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Aftermath of Baring Bank: Responses of the International and Indian Banking Sectors

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ABSTRACT

The Baring Bank or famously called the 'Queen's Bank' was the most prominent and distinguished investment bank in United Kingdom with over 230 years lifespan. The bank collapsed in February 1995 due to uncontrolled one-man power and infallibility of Mr. Nick Leeson, who had managed to conceal his fraudulent concealment of the significant losses. Mr. Leeson had engaged in unhedged, illicit and unauthorized derivatives trading operations between the Singaporean Stock Exchange and Osaka Future Exchange which caused colossal losses of over $ 950 million dollars within one of its subsidiary companies, Barings Future Singapore (BFS). The failure of the Baring Bank demonstrated the need for greater regulation of the derivatives, raised alarms for the faulty internal risk-management controls and trading operations within the banks and corporations in general.

The paper will discuss howthe Baring bank crumbled and factors responsible, the implications of the collapse and the response of the international banking fraternity i.e. the 'Basel Committee on Banking Supervision (BCBS)'. The paper will also elucidate the present prudential regulatory and supervisory framework formulated by the Indian regulators to deal with any mishap similar to that of the Baring bank, which may occur in the Indian banking sector. The research methodology will be doctrinal and analytical in nature as the data will be collected through secondary sources like articles, journals and other internet sources in this respect.

Keyword: Baring bank, rogue trader, illicit derivatives trading, Basel committee, Indian banking sector

I. INTRODUCTION

The banks are the backbone of the economy which performs multi-disciplinary functions of accepting the deposits and advancing loans and catering the financial requirements of the corporate entities. The need for vigilant and resilient banking sector was emphasized and stressed upon by the Union Finance Ministry in the Economic Survey 2020 which was

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presented before the Parliament in January 2020in order to make India a $5 trillion economy by supporting economic growth and not having an inimical and detrimental impact on the welfare and development.[2] The Global banking landscape is changing at an escalating speed, where the physical branch networks are reducing and there is an increment in digital transactions and payments. With the advancement of 'Information Technology', new plans and strategies have been evolved and developed by the fraudsters to take undue advantage and steal from the banks and its customers[3]. Thus, Organizations of all kinds and sizes are subject to deception. In many cases over the past few decades, large public corporations have faced financial fraud, resulting in market turmoil, loss of shareholders, and the collapse of the company itself both at national and international levels. The purpose of the Global Fraud Survey conducted by KPMG in the year 2019-2020 was to study the strategies and risk management policies adopted by various banks in order to tackle internal and external fraud threats. The survey reported that all the financial institutions recover less than 25% of total fraud losses. More than 60% banks recorded increase in the volume of fraud cases and more than 50% of the banks experienced increment in the fraud value.[4]

As per the RBI's Annual Report 2019-2020, the value of bank frauds stood at more than Rs. 1.85 lakh crores which were reported as of June 30,2020 as against the amount of Rs. 71,500 crores in the financial year 2018-19.[5] The report highlighted that the frauds were primarily occurred in the loan portfolio both in volume and value parameters.[6] According to the report, there was a growth of 234% year-on-year basis in the fraudulent cases reported in the Public sector banks and accounted for 80% of the total fraud cases reported i.e. Rs. 1.48 lakh crores whereas the Private sector banks were more vigilant in comparison and accounted for 18.4%.[7]The reasons for delayed detection of fraud cases cited in the report was due to weak implementation of the "Early Warning Signal ***(EWS)*** by banks, non-detection of EWS during the process of internal audits, on account of non-cooperation from the borrower's side during the forensic audit, underreported transactions and malpractices and indecisiveness during the Joint meetings.[8]

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[2] Economic survey 2020-21, Economics Survey, Available at: https://www.indiabudget.gov.in/economicsurvey/
[3] *The multi-faceted threat of fraud*, KPMG, (April 12, 2021, 1:03 PM), https://home.kpmg/xx/en/home/insights/2019/05/the-multi-faceted-threat-of-fraud-are-banks-up-to-the-challenge-fs.html
[4] *Id.*
[5] Advait Rao Palepu, *RBI- Annual Report 2019-20: Bank Frauds more than Double*, Bloomberg Quint, (August 25, 2020, 4:38 PM), https://www.bloombergquint.com/business/rbi-annual-report-2019-20-bank-frauds-more-than-double
[6] Id.
[7] Reserve Bank of India, Annual Report 2019-20, (August 25, 2020), https://rbidocs.rbi.org.in/rdocs/AnnualReport/PDFs/0RBIAR201920DA64F97C6E7B48848E6DEA06D531BADF.PDF
[8]*Id.*

