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The Ketan Parekh fraud and supervisory lapses of the Reserve Bank of India (RBI): a case study

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Abstract

Purpose – The purposes in this paper are: engaging in a critical examination of the framework of the banking regulatory framework in India; assessing the operational efficacy of banking regulatory and supervisory mechanisms; and providing an in-depth legal analysis of the role of the Reserve Bank of India (RBI) as the country's central bank and the principal supervisory authority.

Design/methodology/approach – The method used is legal examination of regulatory practice and case-study based analysis. It relies factually on official publications in the public domain, academic writings and newspaper reports to assess the impact of the fraud and explore the legal, regulatory and financial implications of the supervisory lapses.

Findings – The findings in the paper relate to the impact and extent of he Ketan Parekh fraud and the nature and scope of critical central banking supervision lapses. The paper concludes that such lapses can induce systemic problems in a key emerging economy like India especially when it is rapidly entering the second phase of major banking and financial reforms.

Research limitations/implications – Various investigations are still underway as regards the Ketan Parekh fraud and several cases are being heard in courts and tribunals. The full extent of legal and regulatory liability is yet to be fully ascertained.

Originality/value – It is of immense significance to bankers, lawyers, auditors, consultants, researchers, jurists, law enforcement officials and those involved in financial and banking regulation.

Keywords Banking, Fraud, Financial institutions, India

Paper type Case study

Introduction

The Ketan Parekh fraud is the most recent and biggest of a series of frauds and direct attacks on the systems and procedures of banking in India in the late 1990s. The exposure of the fraud in 1999 along with the collapse of several co-operative banks and the largest mutual fund in India, the Unit Trust of India (UTI) US-64, has seriously undermined the Indian banking system. Coming after a similar banking and capitals market fraud involving Harshad Mehta in 1991, it has exposed the glaring lacunae in the existing Indian banking regulatory and supervisory framework.

The objectives in this paper are two-fold. They are to facilitate:

- a critical examination of the Ketan Parekh Fraud as a bank fraud within the framework of the banking system in India; and
- a legal analysis of the role of the Reserve Bank of India (RBI) as the country's central bank and the supervisory lapses on its part.

I will begin by discussing the magnitude and the extent of the Ketan Parekh fraud and its impact on the domestic banking system by relying on official reports, working papers and government documents. Second, I will briefly examine the legal definition

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of fraud within the present legislative frame-work in India. Third, I will locate the supervisory powers and structural framework of the RBI in the regulation and supervision of the banking system *vis-à-vis* the prevention of large frauds and economic offences. Finally, I will analyse the various supervisory lapses of the RBI at different stages as regards the Ketan Parekh fraud.

Nature and extent of the fraud

The nature of the fraud perpetrated by Ketan Parekh lies in the abuse of the banking system in India to channelise money illegitimately into the stock market. Parekh acquired funds fraudulently over a long period of time from various commercial and co-operative banks through the issuance of large-value pay-orders, which are of the same nature as demand drafts, without the actual cash to back them up or any reciprocal pay-in of funds. The fraud consequently becomes a statement on how the nexus between bankers, corporate bodies, promoters of companies, auditors and stock brokers, in the absence of alert and diligent supervision, can trigger a systemic crisis in the capital markets and which can potentially induce a banking crisis as well. The Joint Parliamentary Committee (JPC) Report[1] on the extent and causes of the fraud, sums it up in the following terms:

> The scam does not lie in the rise and fall of prices in the stock market but in the large-scale manipulation like the UTI, violation of the risk norms on the stock exchanges and banks, and use of funds coming through overseas corporate bodies to transfer stock holdings and stock market profits out of the country (para 2.20, page 10).

The JPC Report highlights the fact that Parekh owned or controlled 23 entities in the stock market which he used to build up a complex network of untraceable transactions in order to hide the sources from where he used to obtain his funds for playing up the market. Parekh's modus operandi was to identify and acquire technology and communication stocks, now termed as "K-10 stocks" and ramp up their prices by simulating enhanced market activity. They included the stocks of various companies like Pentafour, Global Telesystems, Zee Telefilms, Himachal Futuristic Communications Ltd, Pentamedia Graphics, Silver Line Technologies and DSQ[2]. The banking crisis was manifest in the bank run and subsequent fall of Madhavpura Mercantile Co-operative Bank (MMCB) and a collapse of the UTI's US-64 mutual fund, the largest mutual fund of the biggest institutional investor in the Indian stock market.

Collapse of MMCB

The fraud exposed in 1999 when a Rs 140 crore pay-order given to Ketan Parekh by MMCB bounced. The discounting bank, Bank of India (BOI), had already given Parekh Rs 137 crore but when the pay-order was sent to the clearing house it was dishonoured. Meanwhile, Parekh's over-valued shares shares had collapsed in the market and the MMCB could not raise sufficient funds to defend its position[3]. The involvement of MMCB with Ketan Parekh was the only reason for its immediate collapse when the fraud broke. The MMCB issued credit regularly to Parekh in violation of RBI regulations along with UTI and Global Trust Bank and the total exposure of MMCB to Parekh stood at Rs 840 crores before its collapse[4]. The MMCB's Mandvi Branch alone issued 13 pay-orders to Parekh in only two days against all RBI guidelines[5]. The RBI has observed generally as regards co-operative banks in one of its reports[6] as:

> The management and boards of several co-operative institutions continue to reflect political interests rather than genuine co-operative spirit.

