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RBI Revised Master Directions on Fraud Risk Management: July 2024

Introduction

The Reserve Bank of India (RBI) issued revised Master Directions on Fraud Risk Management in July 2024, superseding previous guidelines and consolidating 36 existing circulars. These comprehensive directions apply to a wide range of regulated entities, including commercial banks, cooperative banks, and non-banking finance companies.

Purpose and Objective

The Reserve Bank of India's Revised Master Directions on Fraud Risk Management, issued on July 15, 2024, aim to provide a robust framework for the prevention, early detection, and timely reporting of frauds in regulated entities (REs). The revised guidelines aim to strengthen the role of boards in overseeing fraud risk management, enhance internal audit and control frameworks and ensure compliance with principles of natural justice.

Compliance with the Principles of Natural Justice before declaration of account as fraud

The Master Directions now expressly require that the REs shall ensure compliance with the principles of natural justice in a time-bound manner before classifying Persons / Entities as fraudulent. It duly takes into account the Hon'ble Supreme Court Judgment dated March 27, 2023 (Civil Appeal No. 7300 of 2022 in the matter of State Bank of India & Ors. Vs. Rajesh Agarwal & Ors.). In this matter, the Supreme Court of India addressed the penal measures for fraudulent borrowers as stipulated under Clause 8.12 of the RBI's Master Directions on Frauds. The Court emphasized the application of penal provisions similar to those for wilful defaulters, extending the restrictions to promoters, directors and whole-time directors of the borrowing company.

Notably, fraudulent borrowers are barred from availing bank finance from various financial institutions for five years from the date of full repayment of the defrauded amount. The Court also highlighted the significance of the principles of natural justice, asserting that borrowers must be given an opportunity to be heard before their accounts are classified as fraudulent. Consequently, the Court mandated that banks must serve a notice and provide a hearing to the borrowers before classifying their accounts as fraudulent, ensuring compliance with the principles of natural justice.

Additionally,, the framework on Early Warning Signals (EWS) and Red Flagging of Accounts (RFA) has been further strengthened for early detection and prevention of frauds in the REs including timely reporting to Law Enforcement Agencies and Supervisors. Further, requirement for Data Analytics and Market Intelligence Unit for strengthening risk management systems have been mandated. These Directions have now been made applicable to Regional Rural Banks, Rural Cooperative Banks and Housing Finance Companies as well.The intent is to promote better fraud risk management systems and framework in such REs. With the issuance of these Master Directions, the existing 36 Circulars on the subject stand withdrawn.

Following are the major requirements of the RBI Guidelines on fraud risk management

Criteria for Classification of Accounts as Fraud

- Early Warning Signals (EWS) and Red Flagging of Accounts (RFA):
  - **EWS Framework**: Banks must establish a framework for identifying early warning signals, integrating with Core Banking Solutions (CBS) for real-time monitoring (Clause 8.3).
  - **Red-Flagged Account (RFA)**: An account with one or more EWS indicators that suggest fraudulent activity requires deeper investigation and preventive measures (Clause 8.3.1).

- **Reporting**: Accounts meeting the CRILC (*Central Repository of Information on Large Credits. It is a Database maintained by Reserve Bank of India by collection of Loan and Investment data of borrowers from all Financial Institutions*) threshold and identified as RFA must be reported to the RBI within seven days (Clause 8.3.3).

- Independent Confirmation:
  - Banks must ensure third-party service providers involved in the fraud are held accountable, with their details reported to the Indian Banks' Association (IBA) (Clause 8.12.4).
- Staff Accountability:
  - Banks must examine staff accountability in fraud cases promptly. For public sector banks (PSBs) and AIFIs, this includes referring cases to the Advisory Board for Banking and Financial Frauds (ABBFF) (Clause 8.10.1).
- Penal Measures:
  - Persons/Entities classified as fraud by banks are debarred from accessing credit facilities for five years post-repayment or settlement (Clause 8.12.1).