It is pertinent to note that on a daily basis, there are revelations from organizations that conduct themselves in an unpopular manner.[9] Generally, there are three groups of entrepreneurs who use financial statements. They come from senior management (CEO and CFO); middle and lower level managers and organizational criminals.[10] CEOs and CFOs do fraudulent statistics to hide the true functioning of a business, maintain personal status and control and maintain his or her income and assets. Medium and lower level employees sleep on their job-related financial statements (small company, category or other unit) to prevent misconduct and / or receive performance-based bonuses. The organization's criminals defraud financial statements in order to obtain a loan, or to keep the promoters of a "pump and dump" system. Although many changes in auditing systems are based on financial corruption, or fraud, history and related research repeatedly show that auditing is unreliable in detecting crime at any critical level.According to the report of Association of Certified Examiners (ACFE) on ***"Report to the Nations: 2020 Global Study on Occupational Fraud and Abuse"***[11], the estimated volume of total loss suffered globally by the organizations are to the tune of 5% of revenue generated each year i.e. more than $ 4.5 Trillion dollars. It was also reported that 21% of the fraud cases are the reason for the loss of more than $ one million dollars worldwide, out of which banking and financial services accounted for more than $ 100,000 dollars median loss.[12] The senior most management or the executives of any organization were responsible for only 20% of the total occupational fraud but the loss caused was to the tune of $ 600,000 dollars.[13]

Thus, the detection of bank frauds and mitigation of the bank frauds at earlier stages are essential as with earlier signs banks can prepare themselves to mitigate the risks associated with them timely and in orderly manner. The banks are need to be resilient and vigilant by adopting stringent regulatory and supervisory framework as the adverse effect of the frauds will affect the interest margins, profitability index and may even erode the net worth of the bank leading the bank into a financial crunch and ultimately result in the bankruptcy.

As one must learn from past mistakes and experiences, the author in the paper has tried to study and examine the contagions with respect to the Barings Bank that lead to the collapse

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[9]Körnert, Jan., The Barings crises of 1890 and 1995: Causes, courses, consequences and the danger of domino effects. Vol. 13, Journal of International Financial Markets, Institutions and Money. pp 187-209, (2003), https://www.researchgate.net/publication/222953283_The_Barings_crises_of_1890_and_1995_Causes_courses_consequences_and_the_danger_of_domino_effects

[10] *Id.*

[11] "Report to the Nations: 2020 Global Study on Occupational Fraud and Abuse, Association of Certified Examiners (ACFE), (April 13, 2021, 02:36 PM), https://acfepublic.s3-us-west-2.amazonaws.com/2020-Report-to-the-Nations.pdf

[12] *Id.*

[13] *Id.*

of the bank and what all regulatory changes were introduced by the International banking organization as a response of the failure of the baring bank. The author has also focused on the present regulatory and supervisory regime of the sectorial regulators in order to tackle the situations with respect to fraudulent activities and malpractices in India. The author has also suggested certain recommendations and suggestions in order to curb the rise of fraudulent cases in India and globally too.

Review of Literature

The collapse of Baring Bank was a huge shock as a reputed bank went to bankruptcy due to the workings of one-man Mr. Nick Leeson who was the mastermind behind the misfortune of the bank who had indulged into fraudulent transactions and concealed the same from the parent branch of the bank in London. The impact and reason why the collapse had taken place has been the topic of research numerous times to avoid similar situations in future, which is why there is ample of literature available to review at hand.

The Reserve Bank of Australia (1995)[14] published a report, in which it highlighted and discussed the investigation and enquiry conducted by the Board of Banking Supervision. The report exposed the fraudulent concealment of losses for two continuous years under the nose of the Baring bank management, the financial regulators and the auditors of the bank and traced the unauthorized trading operations. The Reserve Bank in the paper concluded that the complexity with respect to the trading operations and the use of derivates was not the root cause of the collapse of the 230 years old bank but the problems was related to the inadequacy in the systems to 'measure, monitor and mitigate' the inherent risks with respect to the operational risk associated with the workings and communication levels of the management.

