disclosure, asset categorisation, accounting processes, and NPA provisions.
- iv. Setting up special courts to settle disputes quickly, which would cut down on the time it takes for banks to get their money back. In six places, the Indian government set up Debts Recovery Tribunals to get back money that was due under the Banks and Financial Institutions Act, 1993. The most important of these is the Appellate Tribunal in Mumbai.
- v. Set up the Asset Reconstruction Fund through special law so that it can buy some bad loans from banks and other institutions at a lower price.
- vi. Change the banking system, which is based on the market and has 3–4 big banks that can do business internationally, 8–10 national banks with stores all over the country, local banks that only do business in their own area, and regional banks that focus on agriculture.
- vii. Private Banking Companies and Foreign Banks were authorised, with RBI setting minimum capital and compliance standards.
- viii. The RBI became the only banking regulator in India.

The Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 was changed so banks could enter the stock market through public bids. The *ibid.* Report from 1991 made it possible for changes to happen in the banking sector. In 1998, the Narasimham Committee II, also called the Banking Sector Committee, was created. The Committee was made to look at how the banking sector has been revived since 1991 and suggest ways to make India's financial industry stronger<sup>33</sup>. The key areas that the Committee focused upon were the banking system itself, capital adequacy, mergers, laws regulating banking business, automation in banking services to name a few. The

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<sup>33</sup> Kamath K V. and others, 'Indian Banking Sector: Challenges and Opportunities' (2003) 28 *Vikalpa* 83

Committee recommended strengthening Indian banking to address domestic liquidity and exchange rate management challenges related to Current Account Convertibility. To do this, the Committee suggested weaker banks join with stronger ones. Weak banks were allowed to invest in short-term, risk-free assets under the "Narrow Banking Concept" in order to solve the growing NPAs. Strengthening the banking sector was recommended by increasing the Capital Adequacy Ratio (CAR). Basel II sets the CAR at 8%, whereas Basel III sets it at 10.5%. The Committee emphasised banks' autonomy and flexibility in operations and urged reviewing government control over banks. The Committee also advised reviewing and amending India's banking regulations to meet industry demands and global norms.

Besides these recommendations, the Committee also recommended upgradation of existing technology and digitalization of its processes, stricter compliance of corporate governance norms, and training of bank employees to bring professionalism in the delivery of banking services<sup>34</sup>. When India's economy opened up in the early 1990s and changes were made to the banking sector, it helped the banking business a lot. International, domestic, and public banks all had a hand in it. With the opening of FDI and the right for foreign companies to vote, India has started to make changes to its banks.

#### **2.14 Kinds of banking institutions**

Banking Industry in India has since liberalization become fairly strong in terms of products, services, reach, compliance with global standards and its regulation. There are still concerns including the lack of private and international banks in rural India, technological upgrades, and digital transaction data security. The multi-layered Indian banking structure has developed to meet the demands of a diversified client base and borrowers. Indian banks are split into two types: scheduled banks and non-scheduled banks. There are both public and private banks on the list. Large commercial banks, small commercial banks, foreign banks, payment banks, and small finance banks are all on the list of scheduled commercial banks. They are grouped by ownership and/or

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<sup>34</sup> Ahmad A, 'Financial Innovation and Corporate Governance for Sustainability of Islamic Financial Institutions: Challenges & Prospects' (2023) 2 Contemporary Issues in Social Sciences and Management Practices 31

type of business. Scheduled Cooperative Banks come in two different types: coastal and urban.

These two types of banks are both Scheduled Banks, but they are not the same in how they are set up or what their goals are. Commercial Banks are businesses whose goal is to make money. Cooperative Banks, on the other hand, serve the "no profit, no loss" principle by helping each other. Commercial banks are allowed to do banking business by the Act. In other words, they can open accounts and give money to customers.<sup>35</sup> These banks are primarily into retail banking and cater to individual and business needs. Depending on how they were established and who owns them, they are further divided into public and private sector banks.

A lot of state banks are owned by the government. The national or state government owns more than half of the shares. Some of the laws that made them possible were the State Bank of India Act of 1959 and the Bank Nationalisation Acts of 1970 and 1980. The Bank Board Bureau, an independent body of the Indian government, makes suggestions on who should run these banks<sup>36</sup>. Though, private sector banks are still run by private companies or people, which are governed by the Banking Regulation Act of 1949 and the Companies Act of 2013. The RBI has rules, laws, standards, and instructions that all banks, public and private, must follow<sup>37</sup>.

As part of the Financial Inclusion Mission of the Government of India, SFBs were created alongside Public and Private Commercial Banks. Their goal is to help Micro, Small, and Medium-Sized Businesses (MSMEs), small farms, low-income people, and other unorganised sectors save money and get loans by using technology and low-cost operations. These banks were started in the private sector and focus on helping small owners and borrowers. The Regional Rural Bank Act of 1976 created RRBs, in contrast to SFBs, and as the government controls the majority of them, they are classified as Public Sector entities<sup>38</sup>. The main purpose of RRBs is to provide banking services in

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<sup>35</sup> Nr R, 'Role of Commercial Banks in the Development of MSME Sector in India' 61

<sup>36</sup> Gopinath S, 'Corporate Governance in the Indian Banking Industry' (2008) 5 International Journal of Disclosure and Governance 186

<sup>37</sup> Patel SK and Japee G, 'A Comparative Study of Selected Private and Public Sector Bank with Special Reference to Corporate Social Responsibility in India' (2019) 21 Journal of the Gujarat Research Society 3336 <<http://gujaratresearchsociety.in/index.php/JGRS/article/view/3637>>

<sup>38</sup> Brahman BS, 'Performance Evaluation of Bank of India and Union Bank of India with Respect to Priority Sector' (2022) 3 Indo-Asian Journal of Finance and Accounting 161

rural areas with a view to develop agriculture, industry and other business activities in rural India. RRBs operate under strict norms regarding priority sector lending and providing small loans to fulfill the gaps created by the lack of presence of big commercial banks. Foreign Banks have been operational in India prior to independence. However, it is only after the liberalization of the financial policies of the 1990s that their numbers and operations have increased in India. The majority of foreign banks are those that are registered outside of India and do business there as fully owned subsidiaries or branches. Through these branches or subsidiaries, international banks are able to meet the foreign exchange needs of Indian corporations and financial institutions. Payment Banks were allowed within the Banking Structure in India in 2014 as differentiated banks, with a view to provide a wide network of financial services, especially by providing payment/ remittance services and small saving services. The Companies Act of 2013 says that they are public companies and gives them permission to offer banking services (Section 22 of the Act). Payment banks are not allowed to give out loans, so they have low credit and market risk. In India, there already existed Pre-Paid Instrument Issuers (PPIs) providing pre-paid wallets which are used for facilitating payment facilities within their network or to bank accounts outside their networks. These PPIs are nested payments banks, where the wallets are held in escrow with a bank and the balance does not attract any interest from the PPI. With the entry of Payment Banks, PPIs were also allowed to apply for license to convert.

But cooperative banks are controlled by the RBI when it comes to their financial activities. They are also listed as cooperative societies under the State Cooperative Society Act or the Multi States Cooperative Societies Act, 2002. Before India got its freedom, cooperative banks were set up to help areas that commercial banks didn't serve with their money needs. It also served as a source of short-term financing for small investors as well as the rural and agricultural sectors. There are two major parts of the Indian cooperative banking system. These are Urban Cooperative Banking (UCB) and Rural Cooperative Credit System (RCCS). There are short-term and long-term joint credit companies within RCCS, which is split into more than one level. UCB is a plan with only one level. One kind of short-term cooperative credit company is a Primary Agricultural Credit Society. The other two are State Cooperative Banks and Central Cooperative Banks. There are two levels of these banks: primary cooperative agriculture and rural development banks and state cooperative agriculture and rural

development banks. It is very important for small users in rural, semi-rural, urban, and farming (but not agricultural) places to be able to get the money they need through UCBs and RCBs. Although RBI was empowered with regulatory and supervisory powers of Cooperative Banks, these were limited in their applicability which impacted RBI's capability in taking corrective measures vis-à-vis irregularities. In 2020, the Act was changed to improve banking services in the cooperative sector and protect customers' interests by giving RBI more power to oversee banks more closely, especially when it comes to governance and rebuilding. Although India already has a number of different types of banks, a large amount of families, especially those in rural areas and those who are struggling financially, still do not use traditional banks. They mostly count on the unorganized banking sector to meet their needs. There are a number of things that the RBI and the Indian government have done to help these people use controlled banks.

Some of the more significant measures include:

- i. All scheduled banks were advised to open branches in areas whose population exceeds 5000.
- ii. Banks were further advised to ensure that there must be at least one bank account per household.
- iii. Ultra-Small Branches were set up in villages and unbanked blocks, especially the hilly regions of Northeast India.
- iv. To increase the accessibility of banking services, the National Payments Corporation of India (NPCI) created mobile banking services based on unstructured supplemental service data (USSD).<sup>39</sup>, specifically payment of bills, money transfer, balance enquiry, merchant payments etc. without downloading the bank applications that are required for Immediate Payment Service (IMPS) based Mobile Banking

The Banking Structure in India, as can be seen from the above discussion, is multi-tiered and, from an economic perspective, fairly mature<sup>40</sup>. Legislatively speaking, RBI being the central regulatory authority, with regard to banking services, has been given

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<sup>39</sup> Bhoi BK, 'Digital Transformation in India's Payment and Settlement Systems' [2020] Journal of Xi'an University of Architecture & Technology 987 <<https://www.xajzkjdx.cn/gallery/71-mar2020.pdf>>

<sup>40</sup> Mukul G. Asher, '(PDF) of India Pension Plans, Provident Fund Schemes and Retirement Policies: India's Social Security Reform Imperative' [39AD] 2009 1

wide powers to enact Rules and Regulations and issue Guidelines to banks in India on all matters related to banking functions. Despite this, there still exist irregularities in the conduct of the business by banks and in the recent years the quantum of frauds, in terms of financial losses involved, have been constantly rising, with RBI Annual Report of 2020-2021 reporting frauds worth Rs 1.38 Trillion

Even though frauds in the Banking Sector have been present from the very inception, growth of technology and complexity of the system, has, in the recent years provided the opportunity and platform for perpetrators to go undetected for longer periods of time, thereby causing greater harm.

In the next section, the Researcher discusses the meaning, nature and types of frauds in the Banking Sector in India.

### **2.15 Frauds in the banking sector**

India, in the last couple of decades, has developed economically at a great pace but globalization and the ever-evolving technology has catapulted the fraud landscape, especially financial frauds<sup>41</sup>. Newer forms of committing frauds have taken over the more traditional methods and have raised questions with regard to their detection and prevention. The positives of economic development are marred by the negative impact of economic crimes, which cause the greatest hurdles in the overall development of any country. Occupational fraud was described by the ACFE as "the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets" in its 10th Report to the Nations on Occupational Fraud, 1984. These 85 situations are the biggest and most common. The study says that scams cost businesses around the world about 5% of their annual income. Given the nature of some of the scams, it would be unrealistic to collect precise statistics worldwide, thus this proportion is not absolute. India's banking business has the same problems as the corporate sector with financial errors, fraud, and poor control, even though there are strict rules in place. In the last few decades, hoaxes from around the world, especially bank frauds, have gotten a lot of attention. This is because theft costs a lot of money. Losses due to fraud are a normal part of running a business, so most banks and other financial institutions handle some of them in their risk

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<sup>41</sup> Aldhaheeri M and AlNehayan M, 'The Challenges Stemming from Demographic and Technology Issues Within the United Arab Emirates' 99

management plans. But as banking has grown beyond simple tasks like saving and spending money and as e-banking has become more popular, scams have become much more common and the government and officials have had to take strong steps to stop them. India has had a number of bank scams, both domestic and international, since banks were opened up to more people.

There has been fraud in the financial markets and banks for a long time, so bank theft is not a new worry. From 1720 to the middle of the 1850s, many banks went out of business because of fraud and weak balance sheets. In 1840, the East India Company opened the Presidency Bank of Bombay. But by the middle of the 1860s, it was no longer in business because it gave risky loans to companies backed by the owners' shares or personal property. After that, the Bank of Bombay became its name. The Travancore National and Quilon Bank (TNQ) failed in 1938 because of a shaky economy and politics. This showed that the Central Bank, which had just been created, did not have the power to watch over and control how banks did their job. This happened even though people thought that oversight and control would make the sector more stable after the RBI was created in 1934. The bank had borrowed a lot of money, bought back its own shares to raise their value, and had problems with its balance sheets, according to investigations into what caused the bank to fail. Almost 183 banks failed between 1947 and 1950, most of them in West Bengal. Between 1951 and 1960, 315 banks failed. The most well-known bank that went out of business was the Palai Central Bank (PCB) of Travancore. The RBI was given the right to look into banks after the Banking Regulation Act of 1949. At first glance, it saw issues similar to those at TNQ, including loans given to the families of leaders, offices that were losing money, big gains, and other issues. RBI had warned PCB, but its second check by RBI showed that it was still losing money and capital. Most of the loans PCB gave out could not be paid back when it was inspected in 1960. The bank was losing money.

In order to get the loans back, the bank had to be liquidated. The process took almost 27 years, and the Liquidator couldn't get anything back from the bank's Directors or Auditors. The nationalization of banks and strict governmental control abated the problems of bank failures due to malpractices of the Directors, Auditors or the Management of banks to some extent.

The advent of modernization and liberalization of the banking industry which began with the economic reforms of 1991 brought a much-needed boost to the banking industry<sup>42</sup>. This liberalization also ushered with it a spate of frauds and scams both in the banking industry and the securities market.

1992 saw the discovery of one of the largest financial market frauds, which had a negative impact on numerous significant Indian commercial banks as well as several international banks doing business in India<sup>43</sup>. As a result of this fraud, money was taken from banks and given to different stockbrokers in a series of deals involving government stocks between April 1991 and May 1992. This showed that there were structural problems with the Indian financial markets.

With the removal of various administrative barriers and the allowance of private participation in new economic sectors, the 1991 election of a new government expedited the process of economic liberalisation and the opening up of the Indian economy, which promised the private corporate sector unprecedented growth and prosperity. The stock market began to climb sharply as many anticipated the positive news for the private sector. This resulted in a significant rise in the amount of capital needed by stock market participants. The money required was increased by the high margins that the Bombay Stock Exchange imposed on settling trading. Simultaneously, the Public Sector faced new issues as a result of the new free market concept. The public sector was under tremendous pressure to meet financial targets. The demand to increase their profits also applied to the nationalised banks.

In April 1992, the first news story to talk about a lack of the State Bank of India's Government Securities came out. Early results show that about Rs. 4300 crores in cash were stolen in the stocks scam. The scam involved lawmakers, traders, managers, and top executives of big banks that were taken over by the government, as well as foreign banks and other financial institutions. People say that Harshad Mehta, a trader, was to blame for the boom on the Bombay Stock Exchange in 1992. Police say he and his coworkers stole money from financial transfers and bought a lot of shares at a higher

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<sup>42</sup> Banker RD, Chang H and Lee SY, 'Differential Impact of Korean Banking System Reforms on Bank Productivity' (2010) 34 Journal of Banking and Finance 1450 <<http://dx.doi.org/10.1016/j.jbankfin.2010.02.023>>

<sup>43</sup> Gupta PK and Gupta S, 'Corporate Frauds in India - Perceptions and Emerging Issues' (2015) 22 Journal of Financial Crime 79

price in a number of different industries, which made the Sensex go up. The main suspect in the scheme that came to light and showed several problems with the banking system was Mehta.