A similar observation was also given by the Vikhe Patil Committee Report[7]:

> Excessive politicisation and absence of committed leadership dedicated to the vision of the co-operative movement have affected the basic fabric of the democratic co-operative structure. The recovery climate in the co-operative sector has been vitiated due to across-the-board loan waivers. Poor recoveries and diversion of a part of the recoveries to fund losses have severely debilitated the health of these institutions.

In two months, about 250 pay-orders totalling Rs 2,400 crores were issues by MMCB, UTI and GTB to Parekh[8]. In fact, GTB and Standard Chartered Bank provided Parekh with an overdraft facility through which he could route funds into the stock market in violation of RBI guidelines[9]. The total amount involved in the pay-order fraud was estimated by the Central Bureau of Investigation (CBI) to total Rs 1030.34 crores. That meant that the banks advanced this amount of money to Parekh against a permissible overall limit of Rs 475 crores and thereby committing various deliberate irregularities and wilful breach of all RBI guidelines and directives. The CBI Report also has stated that Parekh opened 11 accounts in MMCB, Mandvi Branch, in Mumbai alone and his relatives held 16 accounts in the names of various bogus companies with the BOI, Mumbai Stock Exchange Branch. It also traced an account in Credit Suisse Bank, Zurich, the contracting partner being a corporation named Elista Ltd, registered in Nassau, Bahamas, with the beneficial owner being Ketan Parekh.

Collapse of UTI's US-64

The UTI's US-64 mutual fund, the largest mutual fund in India, comprising of two thirds of the total assets of the Indian mutual funds industry and Rs 57,500 crores in assets, collapsed in the wake of the Ketan Parekh fraud. The US-64 was originally conceived as a savings instrument for pensioners and middle-class salaried persons and its credibility lay in the fact that it offered a regular and safe income and the highest ever yield was 18 per cent in 1993 and 1994. The JPC Report, while stating the primary reason as non-observance of basic investment fundamentals by the fund managers, indicts UTI as follows:

> India's largest mutual fund appears to have taken recourse in brokers for certain transactions, which seem to be in the nature of inter-scheme transfers, and thus has violated its own guidelines[10].

The UTI invested Rs 3,400 crores in just 6 out of a total portfolio of 44 stocks, which was eroded by 60 per cent of its value in one year. It also invested Rs 1,300 crores in another five stocks, which was devalued by 77 per cent and stood at Rs 300 crores within a year. The imprudent investment by fund managers in the "K-10 stocks" was cited by the JPC as a consequence of collusion and connivance with Ketan Parekh. The Report particularly pointed out the investment in Himachal Futuristic Communication Limited (HPFCL) and Global Telesystems, two of Parekh's favourite stocks. It pointed out that as on June 2001, UTI had invested Rs 1050.70 crores in HFCL's equity, the market value of which had depreciated by 92 per cent. The JPC Report clearly stated that UTI "went on building up its portfolio in the Global Telesystems (Private Limited) scrip to facilitate the upward trend in its prices" and that "decisions not to offload the stock to book profits when the prices were favourable or cut their losses in adverse circumstances raises doubts"[11]. The Rs 30,000 crore portfolio of the fund lost its value by half within 2001. By March/April, 2001, US-64 net asset value (NAV) stood at Rs 5.81 below par (Rs 10). The government had to announce a bail out package at a cost of Rs 5,120 crores. The Tarapore Committee Report[12] concluded:

> The sanction and disbursement process does indicate that the sanctity of the sanctioning powers and the laid-down processes have on many occasions not been observed.

Meaning and implication of "fraud"

There is no offence known to common law as "fraud". Fraud is a generic term for a type of criminal offence, of which the elements are variable, including the non-violent dishonest obtaining of some economic advantage or causing some economic loss (Norton and Walker, 2000a). Serious fraud is simply fraud on a large and complex scale, involving large or substantial sums of money (Norton and Walker, 2000a). The term "fraud" has not been defined in the Indian Penal Code but in the Indian Contract Act, 1872. "Fraud" is defined in Section 17 of the Indian Contract Act, 1872, and is as follows:

"Fraud means and includes any of the following acts committed by a party to a contract, or with his connivance, or by his agent, with intent to deceive another party thereto or his agent, or to induce him to enter the contract:

- the suggestion, as to a fact, of that which is not true, by one who does not believe it to be true;
- the active concealment of a fact by one having knowledge or belief of the fact;
- a promise made without any intention of performing it;
- any other act fitted to deceive; and
- any such act or omission as the law specially declares to be fraudulent.

Explanation. Mere silence as to facts likely to affect the willingness of a person to enter into a contract is not fraud, unless the circumstances of the case are such that, regard being had to them, it is the duty of the person keeping silence is, in itself, equivalent to speech."

The historical reason for fraud to be defined as simply an "act" in contract law rather than as a substantive "offence" in criminal law may be traced to the fact that fraud was mainly associated with the distortion or concealment of information, or even giving out of information prematurely[13]. The enforcement of a contract was central to the efficient conduct of business and formed the bedrock for most financial transactions – such acts presented numerous problems for contractual agreements to be enforced. The whole notion of fraud, therefore, has developed around the use or misuse of business – related information: when information is revealed to one contracting party and not to the other or, when wrong or misleading information is deliberately given to impair or cause an economic loss to one contractual party. In economic terms, contractual information needed to remain symmetric, i.e. the same amount and extent of information needed to be in the knowledge of both contractual parties, for the contract to be enforced efficiently[14]. While asymmetry in information was deemed to cause fraud by producing inefficiencies in the enforcement of contracts and raising transaction costs by inducing litigation-based delays, the legal issues arising from a statutory definition of fraud in contract legislation can, at times, also be quite unsettling.