Sheila C. Bair (1996)[15] in her paper discussed the failure of the baring bank and its impact on the US financial market and discussed the timely responses taken by the US Government and the market regulators in this aspect. She argued that the two-fold approach adopted by the Commodities Futures Trading Commission ***(CFTC)*** i.e. a Joint meeting of the largest financial market regulators for development and adoption of bankruptcy laws and to keep in check the liquidity risks which hamper the financial integrity of the markets and assessing the current regulatory regime in the US and adopting measures to protect the funds of the

[14] Reserve Bank of Australia, Implications of the Barings Collapse for Bank Supervisor, pp 1-5, Bulletin November 1995, (April 24,2021, 06:10 PM), https://www.rba.gov.au/publications/bulletin/1995/nov/pdf/bu-1195-1.pdf
[15] Sheila C. Bair, Lessons from the Barings Collapse, Vol. 64 Issue 1 Article 1, Fordham Law Review, pg- 1-10, (1996), https://ir.lawnet.fordham.edu/flr/vol64/iss1/1

customers regardless where they are located, will increase the administrative burden on the institutions and their clients and will lead to substantial increment in the transaction costs.[16] She also pointed out that foreign exchange markets and their regulators need to pull up their socks and focus on issues like safeguarding customer's interest and progressive surveillance measures, on which their business operations are dependent.

Laura Proctor (1997)[17] examined the reasons and background for the failure of the Baring bank and role of the person responsible for the fall of the bank i.e. Mr. Nick Leeson. She raised the questions regarding the regulatory regime and the risk management mechanisms of the financial and derivatives market. She argued that the lack of internal control mechanism and no surveillance over the trading operations within banks were the determinants responsible for the disaster caused to the bank.[18]Finally, she proposed certain measures through which the disaster could have been prevented and similar one's be circumvented in the future which were steady communicated decisions regarding the reporting and utilization of the derivatives, progressive sanctions to keep a check on the internal banking controls, adoption of system revolving which acts as financial defence and changing the compensation system which enables to track and mitigate inherent risks in the derivative markets.[19]

Lynn T. Drennan (2004)[20] in his paper has demonstrated that the mishap caused to Baring bank was due to the serious problems involved in the corporate culture and managerial segment of the bank which did not prohibited but rather encouraged the unethical and unprofessional behaviour by the key managerial personnel. He pointed out that a prudent mixture of appropriate legislations, systematic risk management, ethical conduct on part of the employees and executives followed by appropriate sanctions and good corporate governance is required to prevent such failures in the future.[21]

The present paper is based on the review of the above literature along with the analysis of the legislative and regulatory measures but differs on the approach from the above literatures as it focuses on the contagions which are responsible for the collapse of the Baring bank and examines the changes in the regulatory regime from the view point of the International Banking fraternity in response to the disaster suffered by the Baring bank. The paper also

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[16] Id.

[17] Laura Proctor, *The Barings Collapse: A Regulatory Failure, or a Failure of Supervision*, Volume 22 | Issue 3 Article 6, 22 Brook. J. Int'l L., pp 735-766, (April 4, 1997),

[18] *Id.*

[19] *Id.*

[20] Lynn T. Drennan, "*Ethics, Governance and Risk Management: Lessons from Mirror Group Newspapers and Barings Bank*", Vol. 52, No. 3, Journal of Business Ethics, pp. 257-266, (Jul., 2004), https://www.jstor.org/stable/25123254

[21] *Id.*

focuses and discusses the supervisory and regulatory framework for monitoring and supervising the fraudulent transactions and mechanism of reporting of the frauds, etc. in the Indian scenario at present.

II. BACKGROUND- BARING BANK

The 'Baring' organization was a multifaceted entity comprising of huge pool of subsidiaries acting as distinct and separate entities in various jurisdictions of the world i.e. the Baring Bros.& Co. (an authorized and registered bank in London), a securities company called Baring Securities Limited (BSL), etc.[22]The Baring Bank or the 'Queen's Bank' was the oldest merchant bank in England with over 230 years of history, which was founded by Francis Baring in 1762.[23]

Mr. Nick Leeson, 28 years old, was a back-office clerk joined the Baring bank in 1989 and was transferred to the Barings Futures Singapore in 1992 for the purpose of expanding the business operations in trading transactions for the Barings PLC in Singapore.[24] He dealt in contractual transactions related to the fluctuations in the Japanese Stock Exchange i.e. he had to maximize profit by taking advantage of the low-risk form of arbitrage i.e. difference in pricing of 'Nikkei-225 future contracts listed simultaneously on the Osaka Securities Exchange in Japan and the Singapore International Monetary Exchange (SIMEX).[25] He used to sell the future contract at a lower price in one market and sell it for a higher price in another market, thus, generating profit from the pricing difference for the firm as well as for himself.[26] The earnings generated by Leeson through this low risk arbitrage was not questioned at all by Baring bank due to which Leeson was allowed to execute and settle trade transactions in the derivative market on its own i.e. was made responsible for recording and managing the transactions too.[27]

In 1994, the prominent bank faced backlash due to the unhedged and unauthorized transactions in future contracts and Japanese derivatives market, which he believed to remain in narrow trading range in the near future operating through a *'fictious account 88888'.*[28]The account was opened in 1992 as per Leeson's request and was not reported to the Baring bank