Reporting Mechanism

- Reporting to Law Enforcement Agencies (LEAs):
  - **Private Sector/Foreign Banks**: Report frauds below INR 1 crore to State/UT Police; INR1 crore and above to SFIO and Police (Clause 8.11.1).
  - **Public Sector Banks/RRBs**: Report frauds below INR 6 crore to State/UT Police; INR 6 crore and above to CBI (Clause 8.11.1).
- Reporting to RBI:
  - **Fraud Monitoring Returns (FMRs)**: Banks must report individual fraud cases immediately but no later than 14 days from classification (Clause 8.4.2).
  - **Central Fraud Registry (CFR)**: Banks must utilize the CFR for effective fraud risk management (Clause 3.1).
- Closure of Fraud Cases:
  - Fraud cases can be closed upon completion of LEA actions and staff accountability examination (Clause 5.1).
  - In this context, it is important to note the requirements of RBI Guidelines on settlement of fraud cases in the light of RBI Circular dated June 08, 2023.

Gist of RBI Circular Dated June 8, 2023: Framework for Compromise Settlements and Technical Write-offs

Compromise settlements are viewed as a viable resolution mechanism, ensuring early recoveries while maintaining ongoing legal actions against fraudulent or wilful defaulters.

Compromise Settlement in Wilful Default and Fraud Cases: The RBI circular clarified that the provision allowing banks to enter into compromise settlements with borrowers classified as fraud or wilful defaulters was previously communicated in various guidelines, including the letter dated May 10, 2007, and the Master Circulars on Wilful Defaulters (July 1, 2015) and Frauds (July 1, 2016). The circular emphasizes that the penal measures applicable to wilful defaulters and fraudulent borrowers remain unchanged. These include restrictions on obtaining new credit and debarment from institutional finance for a specified period.

The circular also clarified that the introduction of a minimum 12-month cooling period applies to general compromise settlements, not affecting the penal measures for wilful defaulters or fraudulent borrowers. These measures continue to restrict borrowing despite the cooling period. It further clarified that compromise settlements must be approved by the bank's Board and adhere to board-approved policies. Settlements involving fraud or wilful default must continue criminal proceedings and be subject to judicial consent if recovery proceedings are ongoing.

Filing of FIR and Other Legal Actions

- **FIR Filing**: Banks must report fraud incidents to relevant LEAs and file FIRs promptly, ensuring coordination with LEAs for investigation and further legal action (Clause 8.11.1).

Key Changes as compared to 2016 RBI Guidelines on the Issue

Aspect	2016 Guidelines	2024 Revised Guidelines
Governance Structure	Basic Board oversight	Enhanced Board roles, SCBMF, RMCB oversight
Natural Justice	Not explicitly required	Mandatory compliance with natural justice principles
EWS and RFA	Basic EWS framework	Comprehensive EWS integrated with CBS, RFA framework
Data Analytics	Not mandatory	Required establishment of Data Analytics Units
Reporting Mechanism	Detailed FMR requirements	Streamlined FMR, CFR, CPFIR reporting
Penal Measures	Standard penalties	Five-year debarment post-repayment/settlement

List of the Early Warning Signals (EWS)

- Default in undisputed payment to the statutory bodies as declared in the Annual report.
- Bouncing of high-value cheques.
- Frequent change in the scope of the project to be undertaken by the borrower.
- Delay observed in payment of outstanding dues.
- Frequent invocation of BGs and devolvement of LCs.
- Underinsured or overinsured inventory.
- Invoices devoid of TAN and other details.
- Dispute on the title of collateral securities.
- Funds coming from other banks to liquidate the outstanding loan amount unless in normal course.
- Request received from the borrower to postpone the inspection of the godown for flimsy reasons.
- Funding of the interest by sanctioning additional facilities.
- Exclusive collateral charged to several lenders without NOC of existing charge holders.
- Concealment of certain vital documents like master agreement, insurance coverage.
- Floating front/associate companies by investing borrowed money.
- Critical issues highlighted in the stock audit report.
- Liabilities appearing in ROC search report, not reported by the borrower in its annual report.
- Frequent request for general-purpose loans.
- Frequent ad hoc sanctions.
- Non-routing of sales proceeds through consortium/member bank/lenders to the company.
- LCs issued for local trade/related party transactions without underlying trade transaction.
- High-value RTGS payment to unrelated parties.
- Heavy cash withdrawal in loan accounts.
- Non-production of original bills for verification upon request.
- Significant movements in inventory, disproportionately differing vis-a-vis change in turnover.
- Significant movements in receivables, disproportionately differing vis-a-vis change in turnover and/or increase in aging of the receivables.
- Disproportionate change in other current assets.