In a story that came out in India's national newspaper, The Times of India, on April 23, 1992, top writer Sachet Dalal wrote about Mehta's illegal ways of manipulating the stock market. The Ready Forward (RF) Deal was the most significant way that the fraud was carried out. To understand how the fraud was perpetrated, one must understand that Brokers, unlike Capital Markets, do not have much role to play in the Money Markets. In the usual course of transactions between banks regarding the sale and purchase of Government securities, the settlement process is usually carried out by the transacting banks directly without any broker involvement.<sup>44</sup> Brokers in the Money Market are only intermediaries to the extent of bringing the buyers and sellers together and help in negotiations and do not actually deliver the securities or cash to either of the parties. In return the brokers earn a commission from both the parties. However, in the prelude to the Mehta Scam's few banks started following the process of settlements of Capital Markets, wherein the Stockbrokers negotiated the deal and also handled the delivery of the securities and cash to the buyer and seller respectively. This system used in the Capital Markets meant that buyers and sellers were known to the brokers but did not necessarily know each other.

Another tool that Mehta and his friends used was a Bank Receipt (BR). For an RF deal to go through, the Government Securities being sold by the borrowing bank must be physically placed with the lender bank. This is because the term of the loan is short-term. The same are given back to the borrower bank when the loan is paid off. However, in practice, instead of physically handing over the securities, the borrower bank issues a BR, which fulfills 3 purposes, namely:-

1. It validates the sale.
2. It operates as a receipt of money paid for the securities. and

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<sup>44</sup> Gorton G and Winton A, *Chapter 8 Financial Intermediation*, vol 1 (Elsevier Masson SAS 2003) <[http://dx.doi.org/10.1016/S1574-0102\(03\)01012-4](http://dx.doi.org/10.1016/S1574-0102(03)01012-4)>

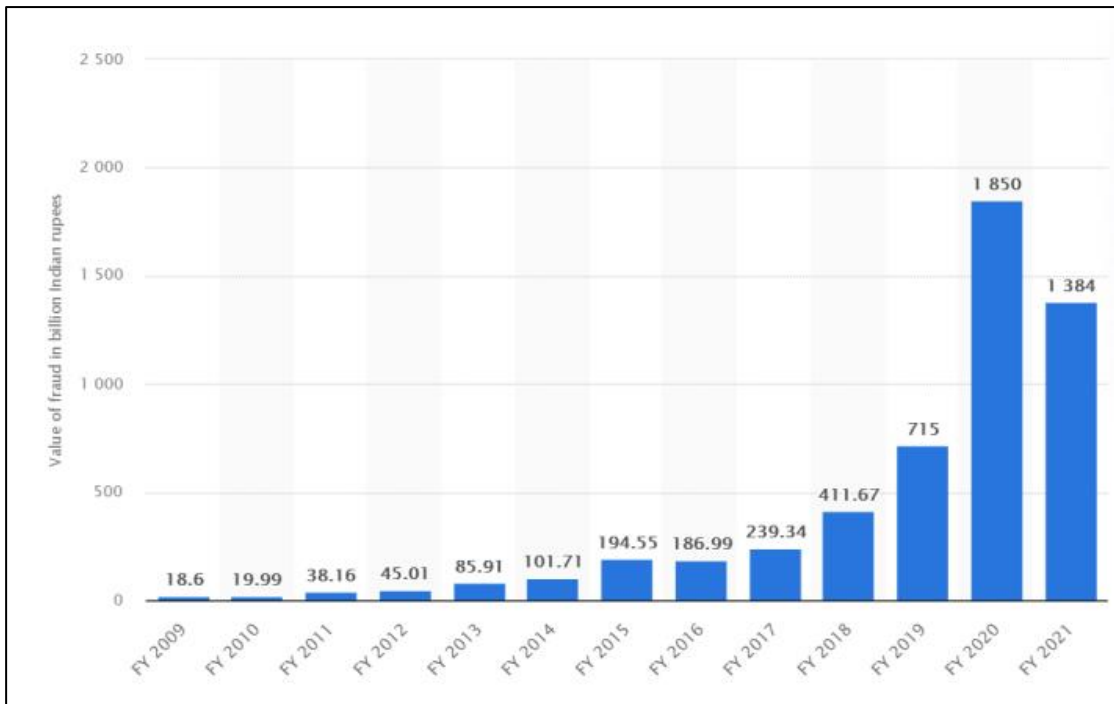
3. It promises the delivery of securities in case the loan is not repaid within the stipulated time and further states that the same are held in trust by the seller for the buyer.

Mehta and his colleagues mastered the technique of utilizing phoney BRs to get unsecured loans from the Banking System, thereby turning a secured loan into an unsecured loan.<sup>45</sup> They convinced a few obscure and minor banks to issue BRs when needed. Mehta distributed the phoney BRs to other banks, who then gave him loans on the erroneous grounds that they were financing against government securities. Mehta increased stock market share prices using the funds he had so obtained. When it was time to return the funds to the bank, the BR came back after the shares were sold for a substantial profit. Mehta persisted in his deceptive practices, which caused stock prices to soar and gave the market a positive trajectory. However, a number of institutions discovered they were holding worthless BRs once the scheme was made public. By that time, Mehta had defrauded the banks of an incredible Rs 4,300 crores. In *Ram Narain Popli v. Central Bureau of Investigation*, the Supreme Court said that dishonest brokers had manipulated bank and financial institution securities transactions for their own benefit in a number of ways, working with certain bank officials to do so. This was clearly against the rules, guidelines, and good business practices that were already in place. This was in response to criminal appeals filed by Harshad Mehta and some of the other accused against the conviction order passed by the Special Court established to deal with the matters related to the securities scam<sup>46</sup>. According to the Committee Report, the estimated sum involved was around 4,300 crore rupees.

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<sup>45</sup> Gupta M, *Mobile Banking Revolution in India Empowering Financial Inclusion* Author : Dr . Minakshi Vijayant Gupta Taran Publication New Delhi (2024)

<sup>46</sup> Hons LLB, 'Shruti Agrawal Submitted under the Guidance of : Dr . Sujata Bali This Dissertation Is Submitted in Partial Fulfillment of the Degree Of' 1



**Figure 2.1: Value of Bank Fraud across India from financial year 2009 to 2021 (in billion Indian rupees) (Keelery, 2025)**

## 2.16 Typology of bank fraud in India

People in general think of banking fraud as things like financial trickery, financial misreporting, stealing, lying, theft, crime, and so on. But in today's highly technologically advanced financial world, not only have the kinds of bank theft grown, but so have the ways they are done. Regulatory bodies are always changing what fraud is, how it should be reported, how it should be found, and other things to stop and avoid it in the banking and financial sectors. It can be broken into three main types: internal frauds, which are done by bank management or employees; external frauds, which are done by customers or other people; and frauds done by outsiders working with bank employees. Human agency is a necessary component of fraudulent conduct, meaning that fraud involves a purposeful activity by one or more people. As previously stated, the first categorization of bank fraud is predicated on the potential fraudsters.

### 2.16.1 External fraud

Fraud perpetrated by someone who is not a current or former employee of the bank or hired by the bank to conduct any of its operations or provide any of its services is known

as external fraud<sup>47</sup>. External frauds may be roughly categorised as those involving outsiders (strangers) or the bank's clients. According to RBI data, customer frauds mostly include the fabrication of KYC papers, counterfeit checks, fraudulent encashment of bank guarantees, loans, etc., and are associated with loan or advance frauds, which account for the largest portion of lost funds. In order to divert funds or use them for other purposes, overvalue securities, or intentionally default on repayments, dishonest customers take advantage of the bank's or the government's policies and programs regarding the provision of loans for the promotion of self-employment, housing, start-ups, etc. Other ways that bank clients cheat banks include using counterfeit or fake papers to get credit facilities or using the same security for many loans from several banks, among other practices.

However, frauds committed by strangers or outsiders might include theft, robbery, and dacoity, as well as frauds using technology, such as identity theft, phishing, and hacking, to mention a few. Historically, thieves, robbers, and dacoits posed the greatest threat to banks from outsiders or strangers. However, improved security measures, the amount of preparation needed to physically rob a bank, the fear of being caught and punished, and the potential for death have all significantly decreased the number of such incidents. On the one hand, technology and online banking significantly decreased the danger to life, but on the other, they greatly enhanced the benefits that might be obtained from a single action. <sup>48</sup>The anonymity and intricacy of the internet allow fraudsters to plan their schemes with little to no chance of being caught.

### **2.16.2 Internal fraud**

Internal fraud, in contrast, is where the banks employees (current or former) or third parties employed by the banks commit or attempt to commit Fraud. <sup>49</sup>Despite the fact that most employees are honest, there is a great threat from employees, especially in

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<sup>47</sup> Sanusi ZM, Rameli MNF and Isa YM, 'Fraud Schemes in the Banking Institutions: Prevention Measures to Avoid Severe Financial Loss' (2015) 28 *Procedia Economics and Finance* 107 <[http://dx.doi.org/10.1016/S2212-5671\(15\)01088-6](http://dx.doi.org/10.1016/S2212-5671(15)01088-6)>

<sup>48</sup> Lee MC, 'Factors Influencing the Adoption of Internet Banking: An Integration of TAM and TPB with Perceived Risk and Perceived Benefit' (2009) 8 *Electronic Commerce Research and Applications* 130 <<http://dx.doi.org/10.1016/j.elerap.2008.11.006>>

<sup>49</sup> Lal Bhasin Visiting Professor M, 'AN EMPIRICAL STUDY OF FRAUDS IN THE BANKS Introduction' (2015) 4 *European Journal of Business and Social Sciences* 1 <<http://ssrn.com/abstract=2703640>URL:<http://www.ejbss.com/recent.aspx-Electroniccopyavailableat:https://ssrn.com/abstract=2703640>Electroniccopyavailableat:<http://ssrn.com/abstract=2703640>>

banking and financial institutions, who are in a unique position to commit Fraud given their access to internal systems and knowledge to legitimately bypass security measures. Most surveys and reports on Fraud that have been carried out by various agencies found that almost 50% of the Frauds reported were perpetrated by insiders. ("Insider Risks and Insider Fraud" is talked about in more depth in Chapter 3). According to the Supreme Court of India in Allahabad Bank v Deepak Kumar Bhola, an employee of the bank was fired after an investigation by the CBI found that he had issued fake chequebooks and withdrawn money from a fake account at another bank using them. The court said that if someone working for a bank that handles public money commits forgery and wrongfully withdraws money that they are not authorized to withdraw, that person is guilty of one of the worst crimes involving "moral turpitude."

### **2.17 Frauds Committed by External Parties in Collusion with Bank Employees**

Banking Institutions are the repositories of money and attract the attention of those who are looking for making quick gains by indulging in fraudulent activities.<sup>50</sup> One of the most difficult Frauds to discover is the one where bank employee(s) partner with either bank customers or strangers to carry out scams. The growing impersonality of banking with the advent of Internet Banking, changing lifestyle needs and most often greed, with minimal risk of detection and punishment, has led to many instances of such Frauds. There are numerous cases that are reported where Frauds have been unearthed by investigative agencies which involve bank employees and outsiders. News reports like- —Twelve people, including three HDFC bank workers, have been nabbed by the Delhi Police for stealing and trying to take money out of an NRI (Non-Resident Indian) account without permission. In just one week, the Central Crime Branch's Anti-Bank Fraud Wing has caught nine people, two of whom were bank employees, for cheating banks out of loans by using fake papers to get them approved, which is against the rules. The fact that they robbed banks out of Rs. 6 crore in five different cases shows how bad this problem really is, according to the cops.

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<sup>50</sup> Wanjiku L, 'Strategic Response of Equity Bank to Fraud Related Risks' [2011] University of Nairobi <[http://erepository.uonbi.ac.ke/bitstream/handle/11295/4367/Kinyua\\_Strategic\\_response\\_of\\_Equity\\_Bank\\_to\\_fraud\\_related\\_risks.pdf?sequence=1](http://erepository.uonbi.ac.ke/bitstream/handle/11295/4367/Kinyua_Strategic_response_of_Equity_Bank_to_fraud_related_risks.pdf?sequence=1)>

## **2.18 Types of Frauds across Different Banking Functional Areas**

The Frauds committed by the above discussed possible perpetrators may fall in any of the categories specified by RBI in The Master Directions on Fraud Classification and Reporting issued by the RBI<sup>51</sup>. Before you can better understand the types of fraud that happen in banks, you need to know which parts of the business are most likely to be hacked and how they can be done. Dr. K. C. Chakraborty, Deputy Governor of the RBI, divides bank fraud into three main groups:

- i. Technology related.
- ii. KYC related (mainly in Deposit Accounts); and
- iii. Advances related

Besides the above-mentioned sub-categories, Banks also report Frauds in other areas of operations, namely:

- i. Off- Balance Sheet Frauds.
- ii. Foreign Exchange Transaction Frauds.
- iii. Inter Branch Accounts Frauds.
- iv. Cash Frauds.
- v. Cheques or other Bills of Exchange Frauds.
- vi. Clearing Account Frauds.
- vii. Others

The above-mentioned categories have been classified on the basis of banking services wherein the majority of Fraud cases are reported by banks. Frauds in these areas may fall under any of the classification notified by RBI, i.e., Criminal Breach of Trust, Misappropriation, Cheating, Forgery etc.

## **2.19 Conclusion**

The increasing complexity and digitization of banking operations have made the financial sector more vulnerable to fraud. Despite the implementation of regulatory frameworks and technological advancements, fraudulent activities—ranging from

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<sup>51</sup> Edge ME and Falcone Sampaio PR, 'A Survey of Signature Based Methods for Financial Fraud Detection' (2009) 28 Computers and Security 381 <<http://dx.doi.org/10.1016/j.cose.2009.02.001>>

cyber frauds and identity theft to loan scams and insider collusion—continue to rise. The involvement of both external perpetrators and, in some cases, complicit bank employees has further aggravated the situation, undermining customer trust and institutional integrity. Strengthening internal controls, enhancing employee vigilance, leveraging data analytics for early fraud detection, and ensuring stricter enforcement of regulatory guidelines are essential to curbing this growing threat. It is important for banks, government groups, and law enforcement to work together and be proactive in order to protect the banking environment and win back public trust.

## CHAPTER 3

# FINANCIAL FRAUD TRENDS AND PATTERNS IN THE INDIAN BANKING SECTOR

### 3.1 Introduction

In India's banking business, things have changed a lot in the last few decades, mostly because of more automation and better technology. Along with these changes, there has been a shocking rise in financial scams in the banking industry. Even though bank fraud has been going on for a while, it's getting harder to spot and stop because fraud plans change all the time and digital banking systems are being adopted so quickly. From traditional forms like cheque frauds and embezzlement to sophisticated cybercrimes and money laundering operations, the scope and scale of financial frauds have expanded significantly<sup>52</sup>.

There have been a lot more frauds recorded in India over the last ten years. If we look more closely at the trends and patterns of this crime, we can see this. It's easier for fraud to happen when there aren't enough checks and balances in place, like when big businesses go digital quickly and without proper management. One worrying trend that the Reserve Bank of India (RBI) has found is that the number and amount of fraud cases have been going up year over year, even though there are now strict rules and different ways to protect people from fraud. These frauds often involve high-profile cases that include loan defaults, falsification of documents, insider trading, and advanced technological crimes such as phishing and hacking.

There are more and more complicated trends of theft in the banking industry. Fraudsters are getting smarter about how to use holes in the banking system and customers' and banks' trust to their advantage. The financial scams don't just happen in one part of the banking business; they happen in both public and private banks. The nature of fraud has also evolved from being primarily external, perpetrated by customers or outsiders, to more internal frauds committed by employees or in collusion

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<sup>52</sup> Mugarura, N., & Ssali, E. (2021). Intricacies of anti-money laundering and cyber-crimes regulation in a fluid global system. *Journal of Money Laundering Control*, 24(1), 10–28. <https://doi.org/10.1108/JMLC-11-2019-0092>

with bank staff. Banks and officials are having a hard time keeping up with the complexity of fraud plans because scammers are changing how they do business<sup>53</sup>.

