KPMG

First Notes

RBI releases revised fraud risk management directions for Regulated Entities

30 July 2024

First Notes on

Financial reporting

Corporate law updates

Regulatory and other information

Disclosures

Sector

All

Banking and insurance

Information, communication, entertainment

Consumer and industrial markets

Infrastructure and government

Relevant to

All

Audit committee

CFO

Others

Transition

Immediately

Within the next three months

Post three months but within six months

Post six months

Forthcoming requirement

Background

With an aim to enhance fraud risk management systems and framework in Regulated Entities (REs), on 15 July 2024, the Reserve Bank of India (RBI) has issued the following revised Master Directions on Fraud Risk Management in the REs:

- Master Directions on Fraud Risk Management in Commercial Banks (including Regional Rural Banks) and All India Financial Institutions (revised MD-Banks)
- Master Directions on Fraud Risk Management in Urban Cooperative Banks (UCBs) / State Cooperative Banks (StCBs) / Central Cooperative Banks (CCBs) (revised MD- co-operative banks)
- Master Directions on Fraud Risk Management in Non-Banking Financial Companies (NBFCs) (including Housing Finance Companies (HFCs)) (revised MD-NBFC)

The revised MD-Banks and revised MD-NBFCs (these are together referred to as the revised MD) are principle-based and strengthen the role of the board of directors in the overall governance and oversight of fraud risk management in REs. The revised MD provide a framework for prevention, early detection and timely reporting of incidents of fraud to Law Enforcement Agencies (LEAs), Reserve Bank of India (RBI), National Housing Board (NHB) and National Bank for Agriculture and Rural Development (NABARD), wherever applicable.

This issue of First Notes aims to provide an overview of the revised MD and their key changes as compared with the erstwhile master directions which they have superseded. The revised MD are silent on the effective date and hence may be applicable with immediate effect. However, the Early Warning Systems of banks and NBFCs (including HFCs) (together referred to as REs) need to be set up or upgraded within six months from the date of this circular.

Overview of the revised MD and their changes

We have broadly brought out the new regulations and the changes in the same as compared to the erstwhile regulations. These changes are marked with appropriate symbols, which are defined below:

▲ Change in regulatory requirements

■ No change/not applicable

Overview of the revised MD and their changes

1. Applicability and purpose

Banks	NBFCs (including HFCs)
1A Applicability	
The applicability of the revised MD-Banks has been extended to all banking companies and All India Financial Institutions (AIFI) (collectively referred to as 'banks' in this document). Therefore, this is applicable to all foreign banks, local area banks, small finance banks, payments bank, corresponding new banks, Regional Rural Banks (RRBs), etc. In AIFI, this includes Export-Import Bank of India, NABARD, National Bank for Financing Infrastructure and Development, NHB and Small Industries Development Bank of India.	The revised MD-NBFCs is applicable to NBFCs (including HFCs) in the Upper Layer, Middle Layer and in the Base Layer (with asset size of INR 500 crore and above).
The erstwhile master directions did not apply to certain financial institutions such as RRBs.	Applicability has been extended from deposit taking and systemically important NBFCs and all HFCs having asset size of INR500 crore and above.

Banks, NBFCs (including HFCs)

1B Purpose

The revised MD provide a framework to REs for prevention, early detection and timely reporting of incidents to RBI, LEA, NHB and NABARD (in case of RRBs).

Bank, NBFCs (including HFCs)

The revised MD are drafted with an approach which includes 'prevention' in addition to detection and reporting. The erstwhile directions focussed on detection and reporting of frauds and taking timely consequent actions.

2. Governance

Banks, NBFCs (including HFCs)

2.1 Organisational structure

REs should set-up an appropriate organisational structure for institutionalisation of fraud risk management within their overall risk management functions/department.

Banks	NBFCs (including HFCs)
RBI requires banks to follow a more structured approach to govern the fraud risk management, as compared to the erstwhile requirement, where responsibility for fraud risk management was assigned towards a bank's CEO, Audit Committee and the Special Committee of the Board.	RBI has imposed governance requirements on NBFCs (including HFCs) for the first time.

2.2 Board approved policy

REs should have a Board approved policy on fraud risk management which should ensure compliance with the principles of natural justice in a time bound manner and require a periodic review of the principles.

The Fraud Risk Management Policy should be reviewed by the board of directors at least once in three years, or more frequently.

The revised MD-banks and revised MD-NBFCs have stipulated the time period within which the following activities should be undertaken to uphold the principles of natural justice:

a. Issuance of Show Cause Notice ('SCN')

b. Reasonable time of at least 21 days to revert to SCN

c. Process for issuance and examination of SCNs

d. Orders to be issued against SCNs with details on conclusion about fraud and its classification.

