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Banking Frauds: Management and Recovery of Non-Performing Assets in India

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Abstract

Banking fraud is a very serious issue facing the Indian banking system. In fact, the problem of banking fraud has been on the rise for the last decade. One of the most common types of banking fraud in India is loan fraud, where individuals, firms, and companies take loans from banks by means of deception or by submitting false documents to the banks. Sometimes loans are sanctioned by the bank, but they are not intentionally returned by the bank customer. There are various factors, including inadequate security measures and collusion between bank officers and bank customers, responsible for bank fraud in India Non-performing asset is a term commonly used in the Indian banking system that connotes a loan or any other financial advance that is in default or has become a non-performing asset for the bank.

The problem of NPAs and their recovery has been the centre of debate in India, particularly in the recent past. The banking industry across the country has been plagued by NPAs. Despite the fact that the Reserve Bank of India has issued many guidelines to address the menace of NPAs, the problem has not yet been sorted out completely. This research article discusses the problem of NPAs in the Indian banking industry and also sheds light on various measures taken by the government in this regard. The role of the judiciary has also been discussed. Moreover, the research paper also suggests various measures to tackle the problem of NPAs in Indian banking system.

Key Words: Banking Fraud, Non-Performing Assets, loan, Reserve Bank of India, judiciary.

1. Introduction

In common parlance, fraud refers to the wilful deception of information for personal gain or to cause wrongful harm to others. Fraud can involve a variety of illegal or unethical actions, such as identity theft, embezzlement, forgery, false advertising, pyramid schemes, and other forms of financial or corporate fraud. It must be noted that the entire fraud loans in India in 2020–2021 were 1.37 lakh crore, which represents almost 99 per cent of all bank fraud, which is alarming.[1] Fraud can occur in different contexts, including personal, business, banking industry, or other government transactions. It can be committed by individuals, organizations, or even by government officers. Currently, the non-performing assets (NPAs) trend in India's banking industry is on the rise, putting the sector's strength and resilience to the test.[2]

Although in India banking frauds are frequently seen as a necessary evil of doing business, with liberalisation the frequency, complexity, and cost of banking frauds have multiplied, giving authorities like the Reserve Bank of India extremely serious cause for concern. The Reserve Bank of India has defined fraud as, *"A deliberate act of omission or commission by any person, carried out in the course of a banking transaction or in the books of accounts maintained manually or under computer system in banks, resulting into wrongful gain to any person for a temporary period or otherwise, with or without any monetary loss to the bank".*[3]

Non-performing assets (hereinafter referred to as NPAs) are loans or advances that no longer generate income for the lender such as bank, typically because the borrower has defaulted or hasn't made payments for at least 90 days. Since it can adversely affect the health, wealth and economic condition of banks, the issue of NPAs has long been a serious concern for the Indian banking industry.

NPAs may occasionally be the consequence of dishonest behaviour, such as loan fraud, in which borrowers get loans by providing false information or submitting forged documentation only to default on the loans later on. The purposeful avoidance of debt repayment by borrowers even when they have the capacity to do so constitutes another type of fraud. A number of high-profile fraud cases involving NPAs have been reported in India in recent years, including the Punjab National Bank (PNB) fraud case involving the false issue of Letters of Undertaking (LoUs) to Nirav Modi and his businesses. In order to avoid NPAs and preserve the integrity of the banking system, strong regulatory control, effective risk management procedures, and prompt discovery and response to fraudulent activity are required.

2. Non-Performing Assets of Bank in India

Non-performing assets (NPAs) refer to loans or advances that have stopped generating income for banks or financial institutions. In other words, when a borrower defaults on a loan or is unable to repay it on time, the loan is generally declared as an NPA.

In India, non-performing assets in the banking sector have grown to be a significant concern as a result of a relatively frequent occurrence of large-scale credit defaults and frauds that contribute to the already enormous levels of NPAs in banks. Non-performing assets do have a direct impact on the functioning of banks or how banks operate. Even though it poses risk to the nature of the benefit and pushes banks to the brink of indebtedness, an abnormal state of NPAs puts entire functioning of banks in jeopardy and adversely affects

[1] Ashish Kajla and Anirban Bhattacharya, "India's Biggest Bank Fraud is a Telling Tale of Public Money Put in Jeopardy" *available at* https://qz.com/india/2130706/public-money-is-at-risk-behind-indias-abg-shipyard-bank-fraud

[2] Gaur, D., & Mohapatra, D. R. (2021) Non-performing Assets and Profitability: Case of Indian Banking Sector. *Vision*, *25*(2), 180–191.https://doi.org/10.1177/0972262920914106

[3] *available at* https://rbi.org.in/scripts/BS_SpeechesView.aspx?Id=826

banks' profitability, total assets, and liquidity etc.[4] Moreover, due to non-performing assets, the image of the bank goes down and the new customers are reluctant to open their account in the respective bank.