### 3.2 Analysis of bank fraud as reported by RBI from 2011 to 2021

The researcher looked at RBI Annual Reports from 2011 to 2021 to find out about fraud cases that were recorded in the area of operations. This helped them understand why fraud is becoming more common in the banking industry. As seen in the RBI Annual Reports, Figure III shows the amount and number of scams that happened in different areas of business. It is important to note that the data only pertains to scams totalling Rs 1 lakh or more. Furthermore, rather than the date of occurrence, the data is based on the date that the fraud incident was reported. The RBI Annual Report of 2020-21<sup>134</sup> states that the average time between the incidence, discovery, and reporting of frauds by banks was around 23 months for most instances of frauds worth less than Rs 1 billion, and 57 months for big value frauds (those worth more than Rs 1 billion).

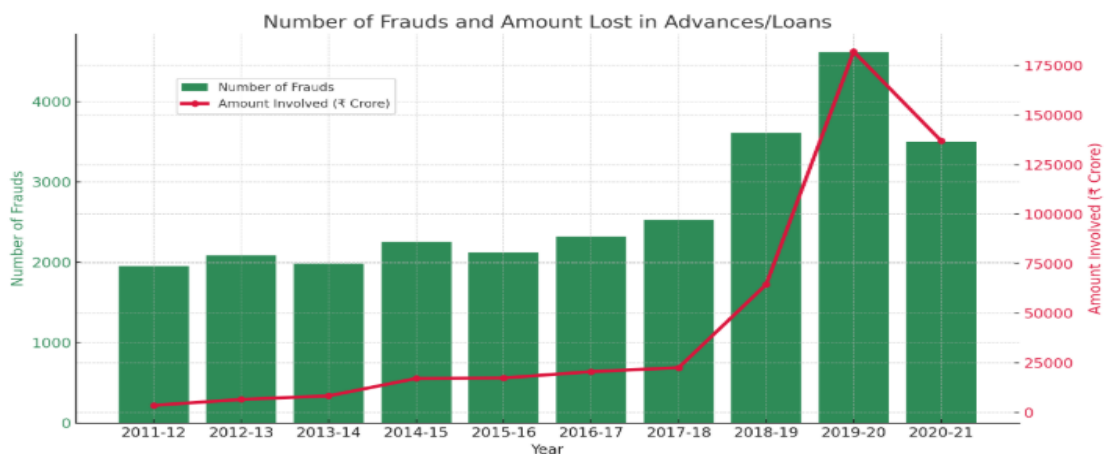
**Table 3.1 Year Data of Fraud Cases Reported in Areas of Operations**

| Area of Operation                    | 2011-12 | 2012-13 | 2013-14 | 2014-15 | 2015-16 | 2016-17 | 2017-18 | 2018-19 | 2019-20 | 2020-21 <sup>1</sup> |
|--------------------------------------|---------|---------|---------|---------|---------|---------|---------|---------|---------|----------------------|
|                                      | No.     | Amount  | No.     | Amount  | No.     | Amount  | No.     | Amount  | No.     | Amount               |
| <b>Advances</b>                      | 1,532   | 3,552   | 2,393   | 6,378   | 2,562   | 10,252  | 1,723   | 6,261   | 1,762   | 17,287               |
| <b>Card/Internet</b>                 | 629     | 63      | 794     | 123     | 1,323   | 147     | 1,191   | 154     | 1,191   | 179                  |
| <b>Deposits</b>                      | 857     | 219     | 791     | 231     | 774     | 311     | 875     | 437     | 857     | 459                  |
| <b>Off-balance sheet</b>             | 33      | 173     | 30      | 170     | 44      | 1,083   | 56      | 88      | 42      | 13                   |
| <b>Foreign exchange transactions</b> | 17      | 112     | 10      | 43      | 10      | 64      | 13      | 21      | 9       | 5                    |
| <b>Cash</b>                          | 120     | 140     | 123     | 140     | 153     | 163     | 120     | 124     | 158     | 252                  |
| <b>Cheques/demand drafts, etc.</b>   | 172     | 100     | 149     | 60      | 154     | 64      | 172     | 85      | 172     | 89                   |
| <b>Inter-branch accounts</b>         | 7       | 7       | 8       | 7       | 9       | 11      | 13      | 22      | 7       | 1                    |

<sup>53</sup> Akelola, S. (2012). Fraud in the banking industry: A case study of Kenya. *A Phd Thesis Paper, Nottingham Trent University, July*, 1-422. <https://core.ac.uk/download/pdf/30624246.pdf>

|                       |       |       |       |       |       |        |       |       |       |        |
|-----------------------|-------|-------|-------|-------|-------|--------|-------|-------|-------|--------|
| <b>Clearing, etc.</b> | 38    | 31    | 37    | 31    | 26    | 24     | 7     | 7     | 7     | 17     |
| <b>Others</b>         | 207   | 197   | 112   | 115   | 102   | 122    | 83    | 103   | 105   | 122    |
| <b>Total</b>          | 4,612 | 4,644 | 4,457 | 7,298 | 5,157 | 12,241 | 4,253 | 7,302 | 4,310 | 18,426 |

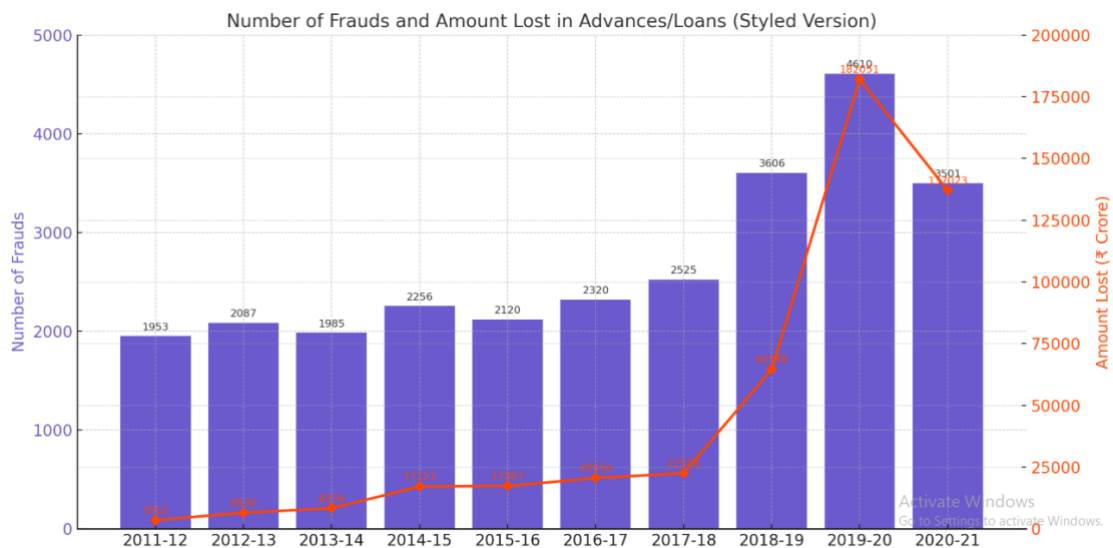
When the researcher looked at Table 1, they saw that both the number and size of frauds have been steadily going up over the last 10 years. There were almost 80% more scams reported in 2020 than there were in 2011. During that time, almost twice as many thefts were recorded in Advances. In 2011, Rs 4,494,000 crores was lost to theft. By 2021, that number would have dropped to Rs 1.38 lakh crores. Over the past 10 years, there have been slightly more reports of scam in all three areas of business: loans, card/internet, and transfers. But there are a lot fewer cases of scam in inter-branch accounts now than there were before. According to a study of reported fraud cases, the number of technology-related frauds reported by banks has grown by leaps and bounds since 2017–18. These include frauds committed through Internet/Mobile Banking, ATMs, Credit/Debit/Pre-paid Cards, and other pay methods like PayTM. On the other hand, Advances related Frauds have been the foremost contributors of the total amount involved in these Frauds.



**Figure 3.1. Year Data on Advance Related Frauds in Banks in India (MintGenie Team 2023)**

The surge in technology related Frauds in the year 2017-18 was to a great extent attributed to the increased use of digital payment systems and internet banking as consequence of demonetization. The year 2018-19 did see a slight fall in the numbers as enhanced security measures like two factor verification of online payments, One

Time password Authentication of transactions were introduced. However, the numbers again increased in 2019-20 and 2020- 21. The rapid expansion of technology-based solutions and the need to conduct most banking operations and services using digital platforms, in the wake of the Covid 19 Pandemic, also increased fraud exposure, which is evidenced by the increase in number of Frauds and the value of these Frauds<sup>54</sup>. As was already said, the Advances/Loan business of banks is responsible for the most fraud, both in terms of the amount involved and the number of cases that have been recorded. There have been more frauds involving big amounts of money (Rs 50 lakhs and more) over the last ten years, especially in group loans where several banks are involved.



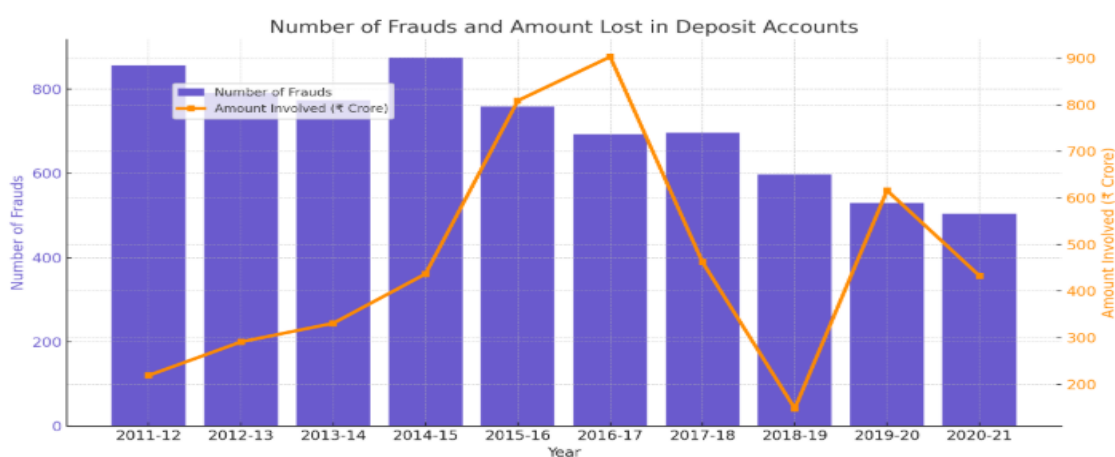
**Figure 3.2 Year Data on Advance Related Frauds in Banks in India (Press Trust of India 2024)**

The data as reported in Reports published by RBI for the last decade (Figure V) shows that there was a sharp increase in the value of Frauds reported in 2018-19 in comparison to the previous years, with an almost 182% increase in value in the year 2019-20. The year 2020- 21 did see a marginal fall in the amount lost to Frauds, however, whether that is on account of an actual reduction in number of Frauds or due to the fact that the data is for 9 months only (on account of change in RBI’s Financial Year from June-July to April-March in 2020) is debatable. One of the biggest issues, as reported by

<sup>54</sup> Levi, M., & Smith, R. G. (2022). Fraud and pandemics. *Journal of Financial Crime*, 29(2), 413–432. <https://doi.org/10.1108/JFC-06-2021-0137>

RBI, is the delay in reporting of cases by banks in this portfolio, as when a Loan Account would be declared Fraud is not clear due to the ambiguity in what would constitute a Fraud. For example, in case of diversion of funds, should the bank declare the account as Fraud where the borrower acknowledges his/her debt and is willing to repay? There are many reasons for the growth of Frauds in this area of operations and the same have been discussed in the next section<sup>55</sup>.

The third largest contributor in terms of numbers and amount lost is the Deposit Account portfolio. From Figure VI, it can be seen that there has been a steady decline in the number of cases reported in the Deposit Accounts, but the amount involved, on the other hand has increased. The year 2016-17 saw the highest loss reported in this area, which according to reports was due to demonetization and consequent rapid digitalization of banking services<sup>56</sup>. The number of Frauds reported and the amount lost was the lowest in 2018-19 and increased again by almost 300% in 2019-20.



**Figure 3.3 Year Data on Advance Related Frauds in Banks in India (Press Trust of India 2024)**

The increase in value of Frauds over the last decade suggests that even though there have been many Legislative measures introduced for regulating and controlling the Banking Business, these have been ineffective in providing deterrence to the perpetrators, The sharp increase in big value Frauds in the last five years (most cases still under investigation) suggests that the fraud schemes have become more complex

<sup>55</sup> Beals, M., & Deevy, M. (2015). *Framework for tax*. Stanford Center on Longevity, 40.

<sup>56</sup> Singh, C. (2018). India Since Demonetisation. *SSRN Electronic Journal*, March. <https://doi.org/10.2139/ssrn.3151238>

to detect, are collusive, with perpetrators being both bank employees and outsiders. According to RBI Annual Reports, Cheating and Forgery were reported as the major components of all Frauds reported, trailed by Misappropriation and Criminal Breach of Trust<sup>57</sup>.

The data on fraud cases broken down by bank group (Figure VII) shows that between 2017 and 2020, Public Sector Banks had the most fraud cases and the most money involved. After these came Private Sector Banks and Foreign Banks. This year, though, more scams were reported by private sector banks than by public sector banks<sup>58</sup>. Overall, there has been a rise in both the quantity and number of fraud cases involving all RBI-regulated firms. The rise is mostly ascribed to the expansion of banking institutions, including new foreign and private sector banks, more ATMs and other payment systems, and new branches opening in previously unbanked regions.

**Table 3.2. Year Data of Fraud Cases Bank Group-Wise**

| <b>Bank Group/<br/>Institution</b> | <b>2017-<br/>18</b> |            | <b>2018-<br/>19</b> |            | <b>2019-<br/>20</b> |            | <b>2020-<br/>21</b> |            |
|------------------------------------|---------------------|------------|---------------------|------------|---------------------|------------|---------------------|------------|
|                                    | No.                 | Amo<br>unt | No.                 | Amo<br>unt | No.                 | Amo<br>unt | No.                 | Amo<br>unt |
| <b>Public Sector<br/>Banks</b>     | 2885                | 3826<br>1  | 3704                | 6420<br>7  | 4410                | 1482<br>42 | 2903                | 8190<br>1  |
| <b>Private Sector<br/>Banks</b>    | 1975                | 2478       | 2149                | 5809       | 3065                | 3421<br>1  | 3710                | 4633<br>5  |
| <b>Foreign Banks</b>               | 974                 | 256        | 762                 | 955        | 1026                | 972        | 521                 | 333        |
| <b>Financial<br/>Institutions</b>  | 12                  | 165        | 28                  | 553        | 15                  | 8          | 147                 | 1114       |
| <b>Small Finance<br/>Banks</b>     | 65                  | 6          | 1                   | 39         | 38                  | 2          | 88                  | 2          |
| <b>Payment Banks</b>               | 3                   | 1          | 1                   | 39         | 2                   | 1          | 2                   | 88         |
| <b>Local Area<br/>Banks</b>        | 2                   | 0.04       | 1                   | 0.04       | 1                   | 0.02       | 0                   | 0          |

<sup>57</sup> Rezaee, Z. (2005). Causes, consequences, and deterrence of financial statement fraud. *Critical Perspectives on Accounting*, 16(3), 277–298. [https://doi.org/10.1016/S1045-2354\(03\)00072-8](https://doi.org/10.1016/S1045-2354(03)00072-8)

<sup>58</sup> Ummah, M. S. (2019). Frauds in Banking Sector: Impact on the Indian Economy Dr. *Sustainability (Switzerland)*, 11(1), 1–14.

|              |      |           |      |           |      |            |      |            |
|--------------|------|-----------|------|-----------|------|------------|------|------------|
| <b>Total</b> | 5916 | 4116<br>7 | 6798 | 7153<br>4 | 8703 | 1854<br>68 | 7363 | 1384<br>22 |
|--------------|------|-----------|------|-----------|------|------------|------|------------|

Based on what was said, bank and other financial institution theft has not only become more popular but has also cost a lot of money over the last ten years. For banks, fraud hurts the business as a whole and makes people less trusting. For instance, banks must make a 100% provision for the full amount owed to them, regardless of the value of the security they hold, or for which they are liable over a period of four quarters from the date of detection, for every fraud case in the Advance and Deposit portfolio. If the fraud is not reported promptly, the full provisioning must be completed right away. In practical terms, this indicates that funds that would have otherwise been accessible for economic circulation were diverted in order to lessen the losses brought on by frauds. Therefore, it becomes crucial to comprehend the causes of the rise in banking sector frauds. Some of the significant elements are covered in the research's following section.