Overview of the revised MD and their changes

2.2 Board approved policy (cont.)

Banks	NBFCs (including HFCs)
RBI has prescribed detailed guidelines of what may be included in a Board approved policy[1], which was not there in the erstwhile directions. The revised MD require the fraud risk management policy to be reviewed by the Board at least once in three years, while the erstwhile MD were silent on this aspect.	Requirement to have a Board approved policy on fraud risk management and its periodical review is a new requirement for NBFCs (including HFCs). The RBI has also prescribed features to be included in the Board approved policy and timelines for review of such policies.

2.3 Special committee

Banks, NBFCs (including HFCs)

REs are required to constitute a committee of three members to be known as 'Special Committee of the Board for Monitoring and Follow-up of cases of Frauds' (SCBMF). This committee should be chaired by an independent director. The composition and function of this committee is given in Annexure 1 to this First Note.

Banks	NBFCs (including HFCs)
RBI has shifted the responsibility to oversee frauds from Audit Committee to SCBMF. Additionally, entire pool of frauds is within the purview of the SCBMF, independent of the amount, unlike the erstwhile requirement, where frauds of more than INR1 crore were required to be reviewed.	This is a new requirement for NBFCs (including HFCs).

2.4 Role of senior management

Banks, NBFCs (including HFCs)

Senior management would be responsible for:

- Implementation of the fraud risk management policy
- Placing periodic review of incidents of fraud before the board of directors/ audit committee.

This is a clarification provided to the REs with regard to the role of senior management in fraud risk management

2.5 Whistle blower policy

Banks, NBFCs (including HFCs)

A transparent mechanism should be developed to ensure that whistle blower complaints on possible fraud cases/suspicious activities in borrower accounts(s) are examined and concluded appropriately under the whistle blower policy.

Banks	NBFCs (including HFCs)
Erstwhile directions directed banks to establish policies which encouraged employees to report fraudulent activity. The revised MD-banks now prescribes detailed guidelines on the manner in which any whistle blower complaint should be dealt with.	This is a new requirement for NBFCs (including HFCs) to develop a whistle blower mechanism.

2.6 Reporting in financial statements

Banks	NBFCs (including HFCs)
There is no specific regulation in the revised MD-banks that requires banks to disclose 'the amount related to fraud reported in the company for the year' in the notes to accounts. However, banks should continue to provide disclosure on frauds as required in "Master Direction on Financial Statements - Presentation and Disclosures"	NBFCs (including HFCs) should disclose the amount related to fraud reported in the company for the year in the notes to the financial statements.
	This is a new disclosure requirement for NBFCs (including HFCs).

[1] The policy should inter alia contain measures towards prevention, early detection, investigation, staff accountability, monitoring, recovery and reporting of frauds.

Overview of the revised MD and their changes

3. Early detection of frauds

Banks	NBFCs (including HFCs)
3.1 Framework for Early Warning Signal (EWS) and Red Flagging of Accounts (RFA)	
Banks need to develop a framework for EWS and RFA (EWS-RFA framework) under the overall fraud risk management policy.	NBFCs (including HFCs) in the Middle Layer and Upper Layer (ML and UL) need to develop a framework for EWS (EWS framework) under the overall fraud risk management policy.
For banks, the EWS and RFA requirements are now under the overall fraud risk management policy.	For HFCs, EWS requirements have been enhanced and are elaborated more comprehensively. For NBFCs, these are new requirements.
The EWS-RFA framework should at the minimum provide for certain matters, such as integration of the EWS with Core Banking Solution (CBS), etc. These requirements have been prescribed in Annexure 2 to this First Notes.	The EWS framework should at the minimum provide for certain matters, such as integration of the EWS with Core Banking Solution (CBS), etc. These requirements have been prescribed in Annexure 2 to this First Notes.
A comprehensive framework should be developed for both credit facilities (loans) and non-credit facilities (other banking transactions).	A comprehensive framework should be developed for both credit facilities (loans) and non-credit facilities (other banking transactions).
The revised MD-banks has brought non-credit related transactions in addition to credit related transactions under the ambit of EWS mechanism. Appropriate parameter settings and periodic testing of operational effectiveness of the EWS system has also been prescribed.	This is a new requirement for NBFCs (including HFCs).
A data analytics and market intelligence unit would need to be established to facilitate appropriate parameter settings and periodic testing of operational effectiveness, collection and processing of information to enable an early detection and prevention of potentially fraudulent activities.	A dedicated MIS unit or other analytics set up would need to be established to facilitate the collection and processing of information to enable an early detection and prevention of potentially fraudulent activities.
The revised MD-banks require setting up of a new 'unit', which will be equipped with the functionality to identify unusual pattern and activities in accounts.	This is a new requirement for NBFCs (including HFCs).
The EWS indicators for both, credit and non-credit facilities should be approved by the Risk Management Committee of the Board (RMCB).	The EWS indicators for both, credit and non-credit facilities should be approved by the Board Level Committee (BLC).
The erstwhile directions provided an illustrative list of EWS that could be adopted by banks. However, it was silent on the approval process for these indicators.	This is a new requirement for NBFCs (including HFCs).
A Turnaround Time (TAT) for examination of EWS alerts or triggers should be prescribed by the board of directors. The revised MD require the TAT should not exceed 30 days.	The revised MD-NBFCs do not prescribe a TAT for NBFCs (ML and UL).
This is a new requirement.	
Banks are required to put in place or upgrade their existing EWS systems within six months from the date of issuance of the revised MD.	NBFC (ML and UL) are required to put in place or upgrade their existing EWS systems within six months from the date of issuance of the revised MD.
3.2 Role of Risk Management Committee of the Board (RMCB)/Board Level Committee (BLC)	
The senior management would be responsible for the implementation of the framework. The RMCB should validate and oversee the effectiveness of the EWS-RFA framework. It would also review at periodic intervals the EWS indicators, status of red flagged accounts, EWS alerts/triggers, remedial actions taken by the bank, etc.	The BLC should validate and oversee the effectiveness of the EWS framework. The senior management would be responsible for the implementation of the framework.