A classical definition of fraud within the law of contract may create several legal uncertainties as regards the effect of fraud on the enforcement of any contract. On one side, it can be effectively argued that fraud affects only "procedure"[15] in enforcement of a contract if the words "no action shall be brought" are imported in the body of the contract or the statute[16]. This can be interpreted to mean that the contract cannot be enforced in a particular jurisdiction that is the law of the place of performance and/or situs of property even though it is valid and enforceable under the law of the place of performance. Alternatively, the contract may be deemed to be "void" and/or "invalid" and fraud can be deemed to affect the "substance" of the contract[17]. The contract, in this case, may be deemed to be not controlled by the domestic law of the forum but by the law of the place of contracting, the law of the place of the performance or the law of the situs of the property, whatever the case may be. (Lorenzen, 1923) Apart from these issues, there may arise several vexing questions from constricting the definition of fraud and placing it only within the law of contract such as:

- whether the definition of fraud constitutes a mere rule of evidence; or
- whether it purports to lay down a specific remedial measure; or
- to what extent does it affect the substance of the contract.

Broadly speaking, fraud may be temporally divided into two distinct classes depending on the time of release of information as related to signing of the contract. If the information was given before the contract was signed it constituted ex-ante fraud; if the information was given after signing of the contract then it constituted post-ante fraud. Most cases of banking fraud in India can be categorised as post-ante fraud[18].

The N.L. Mitra Committee constituted after the Ketan Parekh fraud, when examining the causative factors for the incidence of bank frauds, cited the following reasons in its Report[19]:

(1) Large value credit frauds:
   - absence of proper physical verification of collateral security offered;
   - lack of proper post-disbursement monitoring to ensure appropriate end use of funds; and
   - lack of pre-sanction survey including improper identification of borrower and verification of antecedents of prospective borrowers.

(2) Lapses in internal control mechanism:
   - lack of periodical review of systems and procedures at certain intervals;
   - lack of annual review of frauds and serious irregularities pointed out in audit reports which could also become a basis for review of the basic accounting systems as well as the procedural guidelines;
   - delayed reconciliation of high value intra-branch accounts or inter-branch transactions;
   - lack of periodical review of credit outflow from banks;

- lack of concurrent audit, internal inspection of books, snap audits and verification of audits; and
- connivance of supervising staff as well as involvement of lower level bank staff.

Role of the Reserve Bank of India (RBI)

The RBI started functioning from April 1, 1935 under the RBI Act, 1934. It was a private shareholders' institution until January, 1949, after which it became a state-owned institution under the Reserve Bank (Transfer to Public Ownership) of India Act, 1948, and started central banking functions[20]. The Preamble to the RBI Act states:

> Whereas it is expedient to constitute a Reserve Bank for India to regulate the issue of bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and the credit system of the country to its advantage[21].

The objective of the RBI is to promote the development of financial infrastructure of markets and also to maintain stable payments system and monetary stability so that financial transactions can be safely and efficiently executed.

Meaning and scope of "banking"

The growth and development of banking throughout the nationalisation years in India has to be understood in the context of banks as being established principally as agents and instruments of the state and banking activity being restricted to a deposit-taking activity[22]. It becomes important in this regard and for purposes of this thesis to briefly examine the meaning of the term "banking" as defined by legislative enactments and courts. "Banking" is defined under Section 5(b) of the Indian Banking Regulation Act, 1949, as "the accepting for the purpose of lending or investment of deposits of money from the public, repayable on demand or otherwise, and withdrawal by cheque, draft or otherwise". The Supreme Court has held that the relationship between a bank and its customer is that of a creditor and a debtor[23]. The definition of banking has been traditionally limited to deposit-taking and other commercial activities like trading which a banking institution may engage in did not come under its purview[24]. Section 5(c) of the Act defines a "banking company" as "any company which transacts the business of banking in India"[25].

"Banking policy" has been defined as including "any policy which is specified from time to time by the RBI in the interest of the banking system or in the interest of monetary stability or sound economic growth"[26]. The emphasis on banking as a primarily deposit-taking activity and the role of banks in official credit allocation is brought out by the emphasis of banking policy on "the interests of the depositors, the volume of deposits and other resources of the bank and the need for equitable allocation and effective use of these deposits and resources"[27]. Though no attempt has been made to define the term "regulation" anywhere in the statute, it may be argued that its larger meaning is implicitly built into the definition of "banking policy" to imply government intervention and restriction of banking activity. There are two Indian cases that may be cited to support this premise. The first, where the Supreme Court of India has held that the terms "banking policy" and "banking" are not independent but co-ordinating subjects and both are covered within the supervisory powers of the RBI within the meaning of S.35-A[28]. The second is where it has been held that where a banking company has a private capital structure, the profits going to private pockets of the shareholders, it is not a state or an agency of a state or a public instrumentality[29].

The Supreme Court of India has recently defined banks as financial institutions that are engaged in improving the flow of trade, movement of commerce and expansion of business and thereby improving the socio-economic condition of the people[30]. The thrust of the definition of banking under the Banking Regulation Act, 1949, still remains a restrictive one and focuses fundamentally on the act of taking deposits. It has been adjudged that a co-operative bank does not fall in the category of a banking company in the above-stated Act[31]. The demarcation between banking activity and financial activity by a co-operative society is not always clear and this also causes regulatory and supervisory lines to get blurred. In one case, the Supreme Court has held that "because the appellant co-operative society advanced loans to its nominee and carried out other financial transactions, it did not become a banking company or cease to be a co-operative society"[32]. The capital adequacy norms for co-operative banks is well below commercial banks and the RBI stands as "lender of first resort" for co-operative banks in the form of contribution to initial capital, working capital and refinance. The promotional role of the RBI supersedes its regulatory role in these co-operative banks.