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[22] *See Supra note 17*

[23]A.S. Bhalla, Collapse of Baring bank: Case of Market Failure, Vo. 30, No. 13, Economic and Political Weekly, pp- 658-662, 659, (April 1, 1998), https://www.jstor.org/stable/4402560

[24]*Id.*

[25] *Id.*

[26] Charles A. Samuelson, *The Fall of Barings: Lessons for Legal Oversight of Derivatives Transactions in the United States*, Vol. 29 Issue 3, Article 4, Cornell International Law Journal, pp 767- 806, 771, (1996), Available at: http://scholarship.law.cornell.edu/cilj/vol29/iss3/4

[27] *Id. At pp 772-773*

[28] *Id.*

in London. This account was used by Leeson to manage all the premiums accrued through the unhedged and unauthorized dealings in the derivative markets. This trading strategy went futile after the Japan was hit by the Kobe earthquake in early 1995.[29] The earthquake had adversely affected the Japanese economy due to which 'Nikkei 225' futures contract unfortunately starting declining on both the SIMEX and the Osaka Security exchanges market, which led to huge losses to the tune of $ 950 million dollars for Leeson and the Barings in London.[30] In February 1992, the Baring bank was put under administration that is synonym for bankruptcy in Britain. It was revealed after the position of the bank on SIMEX,the Osaka Securities Exchange, the Tokyo International Financial Futures Exchange and the Tokyo Stock Exchange were liquidated, that the bank suffered from colossal loss of approximately $1.4 billion dollars.[31]The ***"rogue trader"*** was the nickname given to Mr. Nick Leeson for the fraudulent concealment of losses under the façade of the 88888 account, if the Baring bank had take precautionary measures and detected the flawed accounting books without solely relying on the verbal assurances of Leeson, the bank could have avoided the disaster and colossal losses which eventually led to its insolvency. After the bank's bankruptcy, Leeson was taken into detention and was imprisoned for six and half years in Singapore prison for his fraudulent malpractices, but was acquitted in 1999 after being diagnosed with colon cancer.[32]

In the aftermath of the collapse, all the counterparties of the Baring Group suffered from colossal losses due to the default done by the bank in the derivative markets of the Singaporean and Japanese Stock exchanges.[33] It was revealed from the investigations and enquiries conducted by the Bank of England that the financial position of the baring bank was 'idiosyncratic' which were due to the unethical behaviour of Mr. Nick Leeson and the lack of corporate governance in the bank's corporate culture.[34] The impact of the collapse was slightly felt in the Asian market due to high volatility in the Japanese Stock Exchange and in London, but there was no spill-over which caused financial instability in the other economies of the world.[35] The prominent setback was faced by the bank itself as within two weeks,

[29]*See Supra note 14 at pp 1-2*
[30] *See Supra note 17 at pp 735*
[31]*See Supra note 20 at pp 264*
[32]See Supra note 9
[33] Ian Greener, *Nick Leeson and the Collapse of Barings Bank: Socio-Technical Networks and the 'Rogue Trader'*, Vol 13(3), Organization, SAGE Publication, 421-441. https://www.researchgate.net/publication/247747438_Nick_Leeson_and_the_Collapse_of_Barings_Bank_Socio-Technical_Networks_and_the_'Rogue_Trader'
[34] *Id.*
[35] Lewis, P., 'The Collapse of Barings: The Decision; Acceptable Failure Not Seen as a Threat to Financial Systems,' The New York Times, February 28, 1995: D00008.

Dutch Internationale Nedelanden Groep (ING), a bank with a strong capital baseline of £9,100 million, agreed to acquire Baring bank for a consideration of £ one million on the condition that the ING would assume all of the liabilities of the bank by paying off all the depositors and stakeholders.[36] The Dutch bank payed back liabilities worth $1.39 billion to SIMEX, the Osaka Stock Exchange, and Japanese banks who were the creditors of the Baring bank.[37]

III. CONTAGION RESPONSIBLE FOR FAILURE OF BARINGS BANK

The banking sectors are regulated by the reserve banks i.e. Bank of England in UK and the Federal Reserve System in US. The following is a summary of various aspects of the law and how these principles affected Barings.