### **3.3 Reasons for growth of banking frauds**

Most studies in this field point to the following as some of the main reasons why fraud is becoming more common in the banking sector:

#### **3.3.1. Greed and Opportunity**

Donald R. Crossey's 1953 study on the social psychology of theft summed up the reasons people commit economic fraud as pressure, the chance to do something bad, and the ability to explain why what they did wasn't a crime. They called this the "fraud triangle." His theory says that people break trust when they believe that the only way to fix a private financial problem is to break the law of financial trust. They can then use words that help them balance how they see themselves as trustworthy people with how they see themselves as people who use the trusting person's money or property<sup>59</sup>.

One of the reasons for the growth of Frauds, therefore, lies in the changing lifestyle of people, where the needs' have been replaced by wants' and the opportunities provided by the growing technology have eased the way of satisfying these wants with minimal

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<sup>59</sup> Kagias, P., Cheliatsidou, A., Garefalakis, A., Azibi, J., & Sariannidis, N. (2022). The fraud triangle – an alternative approach. *Journal of Financial Crime*, 29(3), 908–924. <https://doi.org/10.1108/JFC-07-2021-0159>

risks and efforts. Several scholars and researchers while studying the reasons behind commission of bank fraud, especially by trusted persons or employees, opined that the risks associated with committing fraud as opposed to say robbery are perceived as relatively low. The rationale behind this was inferred as, that while the robber runs the risk of a lengthy jail term, the person committing a fraud, on the other hand, while easily enriching himself, is unlikely to be caught and if caught may end up paying some fines and not necessarily have to undergo a jail term.

### **3.4 Delay in Detection and Reporting of Frauds**

The second main reason for the rise in bank theft is that it takes too long to find and report fraud plans. In order to make scams much less likely to happen again, it is very important to catch them early. This has been shown in studies on avoiding fraud and fraud risk management. Most scams are done by customers or people who work for the company. In both cases, the fraud is usually found after the damage has been done. Another thing that makes it hard to spot scams is how companies react to and assess the possibility of fraud and the material aspects of the losses that come from it. Internal regulations pertaining to Fraud Risk Management would be weak if risk perception was low, giving opportunity to those with strong personal motivations<sup>60</sup>.

Figure VIII, which is part of Wipro Limited's Report on Fraud Detection and Prevention, 137, shows the main problems that institutions have finding financial scams. The study talked about some of the problems that come up when trying to find fraud, such as slow warning systems, old rule-based detection, a lack of business-driven solutions, and coverage across all channels.

#### **3.4.1 Complacency and Poor Corporate Governance Standards**

Because the banking industry has grown so quickly outside of its main business, top management has lessened their oversight of basic banking services like loans and savings. This has led to a relaxed mood. Frauds in these areas are often caused by

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<sup>60</sup> Hashim, H. A., Salleh, Z., Shuhaimi, I., & Ismail, N. A. N. (2020). The risk of financial fraud: a management perspective. *Journal of Financial Crime*, 27(4), 1143–1159. <https://doi.org/10.1108/JFC-04-2020-0062>

people who don't follow set rules and procedures when giving loans or opening bank accounts, as well as by not having enough oversight over how deviations are handled<sup>61</sup>.

### **3.4.2 Expansion of Business and Pressure**

Besides complacency, the rapid expansion of banks has also led to overburdened employees. The sheer volume of transactions that take place during banking hours, coupled with the pressure of meeting the expectations of shareholders of increasing the market share and profits, push the junior/line staff members to use any methods for achieving their targets. Frauds are becoming more common because of things like lax Know Your Customer (KYC) rules, giving out loans without proper checks, and cashing checks or discounting bills of exchange that turn out to be fake or copied because people are too busy<sup>62</sup>.

### **3.4.3 Lack of Training**

The fast pace at which technology is changing and the growth of Fintech requires the employees and customers to adapt to newer platforms and systems, with inadequate training on using the same and ensuring that all security measures are followed. Access to sensitive data is at times compromised as newer platforms are layered over existing ones leaving gaps in security of the systems, which give fraudsters opportunity to misuse the data for wrongful gain without much risk of discovery. Customers sometimes share their Passwords and Personal Identification Numbers (PIN) without realizing that the same are used by fraudsters to withdraw money from their account or charge their cards for making payments etc<sup>63</sup>.

### **3.4.4 Lack of Means to Recognize Probable Red Flags**

Inadequate technology and methods are in place to identify early warning signs of fraud. The RBI released a framework for handling loan frauds in 2015 to counteract the

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<sup>61</sup> Choudhry, M. (2019). Effective Bank Corporate Governance: Observations From the Market Crash and Recommendations for Policy. *SSRN Electronic Journal*. <https://doi.org/10.2139/ssrn.3447761>

<sup>62</sup> Ostern, N. K., & Riedel, J. (2021). Know-Your-Customer (KYC) Requirements for Initial Coin Offerings: Toward Designing a Compliant-by-Design KYC-System Based on Blockchain Technology. *Business and Information Systems Engineering*, 63(5), 551–567. <https://doi.org/10.1007/s12599-020-00677-6>

<sup>63</sup> Wu, A. C., & Kao, D. D. (2022). Mapping the Sustainable Human-Resource Challenges in Southeast Asia's FinTech Sector. *Journal of Risk and Financial Management*, 15(7). <https://doi.org/10.3390/jrfm15070307>

rise in frauds in the advances/loan portfolio. This framework includes early warning indicators that banks must adhere to in order to lower frauds in this sector. However, most banks either do not have the technology or adequately trained personnel to detect these signals.

### **3.4.5 Inadequate Internal**

Systems and Controls Inadequate Internal Systems and Control Mechanism has been identified by most Scholars as one of the reasons for Fraud, financial or otherwise, wherein there is a lack of clear segregation of duties and responsibilities, or poor maintenance of records/ documents, or faulty/ inadequate incentive mechanism in place for employees, or ineffective or weak internal audit system etc. giving opportunities to the perpetrators<sup>64</sup>

### **3.4.6 Weak Regulatory System**

There aren't many clear rules in place to fight bank fraud, and people who try to do it often fail. These factors have all contributed to the rise in bank fraud. As shown in Annexure I, the Master Directions on theft Classification and Monitoring tell banks that they need to report theft to the right people. On the other hand, the bank uses its own rules to decide what kind of scam to report. What does the Indian Penal Code, 1860 say about crimes like theft, loss of trust, and cheating? This is how the bank figures out if an event is actually a crime<sup>65</sup>. This ambiguity in what would constitute Bank Fraud in itself increases the probability of frauds being committed as sometimes the employees and auditors are not aware whether a particular deviation would come within the classification or not and is thus not reported. Additionally, banks must notify the RBI of frauds exceeding Rs 1 lakh in accordance with the Master Directions. Frauds under Rs 1 lakh are not need to be reported individually. As a result, many scams go undetected, giving scammers a large window of opportunity to perpetrate several low-value frauds with little chance of detection. Additionally, when workers are implicated, a criminal complaint is made, mainly under the Prevention of Corruption conduct, 1988, if it is determined that the fraudulent conduct was committed intentionally. This is done

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<sup>64</sup> Abdul Rahman, N. H., Hamzah, N., Jamaluddin, A., & Aziz, K. A. (2019). Establishing an Effective Internal Control System for Fraud Prevention: A Structured Literature Review. *Asia-Pacific Management Accounting Journal*, 14(3), 21–47. <https://doi.org/10.24191/apmaj.v14i3-02>

<sup>65</sup> Francis, L. (2010). Banking on Robbery: The Role of Fraud in the Financial Crisis. *Casualty Actuarial Society E-Forum*, 2, 1.

after an internal investigation. Most cases where employees are involved either do not get reported to investigating agencies or are not tried as cases of Fraud. This weakness in the Regulatory System provides no deterrence to future perpetrators and leads to the growth of fraudulent schemes being perpetrated by employees either on their own or in collusion with outsiders<sup>66</sup>.

#### **3.4.7 Lack of Coordination among Different Banks across India and Abroad.**

The delay in detection of Frauds, coupled with the delay in reporting the same and red flagging fraudulent accounts, provide fraudsters to carry on their fraudulent schemes in multiple Banking Institutions. Most banks, for fear of loss of reputation and trust, are reluctant to report Fraud cases and lack coordination amongst themselves. This issue is most common in case of consortium banking, wherein multiple banks advance loans to an organization. Amongst themselves also there is a delay in declaring the same case as Fraud which enables the debtor to not only continue with the fraud for a longer time but also gives him time to obliterate the money trail, which makes it hard for investigating agencies to trace and recover the lost assets<sup>67</sup>.

#### **3.4.8 Frequent Change in Procedures and Compliance Requirements.**

Another major contributor to the growth of bank fraud is the frequent changes in the procedures and compliance requirements that banks are required to follow, especially while opening deposit accounts or sanctioning loans. Many times, the persons in charge of the operations are unaware of the changes or there is willful non-adherence of the same<sup>68</sup>. A casual attitude towards adherence to Guidelines and Advisories of the Regulator by senior management leads to indifference amongst other employees and staff members providing for a fertile ground for Frauds. Banking Institutions are facing enhanced competition from newer entities like Payment Gateways and other NBFCs that have started providing banking solutions and services and there is a constant

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<sup>66</sup> Simser, J. (2014). Culpable insiders – the enemy within, the victim without. *Journal of Financial Crime*, 21(3), 310–320. <https://doi.org/10.1108/JFC-11-2013-0068>

<sup>67</sup> Singh, T., & Nayak, S. (2015). Frauds in Banking Corporate Governance Issues. *Charan Singh – Ccs Project Report*, 1411129.

<sup>68</sup> Meissner, M. H. (2018). Accountability of senior compliance management for compliance failures in a credit institution. *Journal of Financial Crime*, 25(1), 131–139. <https://doi.org/10.1108/JFC-11-2016-0074>

pressure to expand business. This has contributed to the dilution of procedures and increased Fraud risks, both from within and outside.

### **3.4.9 Impersonalization of Banking Services.**

Internet and Mobile based banking solutions have made the Banking Business impersonal, where the banker and the customer hardly meet and the only means of identification with the banker are the customers signatures or identity proofs submitted by the customer. Banks are required to follow the KYC norms prescribed by RBI but besides that bank's rarely update the signatures of the customers and often they are found to be illegible, especially in case of truncated cheques, where a scanned copy is sent to the clearing houses for clearance. Most bank employees are not adequately trained to compare the signatures and do a cursory check before clearing the same. With majority of Banking Services available online, the ease of banking has definitely increased but so has the opportunity of Fraud. This is just one example of how digitalization of Banking Services has impersonalized them, creating an environment which provides for many avenues that fraudsters can use<sup>69</sup>.

### **3.4.10 Non-Existent Know Your Employee Norms.**

Almost all surveys and research studies related to financial fraud have found that most cases are committed by insiders or by insiders in collusion with outsiders. For example, the KPMG India theft Survey 2012 found that top management workers are more likely to be involved in theft than non-managerial employees. Another thing the poll showed was that theft is most likely to happen in the financial services area. Banks are most vulnerable to Internal Frauds 'as the rewards thereof are far greater than the risks of discovery and prosecution'<sup>70</sup>. This makes it imperative that organizations must invest in not only doing an initial background check of their employees (pre-employment) but should do a regular update (during employment). Banks mostly have their own recruitment boards and procedures and minimal background checks. There can be numerous reasons and circumstances under which a person who has a clean record at the time of employment, may commit Fraud during the course of his employment, greed, opportunity and dissatisfaction are a few of them. A disgruntled employee, who

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<sup>69</sup> By, S., & Kaushik, N. (2003). *Key customer expectations & banking trends*.

<sup>70</sup> Vanasco, R. R. (1998). Fraud auditing. *Managerial Auditing Journal*, 13(1), 4-71.  
<https://doi.org/10.1108/02686909810198724>

is aware of the internal procedures, can easily manipulate them to his advantage. A periodic check on the employee's activities, lifestyle changes and general behavior can go a long way in preventing Internal Frauds.

To summarize the current Fraud framework aims to prevent the occurrence of Frauds in banks, however, the ambiguity in defining what would constitute Fraud leads to a delay in reporting the same, which in turn is one of the major reasons for the exponential growth of Frauds in the Advance/ Loan portfolio. There is an average delay of nearly 23 months between the occurrence and detection of frauds, indicating that banks are not adequately investing in securing their systems and procedures<sup>71</sup>. The rapid expansion of banks both, physically in terms of number of branches, and digitally in terms of various digital banking solutions, has also contributed to the growth of Frauds. Overburdened employees, competition and pressure to expand business has resulted in dilution of and or non-adherence to laid down procedures, providing for loopholes in the system which are used by the unscrupulous to their advantage. The above-listed reasons for the growth of Frauds in the Banking Sector are not exhaustive. Banks being repositories of money are the easiest target for anyone looking to make quick money without much effort and, therefore, fraud risk must be a part of the risk management policies of almost all Banking Institutions.

### **3.5 Legislative measures to prevent frauds**

The question to be borne in mind while analyzing the efficacy of Legislative response to Fraud is, whether these are Frauds specifically dealt with by those Laws or fall in the category of Frauds which are generally considered as foul play or unfair trade practices and escape prosecution<sup>72</sup>. As we already said, India's fraud laws are mostly found in the Indian Contract Act of 1872, the Companies Act of 2013, and the Indian Penal Code of 1860. These laws cover both contractual and tortuous fraud, and they also have specific criminal laws for things like embezzlement, forgery, criminal breach of trust, cheating, and changing accounts. However, not all Financial or Economic Frauds, which are

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<sup>71</sup> Amiram, D., Bozanic, Z., Cox, J. D., Dupont, Q., Karpoff, J. M., & Sloan, R. (2018). Financial reporting fraud and other forms of misconduct: a multidisciplinary review of the literature. *Review of Accounting Studies*, 23(2), 732–783. <https://doi.org/10.1007/s11142-017-9435-x>

<sup>72</sup> Vaswani, M. (1997). Journal of Financial Crime. *Journal of Financial Crime Iss*, 5(1), 39–44. <http://dx.doi.org/10.1108/eb025814%5Cnhttp://>

sometimes too complicated and involve defrauding the public at large, can be dealt with as contractual or civil wrongs, due to lack of contractual rights between the perpetrators and the public. For example, when loans are taken out against assets that are priced too high and the borrower doesn't pay back the loan, the public as a whole takes the losses, not the parties to the loan (the bank and the borrower). There are no special laws in India that make fraud in the banking sector a crime. The RBI Master Directions on Frauds Classification and Reporting (Refer Annexure I) say that frauds should be categorized based on the laws in the Indian Penal Code, 1860. However, the IPC does not specifically name bank fraud as a crime; it has many different laws that may apply to different frauds depending on their specific facts and circumstances<sup>73</sup>. (Refer Annexure II for provisions of the IPC).