- Significant increase in working capital borrowing as a percentage of turnover.
- Increase in Fixed Assets, without corresponding increase in long-term sources (when project is implemented).
- Increase in borrowings, despite huge cash and cash equivalents in the borrower's balance sheet.
- Frequent change in accounting period and/or accounting policies.
- Costing of the project which is in wide variance with the standard cost of installation of the project.
- Claims not acknowledged as debt high.
- Substantial increase in unbilled revenue year after year.
- Large number of transactions with interconnected companies and large outstanding from such companies.
- Substantial related party transactions.
- Material discrepancies in the annual report.
- Significant inconsistencies within the annual report (between various sections).
- Poor disclosure of materially adverse information and no qualification by the statutory auditors.
- Raid by Income tax/sales tax/central excise duty officials.
- Significant reduction in the stake of promoter/director or increase in the encumbered shares of promoter/director.
- Resignation of the key personnel and frequent changes in the management.

What are the Compliance measures Regulated Entities can develop

- **Board-Approved Policy**: Develop and periodically review a comprehensive fraud risk management policy (Clause 2.1.3).
- **EWS and RFA Framework**: Implement robust systems for early detection and red-flagging of suspicious accounts (Clause 8.3.1).
- **Data Analytics Units**: Establish dedicated units for continuous monitoring and analysis of transactions (Clause 8.3.5).
- **Timely Reporting**: Adhere to specified timelines for reporting frauds to RBI and LEAs (Clause 3.2.1).
- **Staff Accountability**: Promptly investigate and conclude staff accountability in fraud cases (Clause 8.10.1).
- **Coordination with LEAs**: Ensure effective coordination and follow-up with LEAs for fraud investigations (Clause 8.11.2).

Review and Reporting Requirements

- **Board Reports**: All frauds of INR 0.1 million and above must be reported to the Board promptly upon detection (Clause 4.1).
- **Quarterly Review**: Information relating to frauds for each quarter must be placed before the Audit Committee of the Board (Clause 4.2.1).
- **Annual Review**: An annual review of frauds must be conducted and presented to the Board before the end of the June quarter (Clause 4.3.1).

Other Requirements

- **Legal Audit**: Title deeds and other documents for all credit exposures of ₹5 crore and above must be subject to periodic legal audit (Clause 9.1.1).
- **Filing Complaints with LEAs**: Banks must file complaints with LEAs promptly upon detection of fraud (Clause 8.11.1).
- **Penal Measures**: Fraudulent borrowers are debarred from accessing credit facilities for five years from the date of full payment of the defrauded amount (Clause 8.12.1).

Summary of Key Reporting Mechanism

Reporting Requirement	Threshold/Details	Timeframe
Fraud Monitoring Returns (FMRs)	All fraud cases	Within 14 days of classification
Central Fraud Registry (CFR)	Utilization for effective fraud risk management	Ongoing
Flash Report (FR)	Frauds involving ₹50 million and above	Within one week of detection
Monthly Certificate	Confirmation of FMR submission	Within seven days from the end of the month
Fraud Reports to LEAs	Private Banks: below ₹1 crore to State/UT Police; above ₹1 crore to SFIO and Police	Ongoing
	Public Sector Banks/RRBs: below ₹6 crore to State/UT Police; above ₹6 crore to CBI	Ongoing

The revised RBI Master Directions on Fraud Risk Management issued in July 2024 is a significant step in enhancing the robustness of fraud prevention and control measures within India's financial sector. By emphasizing the principles of natural justice, the new guidelines ensure that the rights of all stakeholders are protected while maintaining the integrity of the financial system. The detailed requirements for reporting, audit, and compliance provide a clear framework for regulated entities to follow, promoting transparency and accountability.

We hope you have found this information useful. For any queries/clarifications please write to us at insights@elp-in.com or write to our authors:

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