Overview of the revised MD and their changes

4A. Red flagged accounts/Indicators of fraud

Banks	NBFCs (including HFCs)
4A.1 Classification of accounts as RFA	
The generation of EWS alerts/triggers would necessitate the examination of whether the account needs to be red flagged (in case of banks) and consequently, investigated for a potential fraud. The decision to classify any account as a red flag would be at the individual bank level.	NBFCs are not required to classify accounts as RFA, instead they have to remain alert on activities which could potentially turn out to be fraudulent.
4A.2 External or internal audit	
Once a bank classifies an account as an RFA, it should further investigate into that account with the help of an external auditor or an internal auditor, as prescribed in the fraud risk management policy of the bank. For this purpose: • A policy on engagement of external auditors would need to be developed[2] • Loan agreements with borrowers would need to include a clause on the conduct of an audit at the behest of the lenders.	Where there is a suspicion of a fraud or any wrong doing, the NBFC (including HFC) should further investigate into that account with the help of an external auditor or an internal auditor, as prescribed in the fraud risk management policy of the NBFC (including HFC). For this purpose: • A policy on engagement of external auditors would need to be developed[2] • Loan agreements with borrowers would need to include a clause on the conduct of an audit at the behest of the lenders.
An external/internal audit of the borrower at the behest of the lender has now been made compulsory, earlier it was optional.	This is a new requirement for NBFCs (including HFCs).
4A.3 Reporting to the Central Repository of Information on Large Credits (CRILC)	
Once an account that meets the CRILC reporting threshold (i.e. an exposure of INR3 crore) has been red flagged, it would be reported to RBI's CRILC platform within **seven days** of being red flagged.	This requirement is not applicable to NBFCs (including HFCs).
• Aggregate fund-based and non-fund-based exposure for CRILC reporting has been amended from INR 50 crore to INR 3 crore for reporting red-flagged accounts / frauds. • TAT of seven days for CRILC reporting of eligible RFA accounts has been introduced.	
4A.4 Classification of a borrower as fraud account	
• Banks to complete the process of either classifying an account as a fraud account or removing the status of RFA within 180 days of reporting such account as an RFA on the CRILC platform. • Principles of natural justice should be strictly adhered to before declaring/classifying a borrower account as a fraud account . • Cases that remain in the red-flag status beyond 180 days would be reported to SCBMF and be subject to supervisory review by RBI.	While NBFCs (including HFCs) have not been provided a TAT of 180 days, they would need to ensure that the principles of natural justice are adhered to before classifying an account as a fraud account.
As per the erstwhile master directions, in case of banks as sole lenders, earlier the Fraud Monitoring Group (FMG) had to stipulate the nature and level of investigations and remedial measures in case of borrowers tagged as fraud accounts. Further, in case of consortium lending, the matter was discussed in a Joint Lending Forum (JLF).	The erstwhile master directions did not prescribe this process for NBFCs (including HFCs).

[2] Such a policy would cover aspects such as due diligence, competency and track record of the auditors, among others.

Overview of the revised MD and their changes

4A. Red flagged accounts/Indicators of fraud (cont.)

Banks	NBFCs (including HFCs)
4A.5 Where LEA suo moto initiates investigation	
In this case, banks would immediately red-flag the account and identify whether the account needs to classified as a fraud account. For banks, this process should be completed within the stipulated 180 days timeframe.	In this case, NBFCs would follow the process to identify whether the account needs to classified as a fraud account.
This is a new clarification provided by RBI.	This is a new clarification provided by RBI.

4B Fraud accounts

Banks, NBFCs (including HFCs)

4B.1 Reporting of group companies

Once a borrower account has been identified as a fraud account by any RE, the borrowal accounts of other group companies, in which one or more promoter(s)/whole-time director(s) are common, would also be subjected to examination by the REs concerned from a fraud review perspective.

