Bank Fraud and Bank Failure: A Brief Study

Introduction

Banking fraud is a white-collar crime; most of the banking criminals are faceless. No personal exposure, no written documents, no signatures, no fingerprints, and not even voice of the perpetrator is in existence. Banking fraud has become a worldwide problem that is not set to abate in the near future. It is eroding the profitability of business with disturbing effects on firm solvency. Fraud prevention and detection methods used in the bank were standard and no different from global standards.

Banks and Financial Institutions can become financially distressed and fail. A bank failure occurs when a bank cannot pay its depositors in full with enough reserves left to meet its reserve requirement. In particle, regulators can close a bank when they deem its net worth too low. The higher a bank's holding of reserves, marketable securities, or equity capital, the less likely the bank is to fail.

Bank Fraud

Fraud against banks may be internal or external. They may take the form of theft or electronic transfer of funds done for personal gain by employees. Such offenses may also be committed by third parties using the bank as a vehicle for frauds, or perhaps defrauding the bank itself. Fraud is committed where one person induces another to enter into some contract or transaction on a false belief by a representation of fact which is not true and which he does not believe to be true. Frauds are committed in the banks in various departments by the employees and by the outsiders with the connivance of the bank employees.

Each bank has prescribed the systems and procedures for the handling of banking transactions, but frauds are committed due to loopholes in the system, non-compliance of the procedures, ineffective supervision and control of the working branches. It is not possible to easily identify a fraudulent person, who is more clever than the investigating authorities. Fraud is a dishonest activity leading to loss to others. Dishonesty is never accidental. Therefore, there is always a fraudster behind each bank fraud.

The offence of forgery is committed, when false documents are made with dishonest or fraudulent intention. For making a false document, it is not necessary that there must be writing or contain the signature or facsimile of any person. A document may be made false by wiping out the signatures, which gives its validity. For committing forgery the making of the documents should be with a fraudulent or dishonest intention. Indian banks will do well in learning from the mistakes and security lapses occurred in other parts of the world in centralized banking system and pro-actively implement security and control systems to prevent computer crimes.

Classification of Bank Fraud

Fraud can be committed in the banks in various departments. Bank fraud commonly emerges as a response to inadequate supervisory conditions in a bank. The most popular types fraud based on frequency numbers were cheques, cash theft, and credit card fraud/theft. Types of fraud encountered in the banking environment include internal fraud and external fraud. Fraud hugely


*Advocate
consisted of diversion and misuse of cheques, theft of cash, and card fraud by manipulating systems and through identity fraud. There are two important components in any fraud committed by an employee of a bank, himself or in collusion with a borrower. They are, first, the intention which is subjective; and secondly, the opportunity which is objective.\(^8\)

Bank fraud may involve either insiders or outsiders to a bank. The collapse of the international bank, the Bank of Credit and Commerce International (BCCI), highlighted the problem of insider fraud.\(^9\) Insider fraud underlines the point about the considerable overlap of fraud prevention and prudential supervision. Fraud by outsiders may be at the expense of the bank-cheque, credit card, and mortgage fraud are examples or may involve fraudsters using banks and the banking system to facilitate their schemes or to conceal their gains.\(^10\) Uncovering fraud, by either insiders or outsiders, is only the start of the process of seizing the proceeds and bringing the wrongdoers to book. There are no limits to the variety of frauds committed against banks. They may be committed by employees, individuals outside the organization or by experienced fraudsters outside and inside the organization.\(^11\)

Banking Offence and Punishment Act, 2064 has classified the banking crime under the fourteen heading and some are following:

- Misappropriation of cash tendered by a bank's constituents and misappropriation of cash in remittance;
- Withdrawal from deposit accounts through forged instruments;
- Fraudulent encashment of negotiable instruments by opening an account in fictitious name;
- Misappropriation through manipulation of books of accounts;
- Frauds in demand drafts-issuance and encashment;
- Misutilization/overstepping of lending/discretionary power and non-observance of prescribed norms/procedures in credit dispensation;
- Opening/issue of Letter of Credits (L.Cs) bank's guarantee, co-acceptance of bills without proper authority and consideration;
- Frauds in foreign exchange transactions through non-adherence of NRB's prescribed norms and procedures.