Assets are being transferred, it is unclear whether banks use foreign currency, or whether government oversight could prevent unauthorized transactions like Leeson. There is an requirement as per the British banking law according to which a parent company is required to notify the central bank i.e. Bank of England, whenever a transaction of more than 25% of its total capital is being done. The payment made by Leeson through the funds made available to it by the Barings bank to SIMEX and the Osaka Stock Exchange must have exceeded the statutory limit 25% of the total capital without notifying the Bank of England. Thus, violation of the regulation laws.[38] England's laws requiring the government to protect parental investment organizations did not prevent Leeson from engaging in illegal activities. With the need for reporting that will prevent the Barings from embarking on a more dangerous endeavor, it seems that the independence of the government is one of the reasons for Barings' failure. On the other hand, the increase in regulatory control will transfer the burden on corporate governance to government, which encourages the organization itself to manage corporate affairs more progressively. The Barings family had to pay a high price i.e. lost their reputed bank with over 230 years of golden history due to the lack of internal control checks and un-appropriate corporate culture within the bank. The banking law and other regulatory regime of the England were lacking as there was no concrete and deepened legislation and framework which could have identified and detected the inherent risks at an earlier stage.

Other Unrestricted Activities: The Baring bank was under the control of the Bank of England, but there was lack of regulatory measures to monitor and supervise the practices of

[36] James Chen, Barings Bank, Financial Fraud: Banking Fraud, Investopedia, (October 31, 2020), https://www.investopedia.com/terms/b/baringsbank.asp
[37]See Supra note 32
[38] John Gapper et al., Clarke Rejects Calls for Independent Inquiry-Leeson to Contest Extradition, FIN. TIMEs, Mar. 4/5, 1995, at 1.

derivative markets and trading of the derivatives, which were the proximate cause of collapse of Barings[39]. Some of the operations of the companies under Barings were under SFA control (i.e., we were not under English Bank control). In the United States, on the other hand, there are restrictions on the activities of banks and bank partners.

IV. INTERNATIONAL RESPONSES

The Barings Bank situation turned out to be a turmoil as the reasons behind the collapse were not the complexity of the futures and derivates market but the failure of the internal control of the bank's management and the illicit activities of a single-man who completely ignored the professionalism and moral ethics. The demise of a reputed and prominent bank with a traditional history of over 230 years was seem to be a shock as no one imagined that the loss in only one of its subsidies i.e. BSL would have led to the bank becoming bankrupt. Thus, thesituation called for recasting, reframing and strengthening of the international regulatory cooperation and supervisory framework.

Basel Committee on Banking Supervision (BCBS)

The Basel Committee on Banking Supervision (BCBS) or the Basel Committee was established in 1974 as a result of the financial distress caused in the international forex market and banking markets by the Governors of the Central bank of G10 nations.[40] The headquarters of the Committee is situated at the Bank for International Settlements in Basel.[41] The main purpose of the committee was for regulation and surveillance of the international banking system by enhancing and strengthening the international banking standards in order to improve the financial stability and harmonizing the banking regulations between its member countries on supervisory matters related to banking.

The Basel Committee and the technical committee of the International Organization of Securities Commissions (IOSCO) formulated a joint report on the ***"Framework for Supervisory Information About the Derivatives Activities of Banks and Securities Firms"*** in May 1995, which was further enhanced in 1998.[42] The aim of the framework was to enhance and provide a robust risk management and standardization of derivatives practices

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[39] A single, clearly stated goal is more easily monitored than many vaguely defined goals. Ct-Lu, supra note 64, § 16.2 (citing Milton Friedman, The Social Responsibility of Business Is to Increase Profits, N.Y. TIMEs, Sept. 13, 1970 (Magazine), at 33).

[40] History of Basel Committee, *The Basel Committee on Banking Supervision*, BIS, (April 16, 2021, 09:25 AM), https://www.bis.org/bcbs/history.htm

[41] *Id.*

[42] BCBS & IOSCO, FRAMEWORK FOR SUPERVISORY INFORMATION ABOUT THE DERIVATIVES ACTIVITIES OF BANKS AND SECURITIES FIRMS (Joint report issued in conjunction with the Technical Committee of IOSCO), BIS, pp 1-40, (May 1995), (April 16, 2021, 9:37 AM), https://www.bis.org/publ/bcbs19.pdf

across the globe. The joint report recommended the effective and accurate data and information collective for appropriate surveillance of the derivative activities of the banks as well as the securities firms.[43] The banks and the securities firms were advised the board and the executives to supervise and monitor the derivative transactions taking place in the organization, identification and mitigation of the inherent risks like credit risk, market risk, liquidity risk, etc. associated with it, capital adequacy requirements and financial position through regular and thorough audit checks.[44] All these monitoring and supervisory procedures must be in written form which need to be approved and changed by the senior management officials from time to time as and when required.[45]