The term "investment" has not been clearly defined in the statute. It is unclear as to what "investment" would exactly mean and there can arise an extremely relevant question as to whether it would include the whole gamut of procedural norms covering the range of present-day business activities by international banks as conglomerates. The lack of a statutory definition may make it difficult for courts in the future in interpreting trading, insurance and investment activities of banks against the backdrop of present financial products especially when banking business is rapidly expanding into securities, insurance and investment related businesses at a global level. This can pose a potential problem with the prospect of systemic contagion spreading into banking business being more than a mere possibility with the emergence of secondary debt-trading markets, asset securitisation and credit derivatives as the banking crises in the 1980s and 1990s have shown. It is interesting to observe in this context that the term "bank" under the EC Credit Institutions Directive includes the term "credit institution" which is defined as "an undertaking whose business is to receive deposits and other repayable funds from the public and to grant credits for its own account"[33]. It can be argued that, given the banker-broker-auditor nexus in the large-value bank frauds in the 1990s, a wider definition of "banking" may possibly be more helpful to banking supervisory authorities and market regulatory bodies in containing large-value fraud within the domestic banking system.

Institutional structure of banking in India

There are two important structural aspects that grew out of the nationalisation of the banking system in India. First, a class of banks was created that were directly owned and controlled by the government. These banks, regulated and supervised by the RBI[34], were not only meant to allocate investment resources to suit successive central five-year plans for economic development but were also used to meet the government objectives of employment creation, income distribution and balancing regional economic activities[35]. Second, an operational segmentation was deliberately allowed to develop and was carefully maintained within the banking system in that different categories of banks – co-operative banks, commercial banks, industrial development banks, agricultural banks, rural banks – served separate and limited number of social groups and economic activities.

The banking structure in India can be broadly divided into the following categories:

- public sector banks governed by statute, regulated by the RBI, and controlled by the government;
- foreign banks, registered as branches;
- domestic private banks incorporated under the Companies' Act;
- co-operative Banks, urban banks and rural banks under the dual supervision of the RBI and the state/central governments; and
- non-banking financial companies incorporated under the Companies' Act and regulated by the RBI.

Several financial institutions having the character of banks were created by statutes such as the Industrial Development Bank of India (IDBI), the Small Industries Development Bank of India (SIDBI), the National Bank for Agriculture and Development (NABARD) and several co-operative and rural banks. Such segmentation meant that there could always be the possibility of regulatory and supervisory overlap. This, in turn, meant that ensuring co-ordination between supervisory bodies and regulators to achieve the lending targets became more important in terms of regulatory policy-making rather than establishing a detailed regulatory framework of checks and balances based on prudential norms. The RBI came to be at the epicentre of the monetary and financial system of the country and enjoyed a very distinct and special supervisory and regulatory role as the country's central bank[36]. The banking regulatory framework broadly comprises of:

- Department of Company Affairs (DCA) under the Ministry of Finance of the Government of India which administers the Companies' Act, 1956. The DCA regulates deposit-taking activities of all corporate entities registered under the Companies Act, 1956, and not defined as banks or non-banking financial companies by their statutes.
- RBI as the central regulatory and supervisory body administering the Banking Regulation Act, 1949. The RBI is in charge of regulating and supervising the domestic public sector and private banks, the foreign banks, the development financial institutions (DFIs), and the non-banking financial companies. While most banks are under the sole regulation of the RBI, some like the rural banks and co-operative banks are under the dual regulation of the RBI and the central/state government.
- Securities and Exchange Board of India (SEBI), that regulates the capital markets, the Insurance Regulatory and Development Authority (IRDA), that regulates insurance companies and the governing boards of various stock exchanges and apex financial institutions.

It may be observed from the above structural framework that different regulatory bodies need to conduct their duties of regulating various market participants in their own ways. The problems of moral hazard and adverse selections due to overlap in regulatory and supervisory oversight have always been more than mere possibilities and have repetitively generated fault lines in the prudent regulation and supervision of banking and securities business, particularly whenever there has been an interface between both[37]. It is not a mere co-incidence that the biggest fraud in the financial system in India involving Ketan Parekh, the public sector banks and the capital markets has been partly a consequence of structural regulatory and supervisory overlap.

Supervisory powers of the Reserve Bank of India (RBI)

The RBI started functioning from April 1, 1935, under the RBI Act, 1934. It was a private shareholders' institution until January 1949 after which it became a state-owned institution under the Reserve Bank (Transfer to Public Ownership) of India Act, 1948, and started full-fledged central banking functions[38]. The role of the RBI is to regulate and supervise the functioning of banks, promote development of financial infrastructure of markets, and, maintain a stable payments system and monetary stability so that financial transactions can be safely and efficiently executed. The Preamble to the RBI Act states:

> Whereas it is expedient to constitute a Reserve Bank for India to regulate the issue of bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage[39].