This is a new requirement under the revised MD, for banks and NBFCs (including HFCs).

4B.2 Third party service providers - change in agreement

Agreements with third-party service providers may include a clause, holding them accountable where their willful negligence/malpractice caused a fraud.

4B.3 Third party service providers - reporting to Indian Banking Association (IBA)

Banks	NBFCs (including HFCs)
Banks would need to report details of those third-party service providers that were involved in frauds to the IBA, which in turn would issue a caution list amongst banks.	This requirement is not applicable to NBFCs (including HFCs).
Earlier, reporting to the IBA was optional - this has now become mandatory.	

4B.4 Staff accountability

Banks	NBFCs (including HFCs)
For all fraud cases, examination of staff accountability should be completed in a time bound manner in accordance with the REs internal policy. There has been an amendment in the level of examination - this is given in Annexure 3 to the First Notes.	
Banks Timeline for completion of staff accountability 'within six months' has been omitted discretion has been given to define this period. Accordingly, banks would need to develop/update the staff accountability policy.	NBFCs (including HFCs) Timeline for completion of staff accountability would need to be set up by the NBFCs (including HFCs). Accordingly, such timeline would need to be developed in the staff accountability policy.

4B.5 Penal provision

Banks, NBFCs (including HFCs)

- Borrowers tagged as fraud accounts and their associates should be debarred from raising of funds or seeking additional credit facilities
- Debarment for five years from date of full repayment of the defrauded amount/settlement.
- Post cooling off period, lending to such persons is at the sole discretion of the banks/NBFC.

Banks	NBFCs (including HFCs)
There is no significant change in comparison with the erstwhile requirements in this regard for banks.	This is a new requirement for NBFCs (including HFCs).

Overview of the revised MD and their changes

4B Fraud accounts (cont.)

4B.6 Accounts under resolution

Banks, NBFCs (including HFCs)

- Borrowers tagged as fraud accounts may undergo a resolution either under the Insolvency and Bankruptcy Code (IBC) or under an RBI resolution framework, which could result in a change in the management and control of the business.
- Such borrowers should be examined by the REs to determine whether they should continue to be classified as 'fraud accounts'.
- The penal measures would not apply to such borrowers after implementation of the resolution plan
- However, criminal proceedings and penal measures would continue against the erstwhile promoters/directors, etc.

This is a new requirement for both banks and NBFCs (including HFCs).

5. Reporting of frauds to Law Enforcement Agencies (LEA)

Banks	NBFCs (including HFCs)
Banks should immediately report the incidents of fraud to LEAs, subject to applicable laws, as indicated in Annexure 4 of this First Notes.	NBFCs (including HFCs) should immediately report the incidents of fraud to applicable LEAs viz State police., subject to applicable laws.
The revised MD-banks has provided relaxation in limits for reporting to LEAs.	NBFCs are required to report all frauds to LEAs.

6. Reporting of frauds to regulators

Banks, NBFCs (including HFCs)

6.1 Reporting of incidents of fraud to RBI

While reporting of incidents of fraud to RBI, banks and NBFCs need to select the appropriate 'category' within which a fraud would fit. The list of categories have been given in Annexure 5 of this First Notes. This requirement is not applicable to HFCs. HFCs should report incidents of fraud to NHB in the manner and in returns/formats as prescribed by NHB.

The number of 'categories' within which a fraud should be reported has increased as compared to the erstwhile directions.

6.2 Central Fraud Registry (CFR)

Banks	NBFCs (including HFCs)
• Banks need to set-up systems and procedures to ensure that the information available in Central Fraud Registry (CFR) is used for credit risk and fraud risk management effectively. • Banks to report payment system related disputed/ suspected or attempted fraudulent transactions to Central Payments Fraud Information Registry (CPFIR), maintained by RBI.	No such requirement prescribed for NBFCs (including HFCs)
The requirement to report payment system related disputed / suspected or attempted fraudulent transactions to CPFIR is a new requirement.	

6.3 Modalities of reporting incidents of fraud to RBI

- Fraud Monitoring Return (FMR) to be furnished for each fraud within 14 days from the date of classification. (Time limit for furnishing FMR has been reduced to 14 days. Earlier banks had report within three weeks and NBFCs (including HFCs within 21 days.
- Incidents of fraud at overseas branches of Indian banks should also be reported to the concerned overseas LEAs as per regulations of the host countries. (Earlier the frauds were to be reported only to RBI)
- Incidents of fraud perpetrated in Group entities of REs to be reported to RBI if such entities are not regulated / supervised by any financial sector regulatory / supervisory authority. (Widened the scope of reporting by replacing the term 'subsidiaries and affiliates / joint ventures' with 'group entities').