The above two committees again jointly released a report on the ***"Public Disclosure of Trading and Derivatives Activities of Banks and Securities Firms"*** in November 1995.[46]This report was superseded by the joint report of the Transparency Group of the Basel Committee on Banking Supervision and the IOSCO Working Party of Financial Intermediaries on October 5, 1999.[47]The report emphasized and promoted the need for disclosures related to the derivatives trading activities and the sound risk management mechanism for market transparency and stability of banks and security firms at international level[48]. In compliance with the May 1995 report, the report recommended two approached for disclosure requirements- qualitative approach (disclosures regarding the accounting standards and procedures adopted for auditing, examining the trading and derivatives practices are in line with the defined objectives of the organization or not, appropriate internal control mechanism, etc.) and quantitative approach (disclosures regarding the credit risk, market risk, non-trading activities revenue or loss generation, unrealized or deferred losses if any incurred, etc.)[49]

In September 1998, the Basel Committee on Banking Supervision issued a report on ***"Enhancing Bank Transparency"***[50]which discussed and highlighted the importance of access to information in the discipling the market and vigilant banking surveillance. The report provided general supervisory directions to the banking supervisors and the market

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[43] *Id at pp 4-5*
[44] *Id.at pp 7-8*
[45] (November 1998), ***https://www.bis.org/publ/bcbs39.pdf***
[46] BCBS & IOSCO, Public Disclosure of Trading and Derivatives Activities of Banks and Securities Firms, (Joint report issued in conjunction with the Technical Committee of IOSCO), BIS, pp 1-30, (November 1995), (April 16, 2021, 10:37 AM), https://www.bis.org/publ/bcbs21.pdf
[47] Recommendations for Public Disclosure of Trading and Derivatives Activities of Banks and Securities firms, BIS, pp 1-38, 8 (October 5, 1999), https://www.bis.org/publ/bcbs60.pdf
[48]*Id.*
[49] *Id. At pp 25-30*
[50]BCBS, Report on Enhancing Banking Transparency, BIS, (September 21, 1998), https://www.bis.org/publ/bcbs41.pdf

regulators for formulating the rules and regulations for achieving public disclosure and successful reporting to the banking industry at international level.[51] The basis of the report was on the fundamental principle that markets can be disciplined if the supervisors enforce the reward for having disciplined risk management system and punishment for having imprudent risk management mechanism.[52] The report emphasized that if market participants have timely and readily access to market information through which they can become aware of a bank's activities and financial position, they can easily mitigate the risk and avoid the inherent risks. Thus, enhancing transparency through effective public disclosure is the key for a sound and resilient banking system. The recommendations of the report: a) the banking supervisors and market regulators to devise mechanisms to ensure that the disclosure standards are being complied with, b) ensuring the accuracy and expediency of the information (risk exposures, financial performance, risk mitigation devices, etc.) available, c) public disclosure of all the financial statements and data and facilitating the access for the same, etc.[53]

In July 2015, the Basel Committee issued guidelines on the ***"Corporate Governance Principles for Banks"***[54]and revised the guidelines issued in 2010 with the aim to achieve proper corporate governance structure within the banks to ensure smooth and efficient working. These guidelines provide a framework for the banks and banking supervisors to operate in such a manner as to devise a mechanism that ensures transparency and lucidity in the risk management and the decision making.[55] The appropriate internal control mechanism and sound corporate culture will boost public confidence and reliability as well as ensure a resilient and vigilant banking system. The revised guidelines promoted: a) expansion of the supervisory role of the board of directors on matters involving implementation of the robust risk mitigation strategies and policies, b) formation of three pillars of defence- business units, risk management teams and internal audit and control functions within the banks to ensure the efficient and effective risk identification, governance and mitigation, c) issuing guidelines for the selection and election of members for the board of directors and other senior most officials of the bank management, and d) adequate and appropriate compensation systems and incentive structures for the executives and bank management members, etc.[56]

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[51] *Id.*
[52] *Id.*
[53] *Id.*
[54] BCBS, *Guidelines on Corporate Governance Principles for Banks*, BIS, (July 8, 2015), https://www.bis.org/bcbs/publ/d328.pdf
[55] *Id.*
[56] *Id.*

V. PRESENT INDIAN REGULATORY & SUPERVISORY REGIME

The Reserve Bank of India (hereinafter referred to as ***'RBI'***) was constituted under Section 3 of the Reserve Bank of India Act, 1934 on April 1, 1935.[57] The RBI is the banking sector regulator in India who regulates monitors and supervises the banking activities and operations of all the banks in India.[58] It is evident from RBI's Annual Financial Report 2019-20, that the number and value of fraud cases has been doubled in comparison from 2018-19.[59] As the banking sector regulator, RBI has advised the banks that the first line of defence for prevention of frauds is the suo moto responsibility of the banks. RBI has formulated various master circulars, guidelines and master directions for the banks from time to time regarding identification and classification of fraud prone areas within the banks along with the necessary safety net procedures.