The supervisory powers of the RBI are located in Section 35-A (1) of the Banking Regulation Act, 1949. The section is extracted as below:

"Section 35-A (1): Power of the Reserve Bank to give directions

Where the Reserve Bank is satisfied that:

- in the public interest; or
- in the interest of banking policy;
- to prevent the affairs of any banking company being conducted in a manner detrimental to the interests of the depositors or in a manner prejudicial to the interests of the banking company; or
- to secure the proper management of any banking company generally;

it is necessary to issue directions to banking companies generally or to any banking company in particular, it may, from time to time, issue such directions as it deems fit, and the banking companies or the banking company, as the case may be, shall be bound to comply with such directions".

Under this section, the RBI has been given power to issue specific directions in the interest of banking policy in public interest, to prevent the affairs of any banking company being conducted in a manner prejudicial to the interests of the banking company[40]. The RBI can also exercise its powers under Section 21 of the Banking Regulation Act to control the mobilisation of deposits and advances, issuance of licences, inspection of working of banks, maintenance of cash reserves and paid-up capital requirements. Section 36(1)(a) of the Act empowers the RBI to "caution or prohibit" any banking company from entering into any "particular transaction or class of transactions" in public interest or otherwise. The Supreme Court has held that such direction is binding on the banks and has to be complied with[41]. The circulars issued by the RBI are confidential documents and require the banking companies to transact their businesses in a particular manner in accordance with the terms of the circulars[42]. It is the bank's responsibility to supervise the authorised institutions and to keep under review the operations of the Act and developments in the field of banking which appear to be relevant to the exercise of its powers and duties. In this context, the word does not signify an obligation that is strictly enforceable in law, but is used in a wider sense as synonymous to "functions"[43].

Organisation of RBI's supervisory function

Following the Harshad Mehta fraud, the Narasimhan Committee set up in 1991, recommended the separation of supervisory functions from banking functions. The Committee recommended that the "duality of control over the banking system between the RBI and the Banking Division of the Ministry of Finance should end and that the RBI should be the primary agency for the regulation of the banking system"[44]. This was implemented by the creation of a separate Department of Supervision (DOS) in 22 November 1993. Prior to 1993, the supervision and regulation of commercial banks was handled by the Department of Banking Operations and Development (DBOD). The DOS took over inspection of commercial banks from the DBOD and from April, 1995 it has taken steps to extend its area of supervision over the All-India financial institutions[45]. The DOS was split into the Department of Banking Supervision (DBS) and Department of Non-Banking Supervision (DNBS) on 29 July 1997, with the latter being entrusted with the task of focussed regulatory and supervisory attention towards the NBFC segment[46]. The DBS deals with financial sector frauds related to banks and serves as a secretariat for the Board for Financial Supervision (BFS). The BFS was constituted on 16 November 1994, with the RBI Governor as the Chairman and functions under the RBI (BFS) Regulations, 1994 exclusively framed for the purpose in consultation with the Government of India[47]. The Board is chaired by the RBI Governor and is constituted by co-opting four non-official Directors from the Central Board as members for a term of two years and the Deputy Governors of the Bank act as ex-officio members.

The BFS presently supervises all the commercial banks, financial institutions and non-banking finance companies by way of on-site bank inspections emphasising on capital adequacy, asset quality, management, earnings appraisal, liquidity and systems and controls (CAMELS). Bank examination has been explained "as an on-site evaluation of the assets, liabilities and procedures of a bank conducted by government employees who arrive unannounced and have virtually unlimited access to the records of the institution" (Horvtz, 1980). The BFS conducts off-site surveillance, in-house monitoring, supervision of internal control and audit functions, risk control systems and gathering of market intelligence. The RBI instituted an Advisory Board on bank frauds with effect from 1 March 1997 under the chairmanship of S.S. Tarapore, former member of BFS and Deputy Governor of RBI. Presently reconstituted as Central Advisory Board on Bank Frauds, it functions as part of the CBI and advises the RBI on the cases referred to by the CBI for investigation against bank officers of the rank of General Manager and above (Horvtz, 1980). In August 1999, the RBI mooted the idea of establishing a Prompt Corrective Action (PCA) framework that would incorporate certain indicators as trigger points such as the capital adequacy ratio of banks, percentage of Non-Performing Assets (NPAs) and return on assets and shortfalls (Ahluwalia, 2002). The objective was to ensure that the weaker banks that failed to achieve the prudential benchmarks could be restrained from going in for credit expansion or more mobilisation of deposits at high interest rates. The problem was about agreeing how to tailor the benchmarks to suit all the individual banks and ensure that it was not a case of "one size fits all"; and, the idea, somewhat predictably, is yet to crystallise as part of official supervisory policy.

Lapses in RBI supervision

The principal reasons for the incidence of large-value frauds within the domestic banking system in India through the 1990s can be broadly classified under regulatory lapses arising from criminal conduct and reckless mismanagement which occur due to the critical absence of or failure to enforce:

- internal control systems;
- internal audits of those mechanisms; and
- corrective actions to mitigate or prevent opportunities for fraud, reckless mismanagement, or conflicts of interest raising the potential for such behaviour (Norton and Olive, 1996).

An analysis of the supervisory lapses on the part of the RBI in the Ketan Parekh fraud is detailed below.

Lack of prioritization of large-value bank fraud

The RBI failed to classify large value "bank frauds" as a separate category of offences in any of its internal circulars or guidelines to the banks even after the incidence of Harshad Mehta defrauding several public sector banks and financial institutions. As a consequence, neither the RBI nor the banks had any well-defined criteria for the prioritisation of large value fraud-related cases by taking into account the nature and extent of public monies lost or by the intent of the actors. It also failed to classify as a separate offence by which diversion of bank funds would constitute fraud. The Special Chapter on Vigilance Management in Public Sector Banks, under which the Vigilance Departments of Banks operate, did not define fraud at all. It provided only for two categories of irregularities:

(1) Vigilance A cases where prima facie the misconduct is substantive and warrants initiation of major penalty proceedings; and

(2) Vigilance B cases where lapses are procedural and do not reflect adversely on the integrity of the officer concerned (Paragraph 010.5)[48].