Nepal Rastra Bank (NRB) has not issued a separate circular regarding the fraud related issue. Whereas Reserve Bank of India (RBI) has issued a separate circular and reporting system of the fraud. RBI has considered the classification of bank frauds on the basis of the provisions of the Indian Penal Code and have classified there as under.\(^12\)

1. Cheating
2. Criminal misappropriation of property,
3. Criminal breach of trust,
4. Forgery,
5. Falsification of accounts,
6. Theft,
7. Extortion,
8. Burglary (house breaking),
9. Robbery ad dacoity,
10. Criminal conspiracy,
11. Bribery and corruption, and
12. Offence relating to currency notes and bank notes.

In order to have uniformity in reporting cases of frauds, RBI considered the nature of frauds, modus operandi and preventive steps to be taken by the banks are explained below.\(^13\) Counterfeiting of cheques, bank drafts and travellers' cheques, forging of signature on cheques/instruments.

**Bank Failure**

Bank managers, investors, policy makers, and regulators share a keen interest in knowing what causes banks to fail and in being able to predict which banks will get into difficulty. Bank managers often lose their jobs if their bank fails. Some think a failing bank should be treated the same way as a failing firm in any other industry.\(^12\)

---

8 RP Nairn, Banking System, Frauds and Legal Control, p. 56.
Others claim that failure justifies government protection of the banking system, perhaps in the form of a 100% safety net, because of its potential for devastating systemic effects on an economy\(^\text{14}\). The debate among academics is reflected in the different government policies around the world. Managers of a bank have more information about its financial health than depositors, regulators, shareholders or auditors. Regulator tries to save a problematic bank as a lender of last resort. If it is not possible then the regulator can apply to the High Court for the dissolution of such commercial bank. Regarding the problematic bank and financial institutions can take an action by the Nepal Rastra Bank with the provisions stated in the section 86, 86A, 86B of the Nepal Rastra Bank Act, 2058.

Banks are regulated for three different reasons. The first, reason involves prudential regulations of banks, second reason is dealing with their safety and soundness. The third reason concerns social goals\(^\text{15}\). There is also the concern of systemic risk. Systemic risk occurs when bank failures are potentially contagious, and only then if the losses in one bank cascade into other banks, or to other economies throughout the world. All of the world's major economies are linked together through the financial markets and other business relationships. A major shock in the US economy will have worldwide repercussions. Likewise, the East Asian financial crisis that began when Thailand devalued its currency in July 1997 had a contagion effect that spread throughout Southeast Asia, Russia and Latin America\(^\text{16}\), Japan and some European states, relatively few insolvent banks have been closed in the post-war period, because of real or imagined concerns about the systemic aspects of bank failure\(^\text{17}\).

There are three major reasons why individual banks fail. The reasons are credit risk, interest rate risk, and foreign exchange risk. Two other potential sources of failure are bank runs and fraud\(^\text{18}\). Banks runs will be explained shortly. Fraud is a legal concept, and what constitutes fraud in one country may be standard business practice in another. What was called “crony capitalism” in Indonesia (giving preferential treatment in terms of loans and grants to relatives and friends) is called fraud in the United States\(^\text{19}\).

There are three ways regulators can deal with the problem of failing bank\(^\text{20}\).

1. Put the bank in receivership and liquidate it. Insured depositors are paid off, and assets sold.

2. Merger a failing bank with a healthy bank. The healthy bank is often given incentives, the most common being allowing it to purchase the bank without bad assets. Often this involves the creation of an agency which acquires the bad assets, then attempts to sell them off.

3. Government intervention, ranging from emergence of lending assistance, guarantees for claims on bad assets or even nationalization of the bank.

Bank’s primary source of revenue is interest income from their loan portfolios, and their primary risk is credit risk. It is usually associated with loans and investments. Bankers know that lending is a risky business and that some of the loans will not be repaid. If the losses exceed the amount set aside, the excess amount of losses are deducted from bank capital. If the losses are large enough to eliminate most of the bank’s capital, the bank will fail unless additional capital is added\(^\text{21}\).