Besides the laws already mentioned, there are many more that help stop fraud in the banking sector. These include the Negotiable Instruments Act of 1881, the Banking Regulation Act of 1949, the Prevention of Corruption Act (PCA) of 1988, the Information Technology Act (ITA) of 2000, the Securitizations and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFESAI) of 2002, the Prevention of Money Laundering Act (PMLA) of 2002, the Banking Ombudsman Scheme of 2006, and the Payment and Settlement Systems Act (PSSA) of 2007. The following sections talk about parts of the above-mentioned Acts that are relevant to stopping bank fraud<sup>74</sup>:

### **3.5.1 The Negotiable Instruments Act, 1881**

One way for bank customers to carry on their transactions is with the use of a Cheque<sup>142</sup>, which is a Negotiable Instrument and is dealt with by the Negotiable Instruments Act, 1881. Even with digitalization of Banking Services, Cheques are still considered the safest method for making payments and are used for carrying out transactions that involve big amounts. A Cheque is an evidence of payment made and all transactions done using Cheques are recorded by the banker on which the Cheque is drawn. Over time, both the concept of a check and its safety features have been changed. This is so that computer checks can still be considered checks and so that fraudsters can't use checks. The most common types of check fraud are forgery (making fake

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<sup>73</sup> Pradesh, A. (2020). *Economical and Political Weekly*. LV(May).

<sup>74</sup> Journal, A. I. (2010). *The tell tale of a bite mark – call for action for pediatric specialists*. 10(1).

signatures of the person who wrote the check), material changes (making changes to the value or validity of the check or the payee's name), and cloning of checks (making copies of checks with the same series number as the original check book). The Negotiable Instruments Act of 1881 spells out the rights and responsibilities of both the bank collecting the cheque and the customer writing the cheque in case of fraud<sup>75</sup>.

### **3.5.2 Banking Regulation Act, 1949**

The Banking Regulation Act, 1949 (as amended) was made to control the banking business in India. Its goal was to provide all-encompassing laws to support the growth of banking, stop bank failures, strengthen the banking system, safeguard depositors' rights, and give the Reserve Bank of India the power to oversee banking business and the running of commercial and cooperative banks in India<sup>76</sup>. The Banking Regulation Act, 1949, with a view to provide for a stable and well-regulated Banking Industry, requires that before commencement of Banking Business all Banking Companies need to get a license<sup>143</sup> from RBI, on terms and conditions prescribed by it, which the RBI renews periodically. Additionally, RBI has the power to look at a bank's books of accounts before giving them a license <sup>144</sup>. Every month, every three months, and every year, all banking companies have to send reports about their assets, debts, demands, unclaimed assets, profit and loss accounts, and balance sheets. This is to make sure that the banking business is being run according to RBI's rules and instructions. Section 35A of the Banking Regulation Act, 1949 gives RBI even more power to give Directions or change any earlier Directions as it sees fit to make sure that banking business is run properly<sup>77</sup>. Section 30 of the Banking Regulation Act, 1949 says that all banking companies must have qualified auditors look over their profit and loss accounts and balance sheets. The RBI can also order a special audit if it thinks it is needed for the benefit of depositors, the banking company, or the public. The above-mentioned rules are important for controlling how banking business is done and giving RBI more

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<sup>75</sup> Pao, V. (2021). *Compilation of Research - A Handbook*. June.

<sup>76</sup> Anthala, H. R. (2018). *Banking System in India: a Legal Study With Special Reference To Fraud and Forgery in Public Sector Banks in Ambala City* .... [https://www.researchgate.net/profile/Hari-Anthala/publication/341071618\\_Banking\\_System\\_in\\_India\\_A\\_Legal\\_Study\\_with\\_Special\\_Reference\\_to\\_Fraud\\_Forgery\\_in\\_Public\\_Sector\\_Banks\\_in\\_Ambala\\_City\\_Haryana/data/5eabe490299bf18b958a9103/Binder1.pdf](https://www.researchgate.net/profile/Hari-Anthala/publication/341071618_Banking_System_in_India_A_Legal_Study_with_Special_Reference_to_Fraud_Forgery_in_Public_Sector_Banks_in_Ambala_City_Haryana/data/5eabe490299bf18b958a9103/Binder1.pdf)

<sup>77</sup> Adolph, R. (2016). *Innovations and Reforms in Indian Banking*.

control. However, these provisions while providing regulatory control to RBI over Banking Business do not specifically address the detection or prevention of Bank Fraud.

### **3.5.3 Prevention of Corruption Act, 1988 (PCA)**

Since it became independent, India has passed a lot of special laws to deal with economic and financial crimes. PCA, 1947 was one of these laws. It was made to deal with the rising problem of bribes and corruption among public servants because the IPC, 1860 wasn't strong enough to handle these kinds of situations. The PCA of 1947 was amended twice before it was repealed by PCA, 1988, which was last amended in 2018. Over the years, the definition of Public Servant has undergone several amendments to widen its scope so as to include not only Government employees but all such persons who render any kind of Public Duty. The PCA, 1988, as amended, also includes prosecution of offences committed by corporations. The PCA, 1988 is an important legislation towards curbing corrupt practices and bringing deterrence amongst not only public servants but also corporates vis-s vis bribery and graft. However, Bank Fraud for the most part do not fall in the category of corruption, even though a number of cases where the bank employees are involved, provisions of PCA, and 1988 are invoked<sup>78</sup>.

### **3.5.4 Information Technology Act, 2000 (ITA)**

Technological innovations brought a paradigm shift in the way banking was traditionally done and necessitated that the banking and financial services industry modify its business model to incorporate faster services at lower costs. With the advantages of greater outreach and better services, this also brought its own risks and legislative issues<sup>79</sup>. To meet the challenges brought about by the invasion of technology in all spheres, the ITA, 2000 was enacted in India. It said that electronic transactions, contracts made through electronic data exchange and all other forms of electronic communications, digital signatures and how to prove their authenticity, electronic fund

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<sup>78</sup> Garimella, S. R., & Chowdhury, A. (2018). *United nations convention against corruption , 2005 and india – mapping india ' s compliance Ashfaquzzaman Chowdhur y. July.*

<sup>79</sup> Sardana, V., & Singhania, S. (2018). Digital technology in the realm of banking: A review of literature. *International Journal of Research in Finance and Management, 1*(2), 28–32. <https://doi.org/10.33545/26175754.2018.v1.i2a.12>

transfers between banks and other financial institutions, keeping Bankers Books in electronic form, and crimes committed using electronic media would all be punished.

According to Section 43 and Section 66(1) of the ITA, 2000, people who damage computer systems dishonestly or falsely will be punished, given money, or both. Section 43A also says that people will be compensated if any organised body fails to protect private personal data properly. Additionally, the ITA, 2000 outlines punishments for various offenses, some of which are relevant to bank fraud, including<sup>80</sup>:

a) Section 66C says that identity theft is against the law. People who use someone else's password, electronic signature, or other unique information about them without their permission can go to jail for up to three years and be fined up to Rs one lakh.

b) Section 66D says that users who cheat by impersonating someone else using computer resources can get up to three years in prison and a fine of one lakh rupees.

The Indian Computers Emergency Response Team is also set up by Section 70B of the ITA, 2000. Which would be a government body for incident reaction whose main jobs would be to gather, analyse, and share information about cyber events and issue cyber security guidelines and advisories. The Researcher would like to point out again that while the ITA, 2000 does provide for legislative recognition of electronic transactions and remedies, both civil and criminal, for their contravention, it is inadequate to deal with not just the changing business environment of Banking Institutions but also the ever growing and changing nature of Frauds being perpetrated therein

### **3.5.5 Securitizations and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SARFAESI)**

The Advances/Loans Portfolio is one of the biggest contributors to bank fraud in terms of both the quantity of incidents and their value. Lending money is one of a bank's main jobs. The SARFAESI Act of 2002 was made because most commercial banks' loan portfolios were having a lot of defaults and frauds. Its goal was to combine the laws

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<sup>80</sup> Jain, V., & Kohli, S. (2009). Exploring the security of e-banking systems: Questions of theft, fraud, jurisdiction and the shifting sands of time. *International Journal of Electronic Finance*, 3(4), 339–352. <https://doi.org/10.1504/IJEF.2009.028975>

about the reconstruction and securitisation of financial assets and set up a way for people to repay banks and financial institutions without going through the courts. By enabling banks to rebuild their non-performing assets and sell them to securitisation companies, the SARFAESI Act of 2002 assists banks in turning them into performing assets. Though providing relief to banks the SARFAESI Act, 2002 doesn't provide any deterrence to perpetrators when it comes to committing Frauds in their loan accounts. The recovery of assets in most cases is slow or impossible due to forged or fake title deeds or multiple loans against the same property<sup>81</sup>.

### **3.5.6 Prevention of Money Laundering Act, 2002**

The PMLA, 2002, was another rule that was made to cut down on financial crimes. There are a lot of different kinds of financial institutions in this group, like insurance companies, mutual funds, stock markets, banks, retail and trade shops, and more. There are also non-financial groups in this group, like real estate agencies, gem or metal dealers, and so on. The main goal of the PMLA was to make it illegal and punishable for anyone who hid, owned, bought, or used criminal proceeds by pretending they were clean property. This included anything that was connected to the crime's earnings. In relevance to Bank Fraud, PMLA, 2002 provides for curbing cash transactions of large amounts (above Rs. 50,000) using bank accounts and thereby to some extent prevents Cash Frauds in deposit accounts.

### **3.5.7 Banking Ombudsman Scheme, 2006**

In line with Section 35A of the Banking Regulations Act of 1949, 2006, the RBI set up the Banking Ombudsman Scheme to give bank customers a way to get their problems with Banking Services fixed. The Scheme provides for facilitating the settlement of any customer complaints in a timebound manner and is aimed at protecting their rights. So far as its relevance to Bank Fraud is concerned, the Banking Ombudsman Scheme, 2006 helps customers in case of fraudulent transactions in their deposit accounts and or any other issues that they may face in their dealing with their banks<sup>82</sup>.

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<sup>81</sup> Singh, D. J. (2013). Recovery of Npas in Indian Commercial. *International Journal of Transformations in Business Management*, 2, 77–95.

<sup>82</sup> The, T. O. N., & The, F. O. F. (2012). *A study on the office of the banking ombudsman in india -*. 2003(2), 1–15.

### 3.5.8 Payment and Settlement Systems Act, 2007

The IT Act of 2000 had to be passed when technology got better, and the PSSA of 2007 had to be passed when financial technology, or Fintech, came out as a way to do banking. Indian banks are run by the Reserve Bank of India (RBI), which keeps an eye on and manages them. A set of laws was needed to control different types of payment systems, like RTGS, NEFT, IMPS, and other payment channels and brokers. These laws also needed to cover the digitisation of banking services and financial inclusion. The PSSA, 2007 defines terms like Payment Obligation, Settlement, Gross Settlement Systems, Netting, and Payment System, and grants the RBI, under Section 5, the authority to authorize any entity wishing to start or operate a payment system, provided it meets the requirements specified by the RBI. With the majority of banking transactions now conducted digitally, the PSSA, 2007 not only regulates and supervises the various payment solutions available today but also gives the RBI greater oversight over entities, other than banks and financial institutions, that provide these services. While this is crucial for operational stability, the PSSA, 2007 establishes the liability of system participants in the event of systemic risk but does not specifically address the issue of fraud committed using these payment systems or gateways<sup>83</sup>.

In summary, several laws have been passed to oversee and control the banking industry, yet none of them truly solve the problem of bank fraud. The most susceptible industries to fraud are banking and financial institutions, and the majority of legislative responses to bank fraud have been ex post facto, or retrospective, rather than preventative. Most Legislations dealing with one or the other form of Bank Fraud have been enacted or amended after a series of Frauds. Some studies suggest that of all the people who commit Fraud, only 10% actively look for chances to do so, 80% people would commit Fraud under the right circumstances and 10% would never commit Fraud. Therefore, Law and Policy Makers need to formulate them in a manner that the benefit of committing Fraud weighed against the consequences would deter the 80%, who are likely to commit Fraud in the right circumstances.

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<sup>83</sup> Basnayaka, B. (2023). *a Comparative Study on the Legal Framework Governing Data Privacy in E-Banking in. May.*

### **3.6 Conclusion**

As evidenced from the discussion above, Banking Structure in India is multi layered and serves to the varied needs of a broad customer base along with providing for the borrower's needs<sup>84</sup>. Modern age banking has, become highly diversified and competitive, making the banks more vulnerable to Fraud risks, especially in the Core Banking Services, as the focus of Banking Business, in today 's day and age has shifted to ancillary services. Advancement in technology, providing faster access to Banking Services through Internet and Mobile Banking have further added to the exposure of Banking Business to Fraud risks, both from external and internal sources. Over the last ten years, there has been a steady rise in the number of fraud cases reported by banks, even though the banking sector is well controlled when it comes to practical security standards. Over the past few years, fraud cases have grown at an exponential rate. The next chapter talks about e-banking and the risks that come with it.

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<sup>84</sup> Deolalkar, G. H. (2010). The Indian Banking Sector On the Road to Progress. *Rising to the Challenge in Asia: A Study of Financial Markets*, 59–109.

## CHAPTER 4

### CASE STUDIES OF MAJOR FINANCIAL FRAUDS IN INDIA

#### 4.1 Introduction

There are gaps in the laws and rules that guide banks that allow thieves to steal from them. People lose faith in the financial system, especially banks, when scams like these happen. This slows the economy's growth. Fraud costs a lot of money, and banks have to set aside a lot of money to cover it. This means that capital that could have been used for growth is lost, which slows down the economy's growth. In this Chapter, some of the frauds that have rocked the Banking Industry in recent years have been discussed. These frauds, most still under investigation, bring out the weaknesses in the system and how those entrusted with the depositor's money use their position and knowledge to gain individual benefits. Public, private, and cooperative banks are all included in the case studies<sup>85</sup>.

#### 4.2 Punjab national bank fraud case

The second-biggest public sector multi-national bank in India is Punjab National Bank (PNB), which has 12,478 business correspondents, 13,506 ATMs, 10,528 domestic branches, and two overseas branches (as in September 2021). It began its journey in 1894 with the founding members belonging to different faiths, coming from diverse backgrounds and opened for business to public in 1895<sup>86</sup>. The main reason the Bank was set up was as part of the Swadeshi Movement to give India a national bank with Indian capital. PNB was taken over by the government in 1969. Before that, it was one of the biggest private US banks. In February 2018, one of PNB's offices in Mumbai was involved in a fraud worth Rs.11394.02 crores. This was reported to the Stock Exchange. At the time, it was thought to be the biggest fraud ever committed in the Indian banking industry<sup>87</sup>.

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<sup>85</sup> Honohan, P. (2011). Banking System Failures in Developing and Transition Countries: Diagnosis and Predictions. *SSRN Electronic Journal*, 39. <https://doi.org/10.2139/ssrn.860624>

<sup>86</sup> Malimage, K. (2019). Journal of Forensic and Investigative Accounting Volume 11 : Issue 2 , Special Edition , 2019. *Journal of Forensic and Investigative Accounting* Volume 11 : Issue 2 , Special Edition , 2019. *Journal of Forensic & Investigative Accounting*, 11(2), 353–365.