Section 2 (o)[5] of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 has defined Non-Performing Assets as "an asset or account of a borrower, which has been classified by a bank or financial institution as sub-standard, doubtful or loss asset — (i) in case such bank or financial institution is administered or regulated by any authority or body established, constituted or appointed by any law for the time being in force, in accordance with the directions or guidelines relating to assets classifications issued by such authority or body; (ii) in any other case, in accordance with the directions or guidelines relating to assets classifications issued by the Reserve Bank." This Act is aimed at regularising and reconstructing financial assets by enforcing security assets. The in-depth classification of the assets has been left to the statutory body including RBI. The RBI has, time and again, categorised bank fraud into various categories including Non-Performing Asset. NPAs are the loans advanced to the people wherein the interest remains overdue for period of ninety days. Generally, when the asset stops generating income for the bank it is referred to as NPAs. The gross non-performing assets to the total loan advanced in a financial year 2020 have been eight per cent, which is disturbing and alarming.[6]

NPAs are a concern for banks as they can affect their profitability and financial stability. When a loan becomes an NPA, it means that the borrower is not generating any income for the bank, and the bank may have to write off the loan as a loss. This can result in a decrease in the bank's capital and a reduction in its ability to lend further.

The concept of NPA is important for the banking sector as it helps to identify potential risks and take corrective measures to mitigate them. The Reserve Bank of India (RBI), the central bank of India, has set guidelines for banks and financial institutions to classify loans as NPAs based on the period of non-payment.

The banking industry's main issue is non-performing assets. These, along with a decline in profit, investable funds, and a worsening of other financial metrics, have a negative impact on the performance of banks. NPAs are one of the key factors in evaluating the performance of banks on the equity market and their overall health. The epidemic of COVID-19 has made banks' NPA positions much worse.[7]

3. Law Governing Bank Fraud and Non-Performing Assets in India

The Indian Parliament has passed several laws addressing cheating and fraud, particularly bank fraud. The Indian Penal Code, 1860[8] (hereinafter referred to as the IPC) and the Prevention of Corruption Act, 1988[9] are legal frameworks in India for addressing various aspects of banking fraud. Some aspects of bank fraud are also

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[4] Kandpal, V. (2020). Non-performing assets in India: A critical analysis of public and private sector banks. Corporate Governance and Sustainability Review, 4(1), 65-73. http://doi.org/10.22495/cgsrv4i1p6

[5] Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (Act No. 54 of 2002). Section 2. cl. o.

[6] *Available at* https://www.statista.com/statistics/1013267/non-performing-loan-ratio-scheduled-commercial-banks-india/

[7] Ram Bilas Agrawal & Dr. Mredu Goyal, Non- Performing Assets of Banks: A Literature Review, -- Palarch's Journal of Archaeology of Egypt/Egyptology 18(10), 330-340. ISSN 1567-214x

[8] The Indian Penal Code, 1860

[9] The Prevention of Corruption Act, 1988

covered by the IPC under its various sections, such as Section 403 (dishonest misappropriation of property), Section 406 (criminal breach of trust), Section 409 (criminal breach of trust by public servant or banker), Section 420 (cheating and dishonestly inducing delivery of property), and Section 467 (forgery of valuable security, will, etc.), among others.

Also, the Reserve Bank of India established under RBI Act 1934[10] is the central bank of India. To combat bank fraud and addressing the issue of Bank NPAs, and set forth procedures for its identification and reporting, the RBI has periodically issued a slew of of directives and circulars. A Central Fraud Monitoring Cell (CFMC) has also been established by the RBI to oversee and coordinate the reporting and investigation of bank frauds.

Furthermore, there are provisions pertaining to bank frauds and their investigation in both the Companies Act of 2013[11] and the Banking Regulation Act of 1949.[12] Hence, it is worth mentioning that bank frauds can have serious repercussions and can lead to jail time, fines, and other sanctions. Therefore, it is imperative that banks and other financial institutions take the necessary steps to stop and identify fraud as well as to abide by all applicable laws and regulations.

The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act of 2002[13] is another significant legislation that oversees the bank NPAs in India and deals with bank fraud. This piece of legislation gives banks the authority and power to seize and sell the assets and property of non-paying borrowers without the need for judicial involvement. Additionally, it enables banks to begin legal actions to recover unpaid debts and to enforce security interests in the event of loan defaults.