Overview of the revised MD and their changes

6. Reporting of frauds to regulators (cont.)

6.3 Modalities of reporting incidents of fraud to RBI (cont.)

- In case of overseas banking group entity of Indian banks, the parent bank should also report incidents of fraud to RBI. (This is a newly added section in the revised MD)
- Banks may, under exceptional circumstances, withdraw FMR / remove name(s) of perpetrator(s) from FMR with due justification and with appropriate approval. (This is a newly added section in the directions)

6.4 Closure of fraud cases reported to RBI

- Fraud cases to be closed using 'Closure Module' once cases pending with LEAs / Court are disposed-off and examination of staff accountability has been completed.
- Fraud cases involving amount up to INR1 crore may be closed, for limited statistical/reporting purposes in specific circumstances.
- Details of all closure cases of reported frauds should be maintained for examination by auditors.

Banks	NBFCs (including HFCs)
The conditions of write off, recovery, insurance claims, and review of systems and procedures have been removed. The limits for closure of fraud for statistical /reporting purpose has been revised from INR25 lakh to INR1 crore. Revised MD requires an incremental condition of completing staff accountability and imposing disciplinary action on the staff before closure.	This is a new requirement prescribed for NBFCs (including HFCs)

7. Cheque related frauds - Reporting to LEAs and RBI/NABARD

Banks	NBFCs (including HFCs)
• Reporting of frauds involving forged instruments would be the responsibility of the paying bank rather than the bank presenting the instruments. • The presenting bank which is defrauded would file the fraud report with the RBI and LEAs under the following cases: - Presentment of an instrument is genuine but payment has not been made to the true owner; or - Amount has been credited before realisation and subsequently the instrument is found to be fake / forged and returned by the paying bank.	Not applicable to NBFCs (including HFCs)
The word 'collecting bank' has been replaced by 'presenting bank' for clarification. Reporting authority has been changed from 'police' to 'LEA' The erstwhile directions required paying banker to file a police complaint and not the collecting banker. This requirement is omitted in the revised MD- banks.	

8. Other key matters

Banks, NBFCs (including HFCs)

8.1 Legal audit of title documents in respect of large value loan accounts

- The title deeds and other related title documents in respect of the credit facilities of INR5 crore and above should be subject to periodic legal audit and re-verification (similar to erstwhile requirement)
- Scope and periodicity of legal audit would be in accordance with the Board approved policy.
- For NBFCs (including HFCs), Small Finance Banks, Local Area Banks and Regional Rural Banks, the threshold amount for periodic legal audit of title deeds and other related title documents would be INR1 crore.

Banks	NBFCs (including HFCs)
The threshold limit for legal audits has been reduced to INR 1 crore for Small Finance Banks, Local Area Banks, and Regional Rural Banks. The requirement to furnish a review note to Board / audit committee at quarterly intervals has been omitted in the revised MD-banks.	This is a new requirement for NBFCs (including HFCs).

Overview of the revised MD and their changes

8. Other key matters (cont.)

Banks, NBFCs (including HFCs)

8.2 Treatment of accounts classified as fraud and sold to other lenders/Asset Reconstruction Companies (ARCs)

Before transferring of a loan account/credit facility to other lenders/ARCs, REs need to:

- Complete the investigation of that account from a fraud perspective
- Where a fraud has perpetrated, reporting should be done to RBI/NABARD/NHB before loan is sold to other lenders/ ARCs.

The erstwhile directions mentioned that banks should ascertain that the pool of assets being sold does not contain any loan originated fraudulently or has been classified as fraud as on the date of sale. However, the revised MD require banks and NBFCs (including HFCs) to complete the fraud investigation on each loan being transferred and report it to RBI if the borrower account is concluded to be a fraud account.

8.3 Role of auditor

- Where transactions or documents point to the possibility of fraudulent transactions, auditor should immediately bring it to the notice of the senior management and audit committee (where necessary).
- Internal audit should cover controls and processes involved in prevention, detection, classification, monitoring, reporting, closure and withdrawal of fraud cases, and also weaknesses observed in the critical processes in the fraud risk management framework of the bank and NBFCs (including HFCs).

The new directions have defined the role of internal audit in fraud risk management framework of Banks and NBFCs (including HFCs).

While the scope of statutory auditors of banks remains similar, the scope of statutory auditors of NBFCs (including HFCs) has increased.

8.4 'Date of Occurrence', 'Date of Detection' and 'Date of Classification' of Fraud

RBI has now prescribed definitions of the following terms being used in FMR:

- The **'date of occurrence'** is the date when the actual misappropriation of funds has started taking place, or the event occurred, as evidenced/reported in the audit or other findings.
- The **'date of detection'** to be reported in FMR is the actual date when the fraud came to light in the concerned branch/audit/department, as the case may be, and not the date of approval by the competent authority of the bank.
- The **'date of classification'** is the date when due approval from the competent authority has been obtained for such classification, and the reasoned order is passed.