In July 2015, RBI had introduced ***"Master Circular on Frauds: Classification and Reporting"***[60], according to which frauds has been classified as per the provisions of the Indian Penal Code, 1860: Cheating and forgery, Misappropriation of funds, criminal breach of trust, manipulation of books of accounts through unauthorized transactions which are not recorded or use of fictious accounts, etc. RBI has stressed upon the circulation and reporting of the frauds occurring within the bank to it, through regular checks and internal control, in order to timely avoid the inherent risk by taking the necessary precautionary and preventive actions. To fulfill this purpose, RBI has devised a 'statutory reporting mechanism', the non-compliance of which will result in penalization of the concerned banks by virtue of Section 47(A) of the Banking Regulation Act, 1949 i.e. imposition of fine which is twice the amount of the deposits received or five lakhs rupees whichever is more.[61]This will enhance the staff accountability in case of any delay in reporting of frauds or non-reporting by the bank officials. The reporting mechanism provides for the bank need not to report banking frauds involving amounts less than Rs. One lakh to RBI individually but have to submit the quarterly report regarding the penetration and relevant information including steps taken by bank to mitigate the same and recover the loss.[62] Similarly, if the fraud involves amount more

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[57] RBI, About us, (April 18,2021, 12:35 PM), https://www.rbi.org.in/Scripts/AboutusDisplay.aspx
[58] *Id.*
[59] *See Supra note 7*
[60] RBI, Master Circular on Frauds: Classification & Reporting, RBI/2015-16/1 DCBR.CO. BPD. MCNo. 1/12.05.001/2015-16, (July 1, 2015), (April 18, 2021, 12:55 PM), https://m.rbi.org.in/Scripts/BS_ViewMasCirculardetails.aspx?id=9808#:~:text=2.5%20Cases%20of%20theft%2C%20burglary,as%20detailed%20in%20paragraph%208.&text=The%20cases%20of%20individual%20frauds,reported%20individually%20to%20the%20RBI
[61] Banking Regulation Act, 1946, (April 18, 2021, 01:13 PM), https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/BANKI15122014.pdf
[62] *See Supra note 60*

than Rs. 1 lakh but less than Rs. 25 lakhs, the case need to be reported to the Regional Office of Department of RBI within three weeks from the date of identification of fraud.[63]In case of fraud value of Rs. 25 lakhs & above, the detection of fraud has to be reported to Central Frauds Monitoring Cell, Dpt. Of Banking Supervision, RBI, Bengaluru within three weeks from date of detection.[64]

In consonance with the above Master Circular and in lieu of public interest, RBI using its power under Section 35 A of the Banking Regulation Act, 1949[65], had revised the previous guidelines by introducing the ***"Master Direction on Frauds- Classification and Reporting by Commercial banks and select FIs"*** on July 03, 2017.[66]The consolidated master direction provided for the establishment of a Central Fraud Registry ***(CFR),*** a web- based database based on the Fraud Monitoring Returns, which will held the banks and the banking supervisors in the early detection of the frauds and the extent of the penetration of the frauds in the system, take preventions actions for credit risk governance, reporting and mitigation of the inherent risk exposure.[67] The banks can access the CFR easily and readily through the username and passwords circulated by the RBI in the banking sector. The banks are now required to furnish reports for the fraud value of Rs. 50 million and above to the head office of the bank along with the RBI, headquarter at Mumbai.[68] This report is called the 'Flash report' and must include the nature of fraud, the name of the perpetrator, modus operandi, value of fraud or amount involved, whether complaint has been lodged with CBI/police or not.[69]The directions also provide for the constitution of an Audit Committee of Board (ACB) for generic monitoring of fraud cases along with Special Committee of Board (SCBF) for the purpose of monitoring and following up the fraud cases in the banking system.[70] This special committee will monitor the fraud with value of Rs. 10 million and above exclusively.[71] The following functions will be discharged by the special committee in regard to all frauds of value exceeding Rs. 10 million: a) identification of the systematic loopholes which escalated the penetration of frauds into the system and to put appropriate safeguards against it, b) delayed detection of frauds and their reporting to be done by the committee to RBI and senior