An operational definition of fraud was constructed for the Vigilance Operations of Public Sector Banks in 2002 and a separate category of frauds was constituted as "Banking Frauds" under "Category F" by the Central Vigilance Commission[49] to facilitate fast track processing of such offences. Category "F" frauds may be defined as frauds of Rs 1 crore and above, perpetrated with a criminal intention by any bank official, either alone, or in collusion with outsiders and include:

- misappropriation and criminal breach of trust;
- fraudulent encashment through forged instruments, manipulation of books of account or through fictitious accounts and conversion of property;
- unauthorised credit facilities extended for reward or for illegal gratification;
- negligence and cash shortages;
- cheating and forgery;
- irregularities in foreign exchange transactions; and
- any other type of fraud not coming under the specific heads as above.

Lapses in audit and internal control
The RBI, India's central bank, failed as part of its regulatory duties to secure the fire-walling of traditional commercial banking activities from new activities which relate to securities transactions and to minimise the risk of cross-contamination of affiliated depository institution (Baxter and Ramasastry, 1996). The attendant risks of contagion and moral hazard enveloped the co-operative banks as well as the UTI. The S.S. Tarapore Committee formed to examine the UTI's collapse stated the following as the principal reasons[50]:

- unauthorised investment of Rs 3,000 crores in shares and debt instruments of 24 companies between 1997-2001;
- serious deficiencies in sanctioning process; and
- sanctioning of investments beyond Chairman's delegated powers[51].

The JPC Report as well as the Tarapore Committee points to the nexus of carefully concealed planning and execution of the fraud, of fraudulent borrowing by Parekh and reckless and imprudent investment by UTI's fund managers. The fact that this went on undetected for months without identification or corrective action by any internal control system raises serious questions as to the actual degree of implementation and enforcement of such systems as part of safe and sound banking practices. The JPC Report also raises further question as to the complicity of the senior management who should have reasonably known that the fraud or reckless misconduct was actually occurring, or that conditions within UTI existed to facilitate opportunities for such conduct and conflicts of interest to arise.

The inability of the auditors to detect the fraud and the diversion of funds constitutes a key element of the "expectations gap" between public and professional perceptions of auditor's responsibilities (Freedman and Power, 1991). The regulatory authorities, even after the Harshad Mehta fraud, failed to realise that the supervisory process had to facilitate the development and implementation of internal control systems by relying on banks and financial institutions to "supervise" and "police" themselves through internal audit functions rather than "window-dressing" financial statements (Katz, 1998). This may involve building a system of incentives to address operational risks in three distinct areas as:

(1) incentives continuously to implement, refine and improve existing internal control systems;

(2) incentives for boards of directors and senior management to meaningfully evaluate and enforce internal control systems through established internal audit functions; and
(3) incentives for banking authorities to require that operational risk provisions are meaningfully adopted through supervisory evaluation and corrective actions, as opposed to merely issuing guidance and developing best practices for successful internal control systems (Norton and Walker, 2000b).

Failure to identify large exposure
A crucial regulatory lapse of the RBI in the Ketan Parekh fraud was its failure to identify funds concentrated in the hands of a single borrower or set of borrowers and the subsequent diversion of such funds to the stock market in violation of all RBI guidelines[52]. The bank failed to analyse the risk return profile of investments because of non-monitoring of the credit facilities given to Parekh by UTI and others. There was no scrutiny made as to whether banks had made a proper credit analysis of the borrower in consonance with prevailing credit or equity evaluation norms.

The concentration of bank funds in the hands of a single borrower or a particular set of borrowers constitutes a fundamental cause for capital inadequacy problems faced by banks. The Bank of England's own review following the Johnson Mathey Bank (JMB) collapse concluded that concentrations of lending to individual borrowers or certain sectors were the most important recent cause of difficulties in banks[53]. Such concentration of capital makes capital requirements inaccurate and banks fail to distinguish risk variables. The spread of risk in investments is linked closely to solvency of the bank which in turn determines a banker's diligence and prudence (Norton, 1989). Imprudent investments manifest perverse incentives for banks and financial institutions, as in the case of UTI and MMCB, to look for unsustainably high income against low capital cost at the cost of the depositor and the shareholder[54].

Inadequate market intelligence gathering
There never existed any formal Glass-Steagall type of separation in India, as was the case in the United States, between banking, insurance and securities businesses. As a matter of practice, banks circumscribed their activities, and market segmentation was formalised by a stock exchange norm that prevented outsiders from taking a controlling interest in member firms[55]. This is because the Indian approach to regulation, similar to that of the United Kingdom, does not co-exist easily with a system in which risks freely flow between different parts of the same financial group[56]. This is a principal factor that led to the collapse of the UTI. The RBI ought to have been more alert and diligent in the gathering of market intelligence regarding the movement of shares and identification of broker positions. It failed to analyse:

- the nexus between institutional investors like UTI and brokers; and
- the role of unscrupulous brokers like Parekh as intermediaries in purchasing securities to play the markets.