'Date of Occurrence' and 'Date of Detection' was explained in FMR. It has now been defined in the revised fraud risk management framework by RBI.

8.5 Reporting cases of theft, burglary, dacoity and robbery

- Instances of theft, burglary, dacoity and robbery (including attempted cases) should be reported to the Fraud Monitoring Group (FMG), Department of Supervision, Central Office and RBI immediately (not later than **seven days**) from their occurrence.
- A quarterly Return (RBR) on theft, burglary, dacoity and robbery should be submitted to RBI using online portal, covering all such cases during the quarter. This should be submitted within 15 days from the end of the quarter to which it relates.
- HFCs should report such incidents to NHB in the manner and in the returns/formats as prescribed by NHB.

A timeline of seven days has been defined in the revised MD-banks for reporting of instances of theft, burglary, dacoity and robbery. Earlier, this was to be reported immediately. Reporting parties/authorities have changed from 'Central Fraud Monitoring Cell, Senior Supervisory Manager of Bank, responsible officer of DBS, The Security Adviser and Ministry of Finance' to 'Fraud Monitoring Group (FMG), Department of Supervision, Central Office, Reserve Bank of India'.	This is a new requirement for NBFCs.

Our comments

The revised MDs issued by the RBI aim to bolster the fraud risk management policies and framework of the REs. Some of the key considerations for REs are given below:

- **Revisiting the fraud risk management policies:** There is an enhancement and specificity in the applicability of directions emphasising on prevention, along with structured governance mechanism for institutionalising fraud risk management. The holistic and focussed guidance is a clear indicator of regulatory expectations on fraud risk as a key risk type to be assessed on a continuous basis.

  As the revised MD has a number of updates and amendments, REs would need to revisit their existing policies and make changes. Some of the amendments include:

  - Setting up an appropriate fraud risk management structure
  - Defining roles and responsibility of the board of directors and senior management
  - Establishing a transparent mechanism to ensure whistle blower complaints are examined and concluded
  - Developing additional policies and frameworks, such as the framework for EWS and RFA, a policy on appointment of external auditor for investigation of accounts classified as RFA, etc.

- **Principles of natural justice:** With the revised MD, before the borrower is tagged as a fraud account, they are provided with an opportunity of being heard (by replying to the show cause notice issued by the REs). Further, the documentation of REs for tagging accounts as fraud accounts should include detailed reasons for tagging the accounts as fraud and also include the borrower's submission with their due justification. This drives the adoption of the principles of natural justice while declaring and classifying the account as fraud by the REs. These principles were adjudged by the Supreme Court in 2023.

  It is to be noted that apart from the borrowing entity, a show cause notice could also be issued to third party service providers and professionals (like chartered accountants, architects, valuers, etc.) with regard to services provided by them. Accordingly, fraud investigation could extend to parties other than the entity itself. A show cause notice could be issued to the executives and whole-time directors of the entity. The revised MD excludes independent directors from fraud investigation, as non-whole time directors are normally not in-charge of or responsible for the conduct of business of a company.

- **Enhanced investigation requirements:** The revised MD focusses on a specialised approach towards fraud risk management and specifically towards investigations. Hence, banks are now expected to onboard dedicated investigators to conduct forensic investigations across the entire lifecycle of an event such as borrowal accounts of group entities, accounts that have been red flagged because of LEA investigations and transfer of loan account to other lenders, amongst others. In order to facilitate these investigations, banks would need to incorporate enabling clauses in their agreements with the borrowers.

  With the regulator prescribing banks to focus on specific parameters while appointing auditors and incorporating relevant clauses enabling conduct of audit/investigation, it is pertinent to note that the regulator is expecting responsibility from all three participants viz; appointing institution, auditor being appointed and borrowers, to play an active role in prevention, detection and reporting of frauds in the best interest of the economy at large.

  Even third party service providers would now be held responsible for the services provided by them to banks with regard to pre sanction appraisal and post monitoring of loans. They would also be a part of the fraud investigation as the revised MD specifies that a show cause notice with regard to fraud investigation could be sent to such service providers. Accordingly, agreements with third party service providers would now need to incorporate necessary terms and conditions bringing out that such third parties would be accountable where wilful negligence/malpractice on their part is found to be a causative factor for fraud.

- **Onus on special committee:** The RBI has shifted the overseeing responsibility of fraud risk review and management from the audit committee to a Special Committee (SCBMF).

  As per the erstwhile regulations, the Special Committee was to be constituted with the managing director, the Chief Executive Officer (CEO) in certain cases, and members of the audit committee and board of directors. As per the revised MD, the SCBMF would be a three member committee which would compulsorily include two independent directors and one whole-time director (for banks and certain NBFCs).