<sup>87</sup> Saini, R., & Lodha, S. L. (2014). Banking Development in India. *Journal of Economics and Sustainable Development*, 5(24), 20–30. [www.iiste.org](http://www.iiste.org)

In a note to the Stock Exchange, PNB said that the fraudulent activities happened between 2011 and 2017. Two junior employees at the Mumbai branch of the bank gave multiple unauthorised Letters of Undertaking (LoUs) to different companies owned by jeweller Mr. Nirav Modi without any collateral securities. When one of the accused employees, Mr. Gokulnath Shetty, who was the Deputy Manager of the Branch, left in January 2018, the bogus transactions became public. This was because his replacement turned down a new application for a LoU without any protection being provided. The representatives of Mr. Nirav Modi asserted that the Bank while issuing the previous Lou's had asked for no collateral securities. According to reports, Mr. Shetty logged in to PNB's SWIFT system with passwords that permitted him to issue, verify, approve and also receive the confirmation message of creation of loan with the help of Mr. Manoj Kharat, a Single Window Operator of the same branch<sup>88</sup>. On January 16, 2018, the Nirav Modi group's partnership business came to our Brady House branch in Mumbai with a lot of import paperwork and asked for credit to pay foreign suppliers. This is what PNB told the stock markets. Before the companies could give out Letters of Undertaking (LOUs) to improve buyers' credit, branch officials told them they had to have at least 100% cash on hand. This was because none of the companies in question had a sanctioned limit mentioned. The businesses denied this, arguing that they had been using these transactions for a number of years. Upon closer examination, it was discovered that branch officials had previously issued LOUs via SWIFT without getting the go-ahead from the appropriate authority, acquiring the required importer applications, import documents, and legal paperwork from the bank, as well as without entering the information in the trade finance module of the CBS system<sup>89</sup>.

This alerted the successor of Mr. Shetty of the lapses in banking operations, misappropriation of the monies advanced and the misuse of access privileges by bank employees. From 25 January 2018 to 12 February 2018, investigations revealed unauthorized LoUs, Foreign Letters of Credit and Inland Letters of Guarantee, amounting to a total of Rs, 11394.02 crores in the group accounts of Nirav Modi Group

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<sup>88</sup> Singh, G., Srivastav, S., Gupta, A., & Garg, V. (2020). An analysis of financial fraud through pnb bank scam and its technical implications. *Proceedings of International Conference on Computation, Automation and Knowledge Management, ICCAKM 2020*, 436–442. <https://doi.org/10.1109/ICCAKM46823.2020.9051500>

<sup>89</sup> Krishnamoorthy, B., & Shivkumar, A. (2020). Punjab National Bank: Implementing core banking solution. *International Journal of Services, Technology and Management*, 26(6), 502–519. <https://doi.org/10.1504/IJSTM.2020.110366>

and M/s Gitanjali Group among others. PNB submitted an FMR-I Report, (as per the fraud reporting format of the Master Directions on Fraud Reporting) to RBI and registered a criminal complaint with CBI against the accused including the bank employees involved, for fraud by cheating, criminal conspiracy and abuse of official position. Another complaint was also filed with ED, considering the value of the fraud. The fraud involves various people, bank instruments and systems<sup>90</sup>. In order to better understand how the hoax works, it is helpful to know what happened in real life before the scam was done. The main suspects are Mr. Nirav Modi, who designs and sells jewels, Mr. Mehul Choksi, who is Mr. Nirav Modi's maternal uncle and the head of the Gitanjali Group, Mr. Gokulnath Shetty, who is the deputy manager at the Brady Branch in Mumbai, and Mr. Manoj Kharat, who works as a single window operator at the same branch. An item of Nirav Modi's necklace called the Golconda Lotus Necklace sold at Christie's Hong Kong for \$3 million, making him famous as a jewellery artist. He launched his own brand and opened stores in Delhi and Mumbai in 2014 and 2015 respectively, followed by other outlets in New York and Hong Kong. For his jewelry, he wanted to import diamonds and pearls and thus, applied for a loan in foreign currency as it was cheaper, easier and quicker than getting approvals for foreign transactions and was not affected by fluctuations in the foreign currency exchange rates. Mr. Modi, to avoid the complications of sanctions and collateral securities involved in Loan Accounts, applied for Lou's as guarantee to obtain short-term buyer 's credit from foreign Branches of Indian Banks. It is important to understand the nature, liability of issuer and Regulatory Framework of Lou's and also the working of SWIFT before proceeding further with the modus operandi of the fraud

Letter of Undertaking is a type of Bank Guarantee, issued by a bank to its customers enabling them to avail short term trade credit from a foreign branch of an Indian bank<sup>91</sup>. These LoUs are in the form of trade credits for import of goods to India and are not issued for retail transactions. LoUs, therefore, are a guarantee to the foreign branch of the Indian bank that the Indian branch will settle the outstanding of the customer for whom the LoU has been issued in foreign currency, in case the same is not repaid by the customer. These being short term credit facilities, generally have a tenure of 90 days

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<sup>90</sup> Albrecht, W. S., Albrecht, C. O., Albrecht, C. C., & Zimelman, M. F. (n.d.). *Fraud Examination*.

<sup>91</sup> Jain, S. (2014). Commercial Instruments: Bank Guarantee and Letter of Credit. *SSRN Electronic Journal*, 3. <https://doi.org/10.2139/ssrn.2460246>

to an year for the repayment of the credit extended (in case of non-capital goods). Banking Regulations require that for the issuance of LoUs as security for trade credit, the customer applying for the same has to provide margin money or collateral security to the issuing bank, whereupon the bank sanctions a credit limit to the customer<sup>92</sup>. This ensures that in case the LoU matures and the issuing bank's liability arises, it is secured by the margin money or collateral security. Also, RBI's directions, which were made under the Foreign Exchange Management Act of 1999 and the government's policy on foreign trade, control the issuance of LoUs and say how much credit is allowed and how long the loan is valid for<sup>93</sup>. According to Master Circular, DOR.STR.REC.66/13.07.010/2021-22245 dated 09 November 2021, RBI issued updated guidelines in respect of issuance of Bank Guarantees. These include general guidelines like:

- i. Banks should generally be cautious while issuing performance guarantees and confine themselves to financial guarantees.
- ii. Banks should provide guarantees of shorter duration and no guarantee should have a maturity period of more than 10 years.
- iii. Before issuance of guarantees, banks must ensure financial stability and the ability of the customer to reimburse the bank in case bank 's liability is called for the payment.
- iv. To safeguard the bank from internal risks, Bank Guarantees securing credit of value Rs 50.000 and above, must be signed by 2 officials jointly. This would help reduce the chances of malpractices and frauds by bank employees. In case this system is not followed in some exceptional cases, then such instruments must be scrutinized by auditors.
- v. Verification by auditors (internal and external), especially in case of all types of Bank Guarantees, is an important and crucial aspect of internal control. Banks are subject to various audits, one of which is a Concurrent Audit, which reduces the time interval between a transaction and its independent assessment. It is

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<sup>92</sup> Ummah, M. S. (2019). Banking Review Series 2019 A. *Sustainability (Switzerland)*, 11(1), 1–14. [http://scioteca.caf.com/bitstream/handle/123456789/1091/RED2017-Eng-8ene.pdf?sequence=12&isAllowed=y%0Ahttp://dx.doi.org/10.1016/j.regsciurbeco.2008.06.005%0Ahttps://www.researchgate.net/publication/305320484\\_SISTEM\\_PEMBETUNGAN\\_TERPUSAT\\_STRATEGI\\_MELESTARI](http://scioteca.caf.com/bitstream/handle/123456789/1091/RED2017-Eng-8ene.pdf?sequence=12&isAllowed=y%0Ahttp://dx.doi.org/10.1016/j.regsciurbeco.2008.06.005%0Ahttps://www.researchgate.net/publication/305320484_SISTEM_PEMBETUNGAN_TERPUSAT_STRATEGI_MELESTARI)

<sup>93</sup> Singh, S. (2009). Foreign capital flows into India : Compositions , regulations , issues and policy options. *Journal of Economics and International Finance*, 1(1), 14–29. <http://www.academicjournals.org/JEIF>

considered as an early warning system, which enables the detection of any irregularities or errors that are detrimental to the bank 's business and also helps in preventing fraudulent transactions. Banks have been advised by RBI to carry out concurrent audits in areas where the risk exposures of the bank are high. LoUs being high risk operations, banks must have concurrent audits of the same, besides the periodic Branch Audits and Annual Audits.

Consequent to the fulfillment of all necessary requirements and upon the satisfaction of the issuing bank, regarding the adequacy of the collateral security (which is generally higher than the value of the credit sought), the LoU is processed and a message is sent to the foreign branch using the SWIFT network, advising the branch of the issuance of the LoU. Once the message is received by the intended foreign branch, the amount is released by it and credited to a specific account called the NOSTRO Account of the issuing bank (home branch)<sup>94</sup>. Once the amount is credited (in foreign currency) to this account, the customer can utilize the amount to make payments to the supplier from whom he intended to purchase the goods or services. For example, PNB issued an LoU in favour of an importer, to the foreign branch of Union Bank of India and conveyed the same through SWIFT. Once the message was received, the approved amount was transferred to PNB's NOSTRO Account, as a loan to the importer, who utilized this money to complete his transaction with the foreign supplier. Once either the tenure is up or the importer has realized his input by reselling the imported goods, he will pay the loan advanced plus interest to PNB, which in turn will settle the accounts with the overseas branch of Union Bank of India.

#### **4.3 Swift and its use in the Fraud.**

SWIFT(Society for Worldwide Interbank Financial Telecommunication) is a communications network, that provides for globally set standards for communication between member banks, which are secure and understood by the banking institutions without any ambiguity<sup>95</sup>. The services provided by SWIFT facilitate not only secure transmission of messages between entities, but also an audit trail of all communications, ensuring regulatory compliance. When a bank issues any LoU, a message is sent to the

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<sup>94</sup> Adriani, N. (2018). Electronic copy available at : Electronic copy available at : *Grou*, 23529(2), 1–45.

<sup>95</sup> Scott, S. V., & Zachariadis, M. (2012). Origins and development of SWIFT, 1973-2009. *Business History*, 54(3), 462–482. <https://doi.org/10.1080/00076791.2011.638502>

overseas branch of the Indian bank, conveying the credit transfer to the customer, using the SWIFT network. This message tells the receiving bank to send the allowed amount in foreign currency to the NOSTRO account. It also serves as a promise from the bank that sent the message. Each partner bank has its own code, called a SWIFT code. This code is made up of letters and numbers and clearly shows the bank's name, country, city, and office. This enables clear identification of the initiator of the message and the recipient. To initiate a transaction using SWIFT, there are a minimum of three individuals required, namely a maker, a checker and a verifier, before the transaction is approved and issued. Each of the officials have to login to the system using their access passwords and fill in the requirements as per the nature of the transaction being initiated. The SWIFT network has to be integrated with the CBS (Core Banking System) of the bank, ensuring that any transaction done using the SWIFT network is recorded within the CBS<sup>96</sup>.

Having understood the nature of Lou's and working of the SWIFT network, the lapses in the procedure followed regarding the issuance, abuse of access privileges to initiate and approve the transactions using SWIFT and use of insider knowledge of the banking system are now being discussed to better understand the modus operandi of the fraud<sup>97</sup>.

#### **4.3.1 Lapses in Procedure**

According to RBI directions, any guarantee issued by a bank should have some collateral security in the form of assets or margin money, either equivalent to or more than the guarantee. The Lou's, in this instance, were issued without any collateral security or margin money.

- i. The bank sanctions a credit limit, based on the collateral security or margin money provided by the customer and also previous credit history of the customer<sup>98</sup>. In this case, no credit limits were sanctioned to Mr. Nirav Modi or any of the group's entities.

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<sup>96</sup> Malimage, K. (2019). Journal of Forensic and Investigative Accounting Volume 11 : Issue 2 , Special Edition , 2019. Journal of Forensic and Investigative Accounting Volume 11 : Issue 2 , Special Edition , 2019. *Journal of Forensic & Investigative Accounting*, 11(2), 353–365.

<sup>97</sup> de Goede, M. (2020). Finance/security infrastructures. *Review of International Political Economy*, 28(2), 351–368. <https://doi.org/10.1080/09692290.2020.1830832>

<sup>98</sup> Fabbri, D., & Menichini, A. M. C. (2010). Trade credit, collateral liquidation, and borrowing constraints. *Journal of Financial Economics*, 96(3), 413–432. <https://doi.org/10.1016/j.jfineco.2010.02.010>

- ii. The employees involved, with a single person Mr. Shetty, being the maker, checker and verifier of the transaction, bypassed the security measure in case of SWIFT transactions requiring a minimum of three personnel.
- iii. Once the message is received by the foreign branch, a receipt message is sent back, confirming the transaction. A person other than the above-mentioned three generally receives his message. In the case of PNB, either the receiving banks did not send the confirmations or were received by Mr. Shetty himself.
- iv. The transactions were not recorded in the CBS of PNB, which keeps a record of all transaction of the bank.
- v. Concurrent Audit of high risk transactions, Branch Audits and Annual Audits are mandatory requirements for all Banks and Financial Institutions<sup>99</sup>. In the present case, there were gross lapses on the part of both the internal and external auditors, as they failed to detect the LoUs for a period of almost 7 years. NOSTRO Accounts require to be regularly reconciled and mandatorily require to be audited by either SWIFT messages, emails or documents, to confirm the transactions, which in the present case appears to have not been done. Besides this the internal as well as external auditors should have investigated the increase in the NOSTRO Account, which surprisingly, in the present case, seems to have not been noticed by the auditors.
- vi. As part of their internal risk management strategy, most banks and other financial institutions change their employees on a regular basis. People in sensitive roles are also closely watched. In this case, however, one of the accused employees, Mr. Shetty was in the same position and branch for over a period of 7 years (till he retired).
- vii. Abuse of Position and Insider Knowledge
- viii. The accused bank employees were aware of the fact that the SWIFT network was not fully integrated with the bank 's CBS and used this knowledge to their advantage, by not logging the SWIFT transactions thereon<sup>100</sup>.

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<sup>99</sup> Koutoupis, A. G., & Tsamis, A. (2009). Risk based internal auditing within Greek banks: A case study approach. *Journal of Management and Governance*, 13(1–2), 101–130. <https://doi.org/10.1007/s10997-008-9072-7>

<sup>100</sup> Ambe, K. N., & Ebi, N. J. (2022). Contemporary Crimes Prevalent within Africa's Banking Industry and a Threat Analysis of Such Crimes on Africa's Development. *SSRN Electronic Journal*, October 2020, 1–107. <https://doi.org/10.2139/ssrn.4217275>

- ix. According to reports, physical documents of the transactions were destroyed to hide any evidence of the fraudulent transactions.
- x. Mr. Shetty, being the Deputy Manager, was authorized to clear transactions worth Rs. 10 lakhs to Rs. 25 lakhs only. However, according to newspaper reports, Mr. Shetty authorized and cleared multiple transactions amounting to Rs 1 crore, the highest being that of Rs. 221 crores.
- xi. According to an internal investigation report by PNB, Mr. Shetty, the then Deputy Manager of the Foreign Exchange Department of the Branch, had complete access to the bank's internal systems and thus was able to verify transactions above his sanctioned limits. The report further stated that in the year 2017, Mr. Shetty was authorized as both the maker and checker of entries.
- xii. This enabled him to further escape detection. Mr. Shetty, according to a news report, admitted to the CBI that he had access to Level 5 password to the SWIFT system<sup>101</sup>, which is generally provided to an Assistant General Manager level. The Report further stated that Mr. Shetty admitted to having shared the password with employees of Mr. Nirav Modi.