Second, some bank loans can go bad over time because of factors that are unique to a borrower, or that are beyond the borrower’s control. Changes in macroeconomic or international conditions might adversely affect a larger number

---

of borrowers, and then they default\textsuperscript{22}. Third, bank has an excess concentration of loans to a group of borrowers, and the group is not adequately diversified. In a developing country with repressed financial markets, there may not be any alternatives. Banks in repressed financial markets do not have the same opportunities to diversify their portfolios as banks in developed capital markets. Finally, the creditworthiness of the chaebols was not an issue because the government encouraged the banks to lend to them\textsuperscript{23}. Forth, the loans are not backed by collateral\textsuperscript{24}. Fifth, the loan-to-loan value ratio is 100 percent. That is, the bank lends 100 percent of the amount of the value of the underlying asset\textsuperscript{25}.

In the mid-1970s, there was a major secondary banking crisis in the United Kingdom (UK) brought about mainly by property loan. As a result, in 1979 a statute for the first time required the licensing of banks in the UK\textsuperscript{26}. The collapse of the banks was due largely to mismanagement of assets, lending to a weak loan portfolio in the case of Barings, and for Gurneys, the issue of poor quality finance bills\textsuperscript{27}. In September 1974 the Franklin National Bank failed in the United States (US), having suffered substantial losses in foreign exchange trading. A major US bank Continental Illinois failed in 1983-4 and was bailed out. This was followed by the savings and loan crisis in the US in the 1980s\textsuperscript{28}. Bank of Credit and Commerce International, a fraudulent bank with its holding company in Luxembourg and its main operations in London, failed in July 1991. The complaint was regulation had fallen between the cracks. This collapse in turn promoted the Basel Statement of Minimum Standards for Supervision of 1992 which the authorities of all G10 countries were expected to observe\textsuperscript{29}. The core was that supervision could only be achieved by the active cooperation of all countries involved. Another key issue was who was to carry the costs of lender of last resort facilities to bail out a failing bank\textsuperscript{30}. The Asian financial crises unfolded with the collapse of the Thai baht in July 1997. It spread quickly to Korea and Indonesia. The main problem was that the baht was overvalued and speculators drove it down by short-selling that is, selling currency which they did not own in the expectation that it would be cheaper to buy when the time came to deliver, thereby reaping a profit. The result was that the Thai banking system was immediately plunged into insolvency. Foreign banks panicked and began to cut their lines to Korean and Indonesian banks\textsuperscript{31}.

**Conclusion**

Bank fraud may involve either insiders or outsiders to a bank. The collapse of the international bank, the Bank of Credit and Commerce International (BCCI), highlighted the problem of insider fraud. Banks have introduced certain internal control system and procedures to prevent frauds. The frauds are detected either by the banks' auditors, controlling officers or external agencies i.e Central Bank or other regulate authorities.

Bank fraud leads to loss of money belonging either to the bank or customers. Such losses may be absorbed by the profits for the affected trading period and thus, consequently, reduces the amount of profit which would have been available for distribution to shareholders. Losses from fraud, which are absorbed by the equity capital of the bank, impair the bank's financial health and constrain its ability to extend loans and advances for profitable operations in the bank. In extreme cases, rampant and large incidences of fraud could lead to a bank's failure.

Banking system needs to be more closely regulated than other markets in the economy because of risk of market failure, which can be caused by asymmetric information and negative externalities. Bank failures are examined on a case by case basis, the objective being to identify the qualitative cause of bank failure.

\textsuperscript{22} Benton E. Gup, & James W. Kolar, Commercial Banking, The Management of Risk, 3\textsuperscript{rd} edition, 2016, Wiley, p. 32

\textsuperscript{23} Benton E. Gup, & James W. Kolar, Commercial Banking, The Management of Risk, 3\textsuperscript{rd} edition, 2016, Wiley, p. 32

\textsuperscript{24} Benton E. Gup, & James W. Kolar, Commercial Banking, The Management of Risk, 3\textsuperscript{rd} edition, 2016, Wiley, p. 32

\textsuperscript{25} Benton E. Gup, & James W. Kolar, Commercial Banking, The Management of Risk, 3\textsuperscript{rd} edition, 2016, Wiley, p. 32


\textsuperscript{27} Shelagh Heffernan, Modern Banking, 2005, John Wiley & Sons, Ltd., p. 360.