  Further, the overseeing responsibility of the Special Committee has been increased from the erstwhile limit of fraud involving INR1 crore and above to the entire pool of frauds. Thus, the role of independent directors in fraud risk review and management has increased. This is in line with how the National Financial Reporting Authority (NFRA) and the Securities and Exchange Board of India (SEBI) are endowing greater responsibility on the independent director community in the governance of entities (this is demonstrated with the important role independent directors are playing in corporate governance such as review of related party transactions, and fraud management).

Our comments (cont.)

- **Developing the EWS system (cont.):** The revised MD has provided banks and NBFCs (including HFCs) (ML and UL) with six months for setting up EWS, or upgrading their EWS to comply with the new requirements.

  To empower insight-based decision-making across key risk analytics platforms, the alignment of EWS/RFA mechanism under fraud risk management framework is a crucial step in understanding one-view risk profile of the customer. Accordingly, it becomes imperative for REs to view this as a potential opportunity to refresh and overhaul their existing surveillance and monitoring capabilities to include credit and other banking / non-credit related transactions by way of streamlining framework level gaps and deploying advanced analytics and market intelligence solutions.

  Some of the other aspects REs would need to consider include:

  - Design of EWS mechanism should ensure protection of personal and financial data of the customers
  - EWS system should be able to prevent and detect unusual transactions on a real time basis
  - A mechanism to identify money mule accounts would need to be introduced as the revised MD have laid special impetus on non-KYC compliant accounts and money mule accounts.
  - Periodical review of effectiveness of EWS system needs to be done and the REs would need to implement policies for this purpose.
- **Role of senior management:** The revised MD require the senior management of REs to implement the fraud risk management policy. However, discretion has to be exercised by the RE to determine the composition or level/designation of officers of an RE that would be considered to be a part of its senior management.
- **Consortium lending:** While the revised MD-bank discusses the manner of dealing with fraud accounts, it does not prescribe any specific measures to be undertaken in case of consortium arrangements, which was prescribed in the erstwhile master directions.
- **Impact on group companies of a borrower tagged as a fraud account:** As per the revised MD, group companies (with common promoters or whole-time directors) of borrower entities that have been reported as fraud accounts by REs would also be subjected to examination by the said REs from fraud risk perspective. Further, companies associated with the borrowers which are tagged as fraud accounts would also face the implications of the penal provisions prescribed in the revised MD. These penal provisions include debarment from raising of funds or seeking credit facilities, etc.

  However, this could result in circumstances where a company which is paying its borrowing dues in time, but which has common directors or promoters with entities classified as fraud accounts, or is an associate of such an entity or person would need to undergo investigation and could face penal consequences.
- **Completion of staff accountability:** As per the erstwhile master directions, staff accountability had to be completed within a period of six months. However, it is now required to be completed in a 'time bound' manner. Thus, banks and NBFCs (including HFCs) would need to set the timelines for staff accountability in the fraud risk management policy.
- **Reporting frauds to RBI:** RBI has prescribed a wider list of categories for fraud reporting. REs would require these to be evaluated at the time of investigation and reporting. These categories would need to be also analysed as per the new criminal law as well for further investigation and action by LEAs.
- **Scope of auditors:** As per the revised MD, the scope of statutory auditors of REs now includes to report suspected frauds to management and if necessary, to the audit committee. It is to be noted that the NFRA has provided detailed guidelines to auditors for reporting of frauds identified in companies under its purview. Auditors would need to consider both RBI's and NFRA's requirements while reporting fraud.

The bottom line

Improvements in fraud risk management systems of regulated entities are essential for a strong financial services sector, which would be a foundation for the growth of the country. The RBI has strived to achieve this by aligning the revised MD of both the banks and NBFCs with regard to the requirements of the fraud risk management framework. This is in line with the recent RBI amendments of the scale-based regulations, to reduce regulatory arbitrage between banks and large NBFCs, which has increased the oversight and responsibility of management on large NBFCs.

Annexure 1: Composition and functions of the Special Committee of the Board for Monitoring and Follow-up of cases of Frauds

Composition:

Banks: Whole time director and two independent directors

NBFCs (including HFCs): Chief Executive Officer and two Independent Directors

Exception for Middle Layer and Base Layer NBFCs: Has option of constituting committee of Executives with a minimum of three members, at least one of whom shall be a Whole-time director or equivalent rank Official.

Function:

- Oversee the effectiveness of fraud risk management
- Review and monitor cases of frauds, including root cause analysis, and suggest mitigating measures for strengthening the internal controls, risk management framework and minimising the incidence of frauds
- The coverage and periodicity of such reviews would be decided by the board of directors of an RE.