A comprehensive legal framework for the resolution of bankruptcies and the recovery of unpaid debts by financial creditors, including banks NPAs, is provided by the Insolvency and Bankruptcy Code (IBC) of 2016.[14] This code establishes a timeline for the resolution of insolvency proceedings and permits the employment of insolvency specialists to oversee the activities of a business, including a bank that is going through resolution. The SARFAESI Act, IBC, and RBI guidelines collectively offer a strong legal framework for the management of bank NPAs in India.

The Reserve Bank of India has additionally issued a notification dated July 16, 2020, in which the RBI advises Asset Reconstruction Companies registered under it to implement a free practises code that will ensure openness and fairness in their operations.[15]

The Reserve Bank of India has also issues a notification dated 16th July 2020 wherein the RBI has advised the Asset Reconstruction Companies that are registered under it, to adopt a free practices code that will ensure transparency and fairness in their operations and working system. By invoking Section 9[16] of the Securitisation

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[10] The Reserve Bank of India Act, 1934
[11] The Companies Act, 2013
[12] The Banking Regulation Act, 1949
[13] The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act of 2002
[14] The Insolvency and Bankruptcy Code (IBC) of 2016
[15] Fair Practices Code for Asset Reconstruction Companies, Reserve Bank of India Notification- RBI/2020-21/13, *available at* https://www.rbi.org.in/Scripts/NotificationUser.aspx?Id=11937&Mode=0
[16] The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act of 2002

and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, the RBI has issued these instructions since it is authorised to do so by the aforementioned laws. This provision states that the RBI may adopt rules as part of asset reconstruction procedures.

4. Judicial Framework Relating to Bank Fraud and NPAs

The constitutional courts in India have been very proactive in addressing different aspects of Bank Fraud including Bank NPAs, particularly in the recent past. Some of the landmark judgements passed by the constitutional courts in India are as follows.

In the case of *Ram Narain Popli* v. *CBI* (2003)[17] the Supreme Court was encountered with a matter related to Bank Fraud and the top court, while addressing the issue, held that a banker who dishonestly and fraudulently issues a letter of credit can also be prosecuted under the various provisions of the Indian Penal Code, 1860 including cheating and criminal breach of trust.

Again, the Supreme Court unequivocally ruled in *Central Bureau of Investigation* v. *V.C. Shukla* (1988)[18] that criminal proceedings under the relevant provisions of the Indian Penal Code, 1860 can be initiated against the bank workers if they have bad intention and work with others to perpetrate bank fraud with ulterior motive.

The top court in a landmark case in *Pradeep Kumar* v. *Postmaster General* (2016)[19] was also encountered matters pertaining to Bank Fraud. The court made an observation that even an individual employee of bank or post is capable of committing fraud or cheating on their own or in collusion with others including bank customers. And bank can be held vicariously liable for the offence committed by its employee.

The apex court in the case of *the State Bank of India (Successor to the Imperial Bank of India)* v. *Smt. Shyama Devi*[20] the court categorically said that in the event that an employer was to be held accountable for fraud the same must be committed by the employee during the course of employment.[21]

5. Causes of Non-Performing Assets

Non-Performing Assets in banking sector is not a new phenomenon. Banks have been facing the problems of NPAs for a long period of time. As regards the cases of NPAs in banks, they are diverse and can be attributed various factors including both internal and external factors. In order to address problems of NPAs effectively, it is more important to know the reasons of NPAs in Banks in India. Some of the main reasons as to why the banks are facing NPAs are as follows.

Bank clients who wilfully default: Wilful default describes debtors who have the ability to repay their loans but purposely avoid doing so. In general, there are several causes for wilful default, including theft, misappropriation of cash, or private motives.

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[17] Ram Narayan Popli v. CBI, (2003) 3 SCC 641

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[19] *Pradeep Kumar* v. *Postmaster General*, Civil Appeal No. 8775-8776 of 2016

[20] *The State Bank of India (Successor to the Imperial Bank of India)* v. *Smt. Shyama Devi* (1978) 3 SCC 399

[21] Ibid.

Recession or Economic Slowdown: Many business entities or corporate companies may experience decreased demand for their goods or services during an economic slowdown or recession, which has a negative impact on their sales and profitability. Due to this, it may be difficult for businesses to repay their debts, which may cause the number of bad loans to rise. Additionally, banks may be somewhat reluctant to extend credit during a recession, which would slow the expansion of credit.

Poor credit appraisal and monitoring by the banking Companies: Off and on, Banks authorises loans without performing the appropriate due diligence, such as conducting an insufficient credit appraisal and monitoring of borrowers. This may result in debtors being unable to pay back their debts, which would cause NPAs.

Downturns in specific industries: Downturns in specific industries such as real estate or infrastructure might cause NPAs in banks that have a lot of exposure to those industries. For instance, a fall in the real estate market or any another infrastructure related industry may result in causing banks with significant exposure to the industry to see an increase in non-performing assets.