The above lapses and abuse illustrate how the fraud was perpetrated by just a couple of insiders, of whom one of the accused, Mr. Manoj Karat, has alleged that he is being used as a scapegoat, and that he was just following orders from his senior officials.

The fraud doesn't involve just the issuance of unauthorized Lou's, according to CBI and ED investigations, the money raised through these Lou's was in fact not used to make trade payments but was either used to repay old loans or to fake entities and used as a medium for money laundering. According to various news reports, the import papers presented to PNB, in respect of many transactions, were fake and were sent by firms of Mr. Modi. Based on these papers, PNB would release the payment in favour of these entities<sup>102</sup>. However, instead of actual purchase of gems, the money was used to pay off previous loans or brought back to India through various fictitious transactions. According to ED, the trail of these transactions revealed about 20 shell firms, mostly

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<sup>101</sup> Khatun, M. A., Memon, S. F., Eising, C., & Dhirani, L. L. (2023). Machine Learning for Healthcare-IoT Security: A Review and Risk Mitigation. *IEEE Access*, 11(December), 145869–145896. <https://doi.org/10.1109/ACCESS.2023.3346320>

<sup>102</sup> Singh, G., Srivastav, S., Gupta, A., & Garg, V. (2020). An analysis of financial fraud through pnb bank scam and its technical implications. *Proceedings of International Conference on Computation, Automation and Knowledge Management, ICCAKM 2020*, 436–442. <https://doi.org/10.1109/ICCAKM46823.2020.9051500>

based in Hong Kong and Dubai. The case involved the use of methods like Round-Tripping Kite Flying and Hawala transactions. Newspaper reports that followed the fraud story, reported that while investigating the bankruptcy proceedings of three US based corporations of Mr. Modi, the investigators found that a particular diamond was sold by a US based company, Firststar Diamond Inc., which is indirectly owned by Mr. Modi, to a Hong Kong based company called Fancy Creations Company Ltd., allegedly a shell company under the control of Mr. Modi, sometime in August 2011 for about \$ 1.1 million. Two weeks later, Solar Export, a partnership company established by the Nirav Modi Family Trust, transported the diamond—described as a "fancy vivid yellow orange cushion cut diamond"—back to Firststar Diamond Inc. for \$183,000. The identical diamond was sent once again for \$1.16 million to Fancy Creations Company Ltd. in Hong Kong a week later. The diamond was bought by Mr. Modi's diamond company A. Jaffe in New York, and it was sold to World Diamond Distribution in the United Arab Emirates for \$1.2 million. The investigators' report says that World Diamond Distribution is also Mr. Modi's shell company. According to the investigators' report, this roundtripping happened from 2011 to 2017 and cost a total of about \$213.8 million. It was these shipping invoices that were given to PNB in order to get the loans.

257 The case is being looked into by the CBI, ED, and the Serious Fraud Investigation Office (SIFO). They found that Mr. Nirav Modi and his maternal uncle, Mr. Mehul Choksi, who owns Gitanjali Gems, used fake companies to return the money that was loaned to them to pay for imports back to their Indian bank accounts <sup>103</sup>. According to the officials investigating the fraud, the total amount involved in the fraud was Rs. 12,300 crores; Mr. Modi was responsible for transactions worth Rs. 6,500 crores and the remaining Rs. 5,800 crores worth of transactions involved Mr. Choksi and his company. The PNB Fraud raised many questions with regard to internal controls, reconciliation of accounts and auditing. It highlighted the gross lapses in the Bank's Internal Governance Policies, the risks posed by Insiders in E-Banking Services and also Regulatory lapses. In the aftermath of this fraud, besides PNB left to honour its obligations under the LoUs, the credibility of the Indian Banking Industry and the role of the Regulator, i.e., RBI, was questioned. RBI's immediate response to the fraud was the issuance of a notification discontinuing the issuance of LoUs. Both Mr. Nirav Modi

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<sup>103</sup> Khalique, F., & Srivastava, S. (2024). Nirav Modi: A Case Study on Banking Frauds and Corporate Governance. *Lloyd Business Review*, III(1), 1–16. <https://doi.org/10.56595/lbr.v3i1.19>

and Mr. Mehul Choksi left India before the fraud was exposed and were declared as fugitives. This was not the first case where persons accused of committing economic offences in India had fled the country to escape prosecution. In order to bring to justice and punish persons accused of economic crimes<sup>104</sup>, The Fugitive Economic Offenders Act (FOEA), 2018 was passed by the Indian Parliament with the intention of preserving the integrity of the Indian legal system by preventing fugitive economic offenders from avoiding the legal system by avoiding the jurisdiction of Indian courts. A Special Court was set up to hear the Nirav Modi Case under the FEOA, 2018, which allowed ED to confiscate assets belonging to Mr. Modi, that were not hypothecated or pledged to PNB and attach the assets under the provisions of FEOA, 2018. The above case study highlights all the risks that an Insider poses in the Banking Sector and the need to have stringent internal controls.

#### **4.4 YES Bank crisis- a case of bad business decisions or fraud**

YES Bank was set up as a public limited company in 2003. Mr. Rana Kapoor, the late Mr. Ashok Kapur, and Rabobank International Holding were the first promoters of the company and owned 49% of its equity<sup>105</sup>. The Bank was granted a License by RBI to commence Banking Business in India in 2004. Together with MasterCard International, it made its foray into retail banking in 2005 by launching its Gold and Silver Debit cards and launching an IPO for its stock the same year. The Bank works in retail banking, investment banking, and corporate and institutional banking. A survey by Business Today and KPMG in 2008 found that YES Bank was the fastest-growing small bank. This was only three years after the bank opened for business. After the 26/11 attacks in Mumbai, Mr Ashok Kapur died, and Mr Rana Kapoor, who was the bank's MD and CEO, took over the Board of Directors and the main business of the bank. When he was in charge, Yes Bank mostly worked with drugs, real estate, technology, green energy, and the media. They also worked to grow their business loan section. Mr. Kapoor took a bold approach in developing the loans division by focusing on lending to the Corporate Sector instead of retail customers. Retail customers are small borrowers in comparison to corporates and growing its retail loan portfolio

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<sup>104</sup> International, T. H., Seminar, S., & Experts, V. (2004). Economic crime in a globalizing society: its impact on the sound development of the state - an indian perspective. *Group*, 71–84.

<sup>105</sup> Akhtar, S., Alam, M., & Khan, M. M. (2021). YES Bank Fiasco: Arrogance or Negligence. *Emerging Economies Cases Journal*, 3(2), 95–102. <https://doi.org/10.1177/25166042211061003>

requires any bank to build a large network of its branches. On the other hand, a single corporate borrower can boost the loan portfolio with just one big loan. However, it is less risky as compared to corporate lending, where one default can lead to huge losses<sup>106</sup>. The economic slowdown of 2008-2009, when almost all major banks were not offering new loans to certain sectors or promoters, YES Bank was lending capital to businesses that were in trouble and became the banker to businesses that could not secure a loan from other banks or financial institutions. While lending to these troubled corporates, Mr. Kapoor would charge a high fee, ranging anywhere from 2-10% of the amount sanctioned, with interest rates that were higher than the rates charged by his competitors. In addition, the interest on the amount sanctioned was collected upfront in some instances, thereby securing the Bank's exposure to some extent. Because YES Bank's finances were so bad, the RBI said on March 5, 2020, that it had changed the bank's Board of Directors and put a 30-day hold on all activities at the bank. The job of controller was given to Mr. Prashant Kumar, who at the time was the deputy managing director and top financial officer of the State Bank of India. The Bank's finances have been getting worse since 2018, mostly because it can't attract investors, deal with non-performing assets (NPAs), and avoid being dropped by credit rating agencies. Existing investors called on their bond obligations in response to this downgrade, and savers closed their accounts. The company's finances were getting worse, and there were major problems with how it was run.<sup>107</sup> Problems at YES Bank started in 2015, when UBS, a financial services company, said that the bank's loans to companies that weren't likely to pay back the loans were higher than its net worth. This was the first sign that something was wrong with the bank's assets. But the Bank said these were not true, and it reported to the market regulator, the Securities Exchange Board of India (SEBI). No one paid attention to the red flag, and the Bank's business kept growing, and its stock prices kept going up. The YES Bank Asset Quality Review (AQR) showed that the bank had lied about its NPAs and messed up its balance sheets. Reports say the bank lied about its NPAs by more than Rs 4,000 crore in 2016, Rs 6,355 crore in 2017, and Rs 2,299 crore in 2018-19.

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<sup>106</sup> Carey, M. (1998). Credit risk in private debt portfolios. *Journal of Finance*, 53(4), 1363–1387. <https://doi.org/10.1111/0022-1082.00056>

<sup>107</sup> Douglas, D., & Larry, D. (2003). Working Paper Series. *Review*, 85(6). <https://doi.org/10.20955/r.85.67>

The first AQR, which was carried out in 2017 for the financial year, had revealed the divergence by Yes Bank, whereby the NPAs, as classified by RBI stood, at 5 times higher than those reported by the Bank, yet no serious action against the Bank was initiated except a warning. By 2018-19, the situation had become alarming, Mr. Rana Kapoor was requested to resign as MD. But YES Bank's stock price went down, and non-performing assets (NPAs) kept going up because big lenders stopped paying. It is important to understand the RBI's Prudential Norms on asset classification and advance funding in order to understand what happened with YES Bank that almost caused it to fail. Based on the RBI's 2015 Master Circular on the Prudential Standards that Banks Must Follow<sup>108</sup>

1. An NPA is an asset that doesn't bring in any money anymore. This includes loans or advances where the principal and/or interest is past due and hasn't been paid for 90 days or more if the loan is a term loan.
2. Banks must categorise non-performing assets (NPAs) into three groups based on how long they have been non-performing, specifically:
  - i. Substandard: investments that don't make a profit for a year or less.
  - ii. Doubtful: Twelve-month substandard assets.
  - iii. Loss: Assets that the bank, auditors (internal or external), or RBI examination has deemed unrecoverable but not written off.
3. Banks further need to make provisions for NPA based on the above classification. The loss assets need to be written off, but if they stay on the books, they need to be fully account for. If the asset is doubtful, there is a 100% provision if the security doesn't cover the loan. For the part that is covered by the security, the provision can be anywhere from 25% to 100%, based on how long the asset was doubtful. Banks need to set aside 15% of their total assets in case they come across assets that aren't up to par.
4. Banks to maintain a Provision Coverage Ratio of not less than 70%.  
The major reasons which led to the Yes Bank crisis are: Risky Business Strategy: The strategy adopted by Mr. Rana Kapoor to grow the business was risky and inadequate provisions to mitigate the risks was one of the primary reasons that

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<sup>108</sup> Verma, D. (2023). *Predicting Default Of Indian. January.*

ultimately led to the crisis<sup>109</sup>. Aggressive corporate lending, to already stressed companies, though produced high returns in terms of higher interest rates and fee, also increased the risk of these loans turning NPA.

Underreported NPAs: The AQR revealed that the Bank had been underreporting its NPAs since Financial Year 2016-17. This Underreporting basically showed a skewed picture of the Bank 's balance sheets, inflating its profits<sup>110</sup>. YES Bank and UBS had also given more money than their net worth to companies that weren't likely to pay it back quickly, which was a red flag. One news story says that one of Yes Bank's problems was that it got a lot more loans between 2014 and 2019. The loans grew more than five times, from Rs 55,633 crore in 2014 to Rs 2,41,500 crore in 2019. The rate of growth over a year is 34.1%, while growth rates for other lenders were between 10 and 12%. DHFL, IF&FS, Reliance Group of Industries, Cox & Kings, Café Coffee Day, CG Power, Essel Group, and Essar Power were some of the big companies that didn't pay their bills.

The Bank, as required by the Prudential Norms, did not maintain provision Coverage Ratio. With defaults on loan repayments piling, and the financial health of the Bank deteriorating, the Bank did not make adequate provisions from the profits and its Provision Coverage Ratio, during the Financial Year 2019-20, fell to 43.1%.<sup>290</sup>

5. Ever-greening of Loans: Besides Underreporting, there were allegations that the Bank was hiding its NPAs through \_ever greening of the loans, whereby YES Bank arranged for stop-gap loans from other entities in case the borrower was about to default on the repayments.

This arrangement worked as a temporary measure to postpone the inevitable, and when many of its borrowers like DHFL, Reliance Group of Industries, IL&FS, being some

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<sup>109</sup> Ramesh Ramachandran, S. J. (2020). *EliScholar-A Digital Platform for EliScholar-A Digital Platform for Yes Bank Limited: Too Big to Fail? Yes Bank Limited: Too Big to Fail?* <https://elischolar.library.yale.edu/ypfs-documents2/1676>

<sup>110</sup> Ramesh Ramachandran, S. J. (2020). *EliScholar-A Digital Platform for EliScholar-A Digital Platform for Yes Bank Limited: Too Big to Fail? Yes Bank Limited: Too Big to Fail?* <https://elischolar.library.yale.edu/ypfs-documents2/1676>

of the biggest, failed, the Bank's NPAs rose sharply<sup>111</sup>. With inadequate provisioning and securities, the losses sustained mounted.

6. Declining Financial Health: With large number of depositors closing their accounts and investors pulling out, the Bank's financial health deteriorated with its loan books which stood at Rs 2.24 lakh crores, being greater than its deposit books, which by the end of September 2019 stood at Rs 2.09 lakh crores. Even after the exit of Mr. Kapoor, the Bank was unable to get new investors or raise capital.
7. Poor Corporate Governance and Internal Controls: There were allegations of noncompliance of Corporate Governance norms, especially regarding conflict of interest related to some transactions in which Mr. Kapoor had been part of the decision making.

Allegations were made by a whistleblower, in 2018, regarding the Bank 's deliberate Underreporting and misclassification of its NPAs during the period 2008-2018. The whistleblower also alleged that not all transactions were at arm 's length as required by Corporate Governance norms in respect of related party transactions<sup>112</sup>. Though an internal inquiry was constituted to investigate the matter, the results were inconclusive. According to some, Mr. Kapoor took all major decisions, with most of the Board Members being pliant. Even the CBI charge sheet against Mr. Rana Kapoor alleges that he took —undue personal interest in investments in DHFL that were risky and also did not pay heed to the warnings from the Bank 's Risk Management Committee and Treasury. Internal audits that a bank is required to carry out periodically, coupled with the requirement of an Independent Audit Committee, comprising of Independent Directors, besides the Risk Management Committee, all failed to highlight and or report the anomalies and malpractices being followed, pointing to weak or non-existent internal controls.

Poor Regulatory Control: Despite the warnings and red flags, RBI did not take any actions against the Bank or its management<sup>113</sup>. As early as 2017, when the divergence

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<sup>111</sup> Bajpai, N., & Biberman, J. (2020). *A New Era of Growth: Reforms to Revitalize the Indian Economy. March*. <https://academiccommons.columbia.edu/doi/10.7916/d8-kt52-g288>

<sup>112</sup> Sector, P. (2024). *Effect of corporate governance mechanisms on related party transactions of listed consumer goods companies in nigeria. 1(1)*.

<sup>113</sup> Arora, D., & Agarwal, R. K. (2011). Banking Risk Management in India and RBI Supervision. *SSRN Electronic Journal*. <https://doi.org/10.2139/ssrn.1446264>

in NPAs was revealed by the AQR, RBI was aware of the Underreporting, which ironically continued for another 2 years before RBI acted and asked Mr. Kapoor will resign as CEO and MD. Even the Nominee Director, who was appointed to the YES Bank Board, did not voice any concerns about the Bank's ongoing financial collapse. The YES Bank failure and fraud was described by Bloomberg as a failure in slow motion in full view of authorities<sup>114</sup>.