Annexure 2: Minimum requirements of the EWS-RFA framework of banks and EWS framework of NBFCs

The EWS-RFA framework and the EWS framework should inter alia provide for the following:

Particulars	Applicable to banks	Applicable to NBFCs (including HFCs
Integration of the EWS with Core Banking Solution (CBS) or other operational systems	Yes	Yes
Initiation of remedial action on alerts/triggers from EWS System in a timely manner	Yes	Yes
Periodic review of credit sanction and monitoring processes, internal controls and systems	Yes	-
Effective use of Central Repository of Information on Large Credits (CRILC) database and the Central Fraud Registry (CFR) *(this is only applicable to banks)*	Yes	-
Personal and financial data of customers should be secure	Yes	Yes
Transaction monitoring for prevention or detection of potential fraud should be on real-time basis.	Yes	Yes

Annexure 3: Staff accountability

	Level of examination in case of involvement of	
Staff accountable	**Junior and senior executives**	**Very senior executives***
Private banks, foreign banks and NBFCs (including HFCs)	As per internal policy	Audit committee would initiate examination (as per internal policy) and place it before the board of directors
PSBs, AIFIs and public sector NBFCs	Guidelines issued by Central Vigilance Commission (CVC)	Along with the audit committee examination (as per CVC), such cases will also be referred to the Advisory Board for Banking and Financial Frauds (ABBFF)

In case of fraud cases involving INR3 crore or more, PSBs, AIFIs and public sector NBFCs would refer such cases to the ABBFF for examining the role of all levels of officials/Whole-Time Directors (WTD) (including ex-officials / ex-WTDs).

*Very senior executives refer to the MD and CEO, executive director, executives of equivalent rank

Annexure 4: Bank reporting of Frauds to Law Enforcement Agencies:

Category of bank	Amount involved in the fraud	LEA to whom complaint should be lodged	Remarks
Private Sector / Foreign Banks	Below INR 1 crore	State / Union Territory (UT) Police	
	INR 1 crore and above	In addition to State/UT Police, Serious Fraud Investigation Office (SFIO), Ministry of Corporate Affairs, Government of India	Details of fraud are to be reported to SFIO in Fraud Monitoring Return (FMR) format.
Public Sector Banks / Regional Rural Banks	Below INR 6 crore	State / UT Police	
	INR 6 crore and above	Central Bureau of Investigation (CBI)	

Annexure 5: Categories for reporting of frauds

i. Misappropriation of funds and criminal breach of trust;
ii. Fraudulent encashment through forged instruments;
iii. Manipulation of books of accounts or through fictitious accounts, and conversion of property;
iv. Cheating by concealment of facts with the intention to deceive any person and cheating by impersonation (new category added);
v. Forgery with the intention to commit fraud by making any false documents/electronic records (new category added);
vi. Wilful falsification, destruction, alteration, mutilations of any book, electronic record, paper, writing, valuable security or account with intent to defraud (new category added);
vii. Fraudulent credit facilities extended for illegal gratification;
viii. Cash shortages on account of frauds;
ix. Fraudulent transactions involving foreign exchange;
x. Fraudulent electronic banking / digital payment related transactions committed on banks (new category added); and
xi. Other type of fraudulent activity not covered under any of the above.

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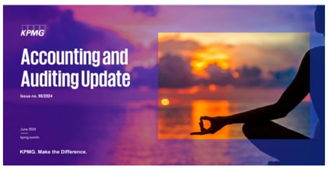
Missed an issue of Accounting and Auditing Update or First Notes?

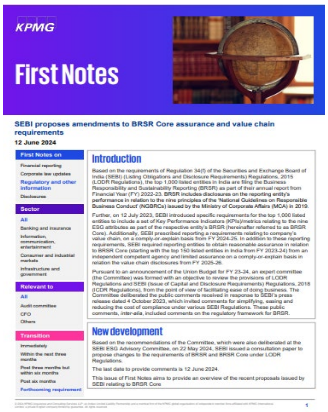


Issue no. 95 – June 2024

The topics covered in this issue are:

- Net zero commitments
- Safeguarding financial statements from fraud
- Regulatory updates

To access the publication, please click here



SEBI proposes amendments to BRSR Core assurance and value chain requirements

12 June 2024

Pursuant to an announcement of the Union Budget for FY 23-24, an expert committee (the Committee) was formed with an objective to review the provisions of LODR Regulations and SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 (ICDR Regulations), from the point of view of facilitating ease of doing business.

Based on the recommendations of the Committee, which were also deliberated at the SEBI ESG Advisory Committee, on 22 May 2024, SEBI issued a consultation paper to propose changes to the requirements of BRSR and BRSR Core under LODR Regulations.

The last date to provide comments is 12 June 2024.

To access the First Note, please click here

KPMG in India is pleased to present Voices on Reporting (VOR) – a series of knowledge sharing calls to discuss current and emerging issues relating to financial reporting.

On 8 July 2024, KPMG in India hosted a webinar to discuss the key updates from the Securities and Exchange Board of India (SEBI) and the International Accounting Standards Board (IASB).

To access the recording of the webinar, please click here

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