Fraud committed by banking personnel or by insiders: Insiders or employees of banks frequently engage in fraudulent actions that might cause NPAs. An employee might, for instance, approve a loan without performing sufficient due diligence or work with the borrower to steal the loan's proceeds. In reality, this is one of the main reasons why bank fraud leads to NPAs.

External Factors: NPAs in the banking sector can also be caused by various external reasons like natural disasters, political unrest in the country, or changes in policies framed by the government. Moreover, a natural calamity like a flood or earthquake, for example, might cause a spike in NPAs because borrowers may be unable to repay their loans because of a loss of income or other assets.

Inadequate security provided by the customer to the bank: It may be difficult for banks to recover the loan amount in the event of failure due to inadequate security being supplied by the consumer to the banks. This might be the result of things like a deficiency in due diligence or pressure to increase credit.

6. Consequences of Non-Performing Assets on banking sector in India

The consequences of non-performing assets (NPAs) on banking industry in India can be severe, affecting not only the banking sector but also the entire economy of the country. Some of the consequences of NPAs are discussed as:

Banks' image gets undermined: The NPAs negatively harm the image of the banking company. Consequently, the other customers of the bank withdraw their deposits from the bank which results in issues related to finance and liquidity of the bank.

Losses for banks: When loans become NPAs, banks stop earning interest on them, which can lead to significant losses for the banks. In some cases, banks may need to write off these loans as bad debt, which can further impact their profitability and financial health.

Financial Losses to the Credit of Bank: NPAs result in reducing the bank's profitability and negatively impact the bank's financial stability. Banks have to make provisions for bad debts, which affects their earnings and capital adequacy ratios. Additionally, if the NPA levels are too high, it can lead to losses for the bank.

Capital erosion: NPAs can erode the capital base of banks and make them more vulnerable in terms of financial instability, ultimately results in bankruptcy. Moreover, NPAs can also affect the financial ability of banks to lend in the future, which can have far consequences on economy in general.

Credit crunch: When banks are burdened with NPAs, they may become cautious in lending to new borrowers, which can lead to a credit crunch in the economy. This, in turn, can impact economic growth and development.

Impact on government finances: When public sector banks also suffer losses due to NPAs, as public sector bank works under the authority of the government, the government has to provide financial and other economic support to them; hence the credit of the government is also impacted.

Regulatory Scrutiny: Regulators closely monitor banks' NPA levels to ensure that they maintain adequate provisions for bad debts. If a bank's NPA levels are too high, regulators may intervene and take corrective action, which can lead to further reputational damage and financial losses.

All in all, NPAs can have wide-ranging consequences for the banking sector, the economy, and even the government finances in India. Addressing this issue requires a concerted effort from all stakeholders, including the government, regulators, and banks themselves.

7. Conclusions and Recommendations

We can say that the banking industry is one of India's largest service industries in the present times. The bank's overall capacity to function, including profitability and lending capacity, is significantly impacted over time by the mounting NPAs. Banks will require re-capitalization, or more money invested in them, to keep them operating, as default rates rise. In addition to recapitalization, prudent credit risk management can aid banks in lowering non-performing assets (NPAs) and fostering industry expansion. Here are some ideas for resolving this problem:

Strengthen credit appraisal and risk management: To identify prospective NPAs at an early stage, banks must improve their risk management and credit appraisal processes. Before making a loan to a borrower, they must perform thorough due diligence to make sure the borrower can pay back the amount.

Improve recovery mechanisms: In order to quickly recover NPAs, banks should improve their recovery processes. This can entail renegotiating the debt, liquidating the asset, or suing the defaulter in the court of law or tribunal.

Encourage loan securitization: Banks should think about securitizing their portfolio of loans, which entails combining various loans and issuing bonds secured by these loans. This can assist banks increase liquidity and decrease their exposure to NPAs.

Strengthen governance and accountability: Banking sector need to have strong governance and, at the same time, accountability mechanisms must be in place to ensure that loans are given based on merit and not influenced by any external factors such as political or bureaucratic pressure. There must be proper application of business mind. This can help reduce the risk of NPAs due to fraudulent or corrupt practices.

Promote debt market development: The expansion of the debt market in India can assist banks in diversifying their funding sources while reducing their reliance on conventional funding techniques. This can lessen the danger of NPAs.

Enhance transparency and disclosure: Banks ought to operate in more transparent manner and publish details about their lending portfolio and the risk attached to it. Certainly, this can lower the risk of NPAs for stakeholders and investors, who can then make more informed decisions.

Hence, all stakeholders including banks, regulators, and the government must come together and they need to work together to address NPAs in the Indian banking system. The Indian banking industry can strengthen the state of the Indian economy by putting these measures into place and lowering the danger of NPAs.