There was a lack of market intelligence sharing between the SEBI and the Market Intelligence and Surveillance Unit (MISU) of the RBI. Such lack of informal mechanism led to a regulatory failure of covering the broader prudential issue relating to the capacity of intermediaries to carry on business on ongoing basis including, in particular, the adequacy of their financial resources or internal control systems (Report of US Department of the Treasury, 1991). The RBI also failed to identify multiple accounts held by single borrower in same branch of BOI, a public sector bank, as well as MMCB, from which money used to be regularly diverted to the markets.

Problem of dual regulation of co-operative banks

The failure of MMCB and several co-operative banks in different parts of the country almost simultaneously raises extremely difficult questions as to the quality and extent of banking regulation. It represents the problem of having a system of overlapping regulatory arrangement in the regulation of co-operative banks without the actual division of regulatory workload or practical separation of supervisory responsibilities.

Co-operative banks in India, though initially established only for rural community development and extension services, now perform most banking functions like deposit mobilisation, supply of credit and remittances. They account for about 45 per cent of institutional lending to the rural sector and cover about 65 per cent of the rural population[57]. Co-operative banks are more in the nature of financial intermediaries as their resource base is substantially made up of borrowings from the RBI, State and Central Governments, and co-operative apex institutions. They have a federal three-tier structure at state, district and village levels and are primarily subject to the control, audit, supervision and periodic inspection of the co-operative of the state government under the Co-operative Societies' Act and less rigorously by the RBI under the Banking Regulation Act. The RBI lays down the guidelines for the functioning of co-operative banks but it is the state government that has powers to regulate them. Second, even when they are regulated, the quality of the regulation and supervision is poor. Rural co-operative banks are not audited by professional accountants but by easily corruptible state government officials. Even when the RBI issue directives to the state governments, the local politicians manage to ensure non-compliance.

The RBI its annual report of 2001 stated[58]:

> The events of the last two years have made it abundantly clear that the present system of dual/triple regulatory and supervisory control is not conducive to efficient functioning.

It concurs with the observation of the Jagdish Capoor Report on Co-operative Banks[59]:

> This results in overlapping jurisdictions and also at times in cross-directives. Besides, it has been noticed that State Registrars do not always act expediently on directions received from RBI, with the result that the managements of these banks are enabled to take advantage of the existing loopholes to commit irregularities.

Conclusion

The Ketan Parekh fraud exposes the conflicting interests between various groups, brokers, bankers, auditors and corporate entities and reiterates the need to have financial and market discipline. It renews the argument that banks should operate with prudent levels of risk, capital and reserves and should be subject to a more effective and accurate regulatory regime (Norton, 1991). The supervisory lapses the RBI have exposed the vulnerability of banks when they operate with a high leverage, opening themselves to a possible "run" in the event of public concern for the banks' solvency.

The fraud reiterates the fact that banking functions now have broader ramifications and a failure of the banking system can, in turn, de-stabilise the entirety of the financial system. It makes a strong case to regulate the whole gamut of banking transactions rather than only banks as deposit taking institutions. It becomes imperative, therefore, for the soundness of the banking system, the stability of the financial system and the safety of the depositors to put in place a more effective and comprehensive legislative enactment that would pre-empt and prevent the incidence of such large- value frauds.

Notes

1. JPC report submitted to the Government of India in 2003, page 10, para 2.20.
2. JPC report submitted to the Government of India in 2003.
3. See "After the Horses Bolted", Frontline, Volume 18, Issue 09, 28 April-11 May, 2001.
4. Interim Report of the CBI on the Ketan Parekh Scam, between September, 1999 and April, 2000, submitted to the JPC in 2001.
5. Interim Report of the CBI on the Ketan Parekh Scam, between September, 1999 and April, 2000, submitted to the JPC in 2001.
6. See RBI, Monetary and Credit Policy Report, 2002-2003.
7. Balasaheb Vikhe Patil Report on Co-operative Banks submitted to the Government of India in December, 2001.
8. Supra 4.
9. Supra 4.
10. See JPC Report submitted to the Government of India in 2003.
11. See JPC Report submitted to the Government of India in 2003.
12. S.S.Tarapore Committee Report on UTI US-64 submitted to Government of India in January, 2001.
13. See Salmond, *Jurisprudence*, 6th edn, 1920, pp. 446-8. Also see P. Picard, "Economic analysis of insurance fraud" in G. Dionne (Ed) *Handbook of the Economics of Insurance*, Kluwer Academic Publishers, 2000.
14. See Salmond, *Jurisprudence*, 6th edn, 1920, pp. 446-8. Also see P. Picard, "Economic analysis of insurance fraud" in G. Dionne (Ed) *Handbook of the Economics of Insurance*, Kluwer Academic Publishers, 2000.
15. The term "procedure" may have different meanings and implications depending on the jurisdiction. It may have a narrower meaning in matters of domestic jurisdiction than in matters related to extraterritoriality. For example, there can arise various complex issues when answering the question, Can the liability of the directors of a bank to mandatorily comply with certain regulatory requirements imposed by statute in one jurisdiction be enforced by courts of another jurisdiction? An analogy in this sense can be drawn as regards the interpretation of the term "penal" in matters related to penal laws by the US Supreme Court in the case *Huntington* v *Attrill*, (1892) 146 US 657, 13 Sup. Ct. 224.
16. This argument has been acknowledged in the leading English case, *Leroux* v *Brown*, (1852) 12 CB 801.
17. A contract may be declared "void" or "voidable" or "uneforceable" depending on the nature and extent of the fraud indentified. A void contract is a contract without a legal effect. The difference between a voidable contract and an unenforceable contract is one between substance and procedure. For a more comprehensive analysis, see Anson, "Contract". Also

the seminal article of Corbin, "Offer and Acceptance and Some of the Resulting Legal Relations" (1917) 26 Yale Law Journal 169, pp. 179-81.