[63] *Id.*
[64] *Id.*
[65]*See Supra note 62.*
[66] RBI, Master Direction on Frauds- Classification and Reporting by commercial banks and select FIs, RBI/DBS/2016-17/28 DBS.CO.CFMC.BC.No.1/23.04.001/2016-17, (July 03, 2017), (April 18, 2021, 1:38 PM), https://m.rbi.org.in//Scripts/BS_ViewMasDirections.aspx?id=10477
[67]*Id.*
[68] *Id.*
[69] *Id.*
[70] https://rbidocs.rbi.org.in/rdocs/notification/PDFs/MD7493544C24B5FC47D0AB12798C61CDB56F.PDF
[71] *Id.*

level management of the bank, c) ensure corporate governance and internal control mechanism are functioning properly, d) reviewing the risk management process and policies which are in compliance with RBI's guidelines and regulatory framework.[72]These guidelines also provide for reporting of the frauds to the Central Bureau of Investigation, Police and the Enforcement Directorate or the Economic offences wing when the value of frauds exceed Rs. 30 million and above.

VI. SUGGESTIONS & RECOMMENDATIONS

1. **Independent specialized officers**: The government should maintain a cadre of officers who are specialized in the fields of law and can timely detect frauds and can carry out investigations speedily. These officers can be recruited through all India services.

2. **Assessment cells within banks**: Banks should have assessment cells or an internal agency which can evaluate the credit worthiness of not only the company/firm to whom they are lending but also the project or business model for which loan is been taken. In order to do this internal evaluation banks should employ 2-3 auditors who can give a correct judgement regarding the credit worthiness of the company as well as the business plan.

3. **Use of latest Technology**: Technology used by the banks for the collection of information of the customers is archaic and needs to be updated. But due to expensive software many banks are unable to employ the advance methods of compilation of data. The Institute for development and research in banking technology should provide banks with relevant software at affordable prices so that they can easily implement the framework suggested by the RBI such as red flagged account (RFA) and early warning signals (EWS).

4. **Strong punitive measures for third parties**: Third parties such as Chartered Accountants, Advocates, and Auditors etc. play an important role in the evaluation of the accounts and business plans of organizations/businesses; therefore, effective monitoring should be made and strong punitive measures should be taken if found to be a part of such fraud. Such measures will also deter third parties in the future from helping companies defraud the banks.

5. **Financial Literacy**: Many a times the employee of the bank does not have a basic understanding regarding the meaning of fraud or what it entails. Therefore, learning lessons should be held for the employees and any latest developments in the field should be made known to them.

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[72] *Id.*

6. **Know our markets**: The banks should have a dedicated cell which can not only evaluate the businesses/ company but also the market in which their products are sold or marketed. As change in the macro economic situation can lead to losses of the company which can in turn motivate the company or business to defraud the banks.

7. **Transparent hiring and adequate incentives**: Top management of the banks need to set ground rules and policies for ethical practices and standard procedures and should have a zero-tolerance policy for negligence and fraudulent practices. Hiring at top management level should be made with transparency, with preference for minimum-3-yearservice and an accountability clause. Also, proper incentives should be given to the employees in regards to long term and short-term targets so that they can stay motivated.

VII. Conclusion

The bank operates on the traditional and conventional activities of mobilization of deposits and advancement of loans, but if a fraud penetrates within the bank, the bank sustains not only colossal losses but also it erodes the net worth and credibility of the bank. The Barings bank disaster was a series of uncontrolled power and infallibility of a rogue trader, who concealed and manipulated the accounts book of a 230 years old bank with great reputation in UK, which ultimately lead to colossal losses of approximately $ 950 million dollars in February 1995. Though the collapse of the bank had no spill over to the economy and no strong tremors were felt worldwide, the unique thing about the bank was that its bankruptcy was resulted due to the loss incurred by one of its subsidiaries i.e. BLS, Singapore. This Barings case called for reframing and renewing of the regulations and legislation related to the trading of derivatives in the market and the lack of corporate governance and inter-industry communication within the banks as well as the securities firms. On these problems, the international banking fraternity i.e. BCBS & IOSCO formulated and revised various guidelines in order to prevent similar happenings in the banking system and the international market in the future. The guidelines primarily focused on the public disclosure and reporting mechanism along with devising risk management and mitigation policies and strategies.

Similarly, RBI had introduced various master circulars, directions and guidelines in order to help the bank identify the fraud prone areas at an earlier stage through the Red Flags account and the Early Warning Signals (EWS), despite these there has been an alarming increase in the bank frauds in India and incurred huge losses for the entire banking sector. The regulatory and supervisory framework cannot stop the occurrence of frauds but they do help in lowering the risk and mitigating the same if detected and reported early. Thus, the financial literacy and stringent regulatory reporting mechanism along with infusion of Ais in the banking system can easily detect the abnormal transaction, frauds, manipulation and underreporting of the internal and external audits of the banks.

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