The above reasons may point towards a scenario that the troubles at YES Bank were only bad business decisions with no mala fides. However, a few days after RBI put the Bank under moratorium, ED arrested Mr. Rana Kapoor under the PMLA, on charges of laundering money. The charge sheet filed by ED alleged that out of the total loans sanctioned by YES Bank during the tenure of Mr. Kapoor, Rs. 20,000 crores worth of those loans had become NPAs.<sup>297</sup> The ED further alleged that Mr. Kapoor had received Rs. 5,050 crores as bribes for sanctioning these loans, besides misusing his office, forming shell companies to launder money and other irregularities in sanctioning loans.

A case was registered by CBI, on 7 March 2020 against Mr. Kapoor under suspicion of fraud, cheating and criminal conspiracy in the disbursement of loans to DHFL and its promoters. CBI filed its charge sheet in June 2020 against Mr. Kapoor and 11 other people including DHFL, its promoters, Mr. Kapoor 's daughters, owners of Droit Urban Ventures Ltd. as accused in the fraud that led to the YES Bank failure.

Both the ED and the CBI cases were about how Mr. Kapoor and his family got Rs. 600 crores from DHFL for giving the company credit through YES Bank. They did this by investing Rs. 3,700 crores in short-term debentures of DHFL, which was having a hard time making money. As a loan, DHFL gave this amount of Rs. 600 crores to DoIT Urban Ventures Ltd., which is owned by Kapoor's daughter.

The cases against Mr. Kapoor and others are sub-juice, however from the details of the YES Bank failure, it is clear that poor Governance standards and internal controls in banks can lead to disastrous results for the investors and depositors and the Banking Sector as a whole. The confidence of people in the Banking Sector took a serious hit,

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<sup>114</sup> Ramchandani, K., & Jethwani, K. (2021). Yes bank: an untold story. *Emerald Emerging Markets Case Studies*, 11(1), 1–37. <https://doi.org/10.1108/EEMCS-04-2020-0123>

with most banks 'share prices seeing a decline after the news of the moratorium placed on YES Bank.

#### **4.5 ABG Shipyard: unfolding of India's biggest bank fraud\***

In the same year that the PNB-Nirav Modi case made a lot of news, there was news of a bank scam involving an amazing Rs. 22, 482 crores. This is almost twice as much money as the first case. This caused buyers to doubt the honesty of the banking industry once more. It was said that 28 banks, with ICICI Bank being the main one, offered funds to the company as part of a group. The ABG Group set up ABG Shipyard Ltd. (ABG SL) as a business in Gujarat, India, in 1985 to build and fix ships. Then it grew to be one of India's biggest factories, and people from all over the world hired them to build ships<sup>115</sup>.

According to a report from Ernst & Young LLP, State Bank of India, one of the loan banks, filed a charge with the CBI. This is how they found the fraud. In 2008 and 2009, the global financial crisis was the start of ABG SL's problems. This caused a drop in demand for goods around the world, which in turn caused a drop in foreign trade, which hurt the shipping business. This led to a fall in the demand for ships and cancellation of orders, thereby putting a strain on ABG SL's finances. In 2013, ABG SL's account was declared as NPA but was later reconstructed under the Corporate Debt Restructuring Scheme. However, ABG SL was unable to get any fresh orders because of the terrible recession that the shipping industry was experiencing globally. The company once again failed to repay its interest on the loans because it was unable to reach the milestones that were anticipated when the loan was restructured<sup>116</sup>.

The account of ABG SL was checked as part of the accounting process. The 2016 Auditor's Report found many problems with how the company used the money that the banks gave them. The ABG SL account was again found to be non-performing in 2016 based on the Auditor's Report. In 2018, a forensic audit was initiated. A forensic audit was done by Ernst & Young LLP and looked at the years 2012–2017. The case was

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<sup>115</sup> Khaliq F and Srivastava S, 'Nirav Modi: A Case Study on Banking Frauds and Corporate Governance' (2024) III Lloyd Business Review 1

<sup>116</sup> Gupta M, Aggarwal PK and Gupta R, 'Corporate Sustainability with Forensic Auditing: An Evidence from India' (2023) 35 International Journal of Experimental Research and Review 128

then sent to NCLT by the major bank, ICICI Bank Ltd., so that the Corporate Insolvency Resolution Process could begin.

News sources say that in 2020, SBI, the Consortium's biggest public sector bank, sent a protest to the CBI. They said that the report from the forensic accountants showed that ABG SL had not only spent the money but also given it to other groups. The Auditor's Report claims that the money was allegedly utilised for unreported reasons, that investments were made via a company located in Singapore, and that associated persons received pay-outs totalling hundreds of crores. Additionally, properties were purchased using the money that ABG Shipyard contributed.

When the CBI publicly charged ABG SL, its head and MD, Mr. Rishi Kamlesh Agarwal, and other company directors in February 2022, they said they had broken trust, stolen money, and taken money from something else. This came after simple checks of facts and issues.

Many people are worried about how long it took the group to send the report and how long it took the CBI to file the FIR after that. It will be easier to find fault with the Consortium of banks and inspectors because they check big loan accounts all the time. The fraud should have been found long before the accounts went bad<sup>117</sup>.

Even though the present fraud is one primarily perpetrated by the customer on the Bank, it still raises questions with regard to internal controls and the vulnerabilities the current banking system has presented in detecting and preventing such huge frauds from happening.

#### **4.6 IL&FS Corporate Governance Failure**

Infrastructural Leasing and Financial Services (IL&FS), a big building finance company, went bankrupt in 2018. It was one of the worst corporate management mistakes in recent Indian history. When the company didn't pay back its loans, it caused one of India's worst financial problems, which affected the banks and financial sectors. As the manager of a big collection of building projects across the country, IL&FS had a complex network of companies and joint ventures. The company had been enjoying

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<sup>117</sup> Gawali B and Dube D, 'Law and Process of Investigation by Central Bureau of Investigation: Issues and Perspectives' [1111] Ssrn 1

a high credit rating and widespread investor confidence until its financial distress became public.

#### **4.6.1 Causes of the Fraud:**

The failure of IL&FS's corporate governance was caused by a number of different internal and external forces. Some of the most important internal problems were unclear financial reports, weak internal controls, and big mistakes with money management. This was because the business used short-term loans to pay for long-term building projects, so its assets and bills were not fairly balanced. The company did not have a good risk management system, which made the bad management even worse. As a result, the company did not notice its growing financial flaws <sup>118</sup>.

Moreover, IL&FS's leadership had been involved in questionable financial practices, such as hiding bad debts and inflating the value of assets to maintain its credit rating. There was also a systemic failure in the way the company's auditors, the board of directors, and other stakeholders overlooked red flags, allowing fraudulent activities to persist unchecked for years.

#### **4.6.2 Institutional Response:**

In India, the Reserve Bank of India (RBI), the Securities and Exchanges Board of India (SEBI), and IL&FS all took too long to do something about it. The board and management of IL&FS didn't do anything about the problem in time, and by the time the defaults were found, the damage was already very bad. The situation got out of hand because the RBI and SEBI didn't keep a close eye on the company's finances and government. It was only after the defaults that the government stepped in, appointing a new board to manage the crisis and restructure the company<sup>119</sup>.

#### **4.6.3 Outcomes of the Failure:**

With a total exposure of over Rs 91,000 crore across many banks and financial institutions, the fallout from the IL&FS bankruptcy was disastrous. Due to the severe

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<sup>118</sup> Khari D and Sharma D, 'The IL & FS Financial Statement Fraud : A Failure of Governance , Auditing , and Regulation' (2025) 21 804

<sup>119</sup> Kukreja G, Gupta S and Bhatia M, 'The Failure of Corporate Governance at Infrastructure Leasing and Financial Services Limited: Lessons Learnt' (2021) 10 South Asian Journal of Business and Management Cases 63

liquidity shortage caused by the company's failure, many people began to worry about the viability of India's financial system. A reassessment of corporate governance norms in India was also prompted by the case, with demands for more stringent supervision procedures to guarantee accountability and transparency in the banking industry.

Several individuals were arrested, including the former managing director and the chairman of IL&FS. The case also exposed gaps in the functioning of credit rating agencies, as IL&FS had been receiving high ratings from these agencies despite its growing financial issues.

#### **4.6.4 Identifying Gaps in Fraud Detection and Management:**

The IL&FS debacle has highlighted several critical gaps in the management of fraud and corporate governance within India's financial and corporate sectors:

- i. **Weak Governance Framework:** The failure of IL&FS to maintain proper governance protocols at every level of operation was a major factor that enabled fraud to flourish. The board's lack of independence and poor oversight mechanisms allowed executives to engage in reckless financial management without fear of accountability<sup>120</sup>.
- ii. **Inadequate Risk Management:** IL&FS's reliance on short-term borrowing for long-term infrastructure projects exemplified a fundamental flaw in its risk management practices. There was a failure to adequately assess the risks of such strategies, and the company was unprepared when the financial conditions worsened.
- iii. **Lack of Transparency:** The opacity in IL&FS's financial reporting, particularly regarding its liabilities and asset values, was a critical issue. The company's complex web of subsidiaries made it difficult for external stakeholders, including investors and regulators, to assess its true financial condition<sup>121</sup>.
- iv. **Ineffective Regulatory Oversight:** One of the most glaring gaps was the failure of regulatory bodies to detect and address the mounting problems at IL&FS in a timely manner. The RBI, SEBI, and other regulatory agencies did not

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<sup>120</sup> Khari D and Sharma D, 'The IL & FS Financial Statement Fraud : A Failure of Governance , Auditing , and Regulation' (2025) 21 804

<sup>121</sup> Rika Widianita D, 'Unraveling the Mirage: The IL&FS Accounting and Financial Fraud Case Study Baranidharan' (2023) VIII AT-TAWASSUTH: Jurnal Ekonomi Islam 1

adequately monitor the company's financial health, which allowed the fraud to escalate without intervention.

- v. Failure in Early Detection: The delay in identifying and addressing the company's financial troubles points to systemic issues in early fraud detection mechanisms within Indian financial institutions. Banks, auditors, and rating agencies failed to act on warning signs, enabling the fraud to continue unchecked.

#### **4.7 Conclusion**

In conclusion, study highlights the critical lessons drawn from major financial frauds in India, shedding light on the systemic vulnerabilities within the banking and financial sector. The case studies examined reveal patterns of weak internal controls, regulatory oversight failures, and, in many instances, the active or passive involvement of insiders. In addition to causing large financial losses, these instances eroded public confidence in financial institutions. Strong risk management procedures, improved corporate governance, more stringent compliance standards, and prompt regulatory body involvement are all urgently needed, according to the report. Stakeholders may better understand the underlying causes of fraud and endeavour to create a more robust, transparent, and accountable financial system by taking lessons from these real-world examples.

## CHAPTER 5

### CONCLUSION AND SUGGESTION

#### 5.1 Conclusion

The number of financial scams in India, especially in the banking industry, has grown a lot in the last few years. In India, there are more and more scams involving money. A lot of people have heard about the Punjab National Bank scam, the Yes Bank financial troubles, and the IL&FS corporate governance failure. This study looked at some of the most well-known examples. The case studies in the study show that the Indian banking industry still has major problems, even though rules and technology have gotten better.

One of the main points of the study is that theft is easy to happen in the Indian banking system because of a mix of internal and external factors. The rise in financial frauds is mostly due to regulators not keeping an eye on things closely enough, weak risk management, and weak internal controls. In many cases, the rapid pace of digitalization and expansion of banking services have exacerbated the risk of fraud, with new avenues for exploitation emerging faster than the ability of institutions to detect and manage them.

The case studies looked at in this study show similar patterns of fraud, like changing financial records without permission, having insiders involved, and banks and government bodies not stepping in quickly enough. High-profile people were involved in the Punjab National Bank scam, and structural flaws let such a large-scale fraud happen. This shows that there needs to be more openness and stronger enforcement of regulations. In comparison, the Yes Bank problem showed how dangerous it can be to have bad financial management and governance. Also, the failure of IL&FS showed how bad corporate governance can hurt banks and the economy as a whole.

But even with these issues, the Indian banking industry has done a better job of finding and running down scams. India's regulators, like the Reserve Bank of India (RBI) and the Securities and Exchange Board of India (SEBI), have taken a number of steps to strengthen laws, improve internal processes, and make things clearer. The underlying

causes of fraud have not, however, been adequately addressed by these actions, especially when intricate financial schemes and insider collusion are involved.

The study also shows that the Indian banking industry needs a stronger and more adaptable plan to fight financial crime. To make this happen, stricter rules and laws must be put in place, and cutting edge technologies such as AI and machine learning must be used to spot scams. To slow down the rise of financial fraud even more, institutions need to train their staff better in how to spot it and encourage a mindset of morality and responsibility.

In conclusion, while significant strides have been made in improving the Indian banking system's ability to prevent and manage fraud, much work remains to be done. Case studies of major financial crimes should lead to more changes that strengthen the banking system, protect investors' and customers' interests, and restore trust in the financial industry. Addressing the structural gaps found in this study is one way for India to make its banking system stronger and safer, making it better able to handle future financial crime problems.

## **5.2 Suggestions**

### **i. Prevalence of Large-Scale Financial Frauds**

It was found that over the last ten years, there has been a big rise in the number and size of financial frauds in India. Most of these have happened in the banking industry. A lot of people were interested in the cases involving Nirav Modi, Vijay Mallya, and the Punjab and Maharashtra Cooperative Bank (PMC Bank). These cases show how weak the system is.

### **ii. Ineffective Internal Controls and Oversight**

One of the key findings is the inefficacy of internal checks and balances within banks. Weak Know Your Customer (KYC) norms, lax due diligence, and the manipulation of core banking systems have allowed frauds to go undetected for prolonged periods.

### **iii. Delayed Detection and Reporting**

A recurring pattern in the case studies is the delayed recognition and reporting of frauds. In many instances, irregularities were only discovered during audits

or whistleblower reports, by which time the financial damage was already substantial.

**iv. Political and Corporate Nexus**

The analysis indicates that in several cases, political interference and collusion between high-level executives and corporate borrowers played a role in facilitating fraud. This reflects a compromised governance structure in certain public and private sector banks.

**v. Lack of Accountability and Recovery Mechanisms**

Post-fraud recovery remains minimal. Asset recovery through legal processes such as insolvency proceedings, asset seizure, or extradition has shown limited success. The time-consuming nature of Indian judicial and recovery systems further weakens deterrence.

**vi. Regulatory Gaps and Inadequate Enforcement**

Despite reforms and regulatory frameworks by the Reserve Bank of India (RBI), enforcement remains inconsistent. Frauds often exploit regulatory loopholes or thrive due to a lack of real-time monitoring and integration among financial institutions.

**vii. Complacency in Corporate Governance**

The rapid expansion of banking activities, especially in retail and digital domains, has not been matched with corresponding improvements in corporate governance. Several banks have failed to adapt their risk assessment mechanisms to the changing financial landscape.

**viii. Technological Misuse and Cyber Frauds**

With digital banking on the rise, cyber-related financial frauds have become more frequent. Phishing, identity theft, and digital transaction manipulation have exposed banks and customers to new forms of risk, often without adequate cybersecurity infrastructure.

**ix. Customer Trust and Banking Stability**

Large-scale financial frauds have adversely impacted public trust in the banking system. Repercussions include withdrawal of deposits, erosion of shareholder confidence, and declining market valuations of affected banks.

**x. Need for Systemic Reforms**

The findings underscore an urgent need for holistic reforms from strengthening audit mechanisms and board accountability to improving fraud detection technologies and streamlining regulatory oversight.

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