18. See N.L. Mitra Report on "Legal aspects of bank frauds, 2001". Also see "India fraud survey report, 2001" brought out by KPMG, India; CBI's "Paper on large value frauds in banks" (CBI, July, 1999).
19. See N.L. Mitra Report on "Legal aspects of bank frauds, 2001".
20. For more detailed reading of the RBI's early functions, see "RBI: functions and working", Bombay, 1983.
21. See Preamble to the RBI Act, 1934.
22. *Venkateshwar Rice and Flower Mill* v. *Union Bank of India*, 1988, (63) Company Cases 483 AP.
23. *Canara Bank* v. *Canara Sales Corporation*, AIR 1987 SC 1603.
24. See AIR 1970 SC 564.
25. See Section 5 (c) of the Banking Regulation Act, 1949.
26. See Section 5 (c-a) of the Banking Regulation Act, 1949. This particular sub-section was incorporated by the Act 58 of 1968 and came into effect from the 1st February, 1969, when the first phase of bank nationalisation was effected.
27. Section 5 (c-a) of the Banking Regulation Act, 1949.
28. See *Canara Bank* v. *P.R.N.Upadhyaya* (1998) 6 SCC 526 at pp. 530-31; Also *RBI* v. *State Bank of India (SBI)*, 1996, (85) Company Cases 554, Bombay.
29. *K.M.Sethumadhavan* v. *Dhanalakhsmi Bank Ltd*, 1988, (64) Company Cases 399 (Ker).
30. *Associated Timber Industries* v. *Central Bank of India* AIR 2000 SC 2689.
31. *Phoenix Impex* v. *State of Rajasthan* AIR 1998 Raj 100 at 103.
32. *Associated Timber Industries* v. *Central Bank of India* (2000) 7 SCC 93 at p. 97.
33. European Community Credit Institutions Directive, 2001/12/EC, Article 1.
34. In terms of structure, this is a similar situation to the one that arose following the Banking Act, 1863, of the United States which created a class of nationally chartered banks in the US to be supervised by the Comptroller of the currency. The difference with the Indian situation is that while most of the banks were nationalised by the central government in India, a lot of the state banks in the US refused to obtain a national charter, thereby, retaining their duality.
35. See R.N. Malhotra, "India's monetary policy and the role of the banking system in economic development", RBI Bulletin, March 1990. Also RBI, "Report of the study group for follow-up of bank credit", RBI Publication, Bombay, 1975.
36. See RBI, *Functions and Workings*, RBI Publication, Bombay, 1983.
37. See the "Report of the advisory group on banking supervision" under the Chairmanship of M.S. Verma, submitted to the Government of India in September, 2000. Also see "Report of the advisory group on securities market regulation", under the Chairmanship of Deepak Parekh, submitted to the Government of India in May, 2000.
38. For detailed reading see "RBI: functions and working", Bombay, 1983.
39. See Preamble to RBI Act, 1934.
40. See *Bank of India Finance Ltd.* v. *Custodian AIR* 1997 SC 1952 at p. 1960; Also *Bharat Co-operative Bank Ltd.* v. *Bank of Baroda*, 2001, (105) Company Cases 870, at p. 879, (Guj).
41. *Bank of India Finance Ltd.* v. *Custodian AIR* 1997 SC 1952 at p. 1960.
42. *Bank of India Finance Ltd.* v. *Custodian AIR* 1997 SC 1952 at p. 1960.

43. *Attorney-General* v. *Cooper* [1974] 2 N.Z.L.R. 713 (C.A., N.Z.), p.720; Canadian Pacific *Tobacco Co. Ltd.* v. *Stapleton* (1952) 86 C.L.R. 1 (H.C. of A.).
44. See Narasimha Committee, "Report of the committee on the financial system", RBI, Mumbai, 1991, p. 130.
45. See RBI Annual Report 1995-1996, Bombay.
46. See Paper titled "Supervision of Indian financial system, 1995-2000", RBI, DBS, Mumbai, December, 2000.
47. See Paper titled "Supervision of Indian financial system, 1995-2000", RBI, DBS, Mumbai, December, 2000.
48. See "Special chapter on vigilance management in public sector banks", Paragraph 10.5, Central Vigilance Commission, India, 2001.
49. See Letter dated 5 April 2002, No. 001/MISC (V-3)/002 of the Central Vigilance Commission to Central Vigilance Officers (CVOs) and Chief Managing Directors (CMDs) of all banks, CVO/RBI Banking Division and Director of the CBI classifying bank fraud.
50. Supra 10, Tarapore Committee Report.
51. Supra 10, Tarapore Committee Report.
52. Supra 4.
53. See Report of the Leigh-Pemberton Committee, Cmnd 9550, June 1985, Chapter 5.
54. See Report of the Leigh-Pemberton Committee, Cmnd 9550, June 1985, Chapter 5.
55. Dale, Richard, "International banking deregulation". p. 113.
56. Dale, Richard, "International banking deregulation". p. 113.
57. See RBI, Report on Trend and Progress of Banking in India, 1999-2000.
58. See Annual Report of the RBI, 2001, RBI, Mumbai.
59. See Report on Co-operative Banks by Jagdish Capoor, Former Deputy Governor of the RBI, submitted to the Government in 2000.

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