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## ***ABOUT US***

WHITE BLACK LEGAL is an open access, peer-reviewed and refereed journal provided dedicated to express views on topical legal issues, thereby generating a cross current of ideas on emerging matters. This platform shall also ignite the initiative and desire of young law students to contribute in the field of law. The erudite response of legal luminaries shall be solicited to enable readers to explore challenges that lie before law makers, lawyers and the society at large, in the event of the ever changing social, economic and technological scenario.

With this thought, we hereby present to you

# **A SHIFT FROM REACTIVE TO PROACTIVE MEASURES: RBI'S MASTER DIRECTION ON FRAUD RISK MANAGEMENT 2024**

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## **Introduction:**

The article at hand explores the evolution of regulatory frameworks in relation to the Fraud risk management directions issued by RBI, focusing on a shift from older, reactive measures to more proactive strategies in addressing key issues. The previous regulation was primarily concerned with addressing problems as they arose, often responding to crises or challenges after they had already impacted the industry. In contrast, the newer regulation is designed to anticipate potential issues, aiming to prevent them before they escalate. This proactive approach is seen as more effective in promoting long-term solutions and fostering a more sustainable environment. The article also delves into a significant case where the Supreme Court intervened, issuing guidelines that called for immediate action on the regulation because of the violation of principle of natural justice in the older regulation. This ruling underscores the importance of adhering to more forward-thinking policies, ensuring that enforcement mechanisms are robust and can be implemented effectively to mitigate risks and safeguard public welfare.

On 15 July 2024, Reserve Bank Of India ("RBI") furnished the revised master direction on fraud risk management<sup>1</sup>, which supplanted Reserve Bank of India (Frauds - Classification and Reporting by commercial banks and select FIs) Directions 2016<sup>2</sup>, and it also consolidate all different types of 36 circulars on the same matter. This is done for the purpose of exercising the power designated under Chapter III-A and Chapter III-B of the Reserve Bank of India Act, 1934, and Section 21 and Section 35A of the Banking Regulation Act, 1949. But the main

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<sup>1</sup> [https://www.rbi.org.in/Scripts/BS\\_ViewMasDirections.aspx?id=12702](https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=12702)

<sup>2</sup> [https://www.rbi.org.in/Scripts/BS\\_ViewMasDirections.aspx?id=10477](https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=10477)



purpose to bring this Master Direction was to take a proactive approach rather than a reactive approach and also to ensure Principle of Natural Justice which was earlier seen as one of drawback in 2016 Circular as observed in the case of [State Bank of India & Ors. v. Rajesh Agarwal & Ors.](#) It was also done to amplify the existing substructures in banking sector for the purpose for prevention, detection and other such acts done in this sector.

This article will critically analysis the present master direction with the earlier one to look how the shift took place from reactive to proactive mechanism through the major changes in recent master circular. As well as this paper will also going to discuss the 'Judicial contribution' for the said changes and also for exercising of Principle of Natural Justice while reporting and detection of Fraud by the Banks.

### **Judicial Approach**

In [State Bank of India & Ors. v. Rajesh Agarwal & Ors.](#)<sup>3</sup>, Supreme Court has closely observed the issue that whether Reserve Bank of India (Frauds Classification and Reporting by Commercial Banks and Select FIs) Directions 2016, aligned with the Principle of Natural Justice. As the background of the case starts from the incident when the said circular was challenged before High Court of Telangana on the same ground as mentioned above and the judgment came in the favor of appellant that the said circular must be aligned to Principle of Natural Justice, then the respondent challenged the impugned judgment as civil appeal before the supreme court, and considering the following contention Supreme Court upheld the judgment of High Court of Telangana:

As per the clauses 8.9.4 and 8.9.5 of the said direction gives power to all banks to individually declares any account as red flag account or fraud and should communicate the same to RBI within 21 days of detection and also make it publish on CRCIL platform. All this clearly reflects the level of arbitrariness. This shows that there is no such direction under this clause which talks about giving notice to the borrowing company or it's promoter or any whole time director or a chance to hear them, which is the clear violation of one of the element of Principle of Natural Justice.

Furthermore there is no such direction mentioned where party is allowed to present their

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<sup>3</sup> <https://updates.manupatra.com/roundup/contentsummary.aspx?iid=42459>



defenses against the allegation like red flag of account or fraud which is charged against the borrowing company which is again a violation of 'Audi alteram partem', an important element of Principle of natural justice.

Also the parties are not getting any specific reason for the particular decision or judgment which is again one of the violation of 'Reasoned Decision' under principle of natural justice also parties are not getting any copy of the decision which again reflects the arbitrary power exercised by bank which is empowered through said directions.

The another main contention raised was as the objective behind the RBI Master direction is to do speedy and quick detection of any fraud and the reporting of such fraud to the authorized agencies should be done on earlier basis this alone cannot hinder or justifies the violation of Principle Of Natural Justice.

Another consequential contention raised was in relation to the diplomacy related to the rights conferred under the said direction was raised as under the clause 8.12.5<sup>4</sup>, the scope get widen by giving opportunity to being heard to third party but the same scope get narrower in case of borrower.

The other contention reflects light upon the objective of the said circular by stating that the act will become toothless if in case the fraudulent borrowers not get restricted from availing the financial services, mentioning it as preventive action but on same page it violates Articles 14,19 and 21 of the promoters, directors because this restriction is for 05 year and for this no show cause notice as well as no opportunity of being heard has been provided to said borrowers, which is again a violation of principle of natural justice<sup>5</sup>.

Even the said circular is silent about the participation of borrower in the process of forensic audit report as well as again violating the principle of natural justice, as there is lack of transparency which can cause biasness towards one and make the process arbitrary in nature.

The observation done by the court is on the basis of abovementioned grounds and so the conclusive remark is also given on the same certain grounds where court also has directed the

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<sup>4</sup> <https://indiankanoon.org/doc/105925409/>

<sup>5</sup> <https://indiankanoon.org/doc/105925409/>

RBI to look into the said Master Direction and directs to issue the show cause notice to the borrowers by the banks and also directs to look into the clauses or regulations which directs the involvement of borrowers in the process of forensic audit report.

### **Comparative study between new regime and old regime:**

Under legal framework the comparative analysis of both the Master circular dated 2016 and 2024 will be discussed and with the help of said comparison the shift from reactive to proactive measures will be represented. Most important changes that has been done are articulated here: First shift towards proactive mechanism can be observed by comparing the governing structure of present direction and the earlier one as in earlier one there was lack of accountabilities on top managerial persons and the regulation was silent about it which was one of the biggest grey area, but this issue has been resolved as the present direction in Clause 2.1.4<sup>6</sup>, it is clearly mention that it's a duty of senior management to conduct periodical review of the said fraud risk management policy as well as implementing such policy is also there duty to perform.

In clause 2.1.4 the accountability on senior management like General Manager and all other persons of equivalent positions has increased, as they are responsible to look over institutional fraud detection and also to take justified action on these frauds.

Thirdly, this direction also gives importance to the transparency along with the organizational structure which is needed to be maintained. As in clause 2.1.5<sup>7</sup>, the transparency needed to be maintained in case of whistle blower policy and to enhance its applicability.

As per clause 2.1.3.1<sup>8</sup> the role of Independent directors as well as non executive directors gets more vital in present direction, which also increased their responsibility as well as accountability. As they are the most important members of 'Special Committee of the Board for Monitoring and Follow-up of cases of Frauds' along with whole time director but the committee will be headed by either independent director or non executive director, which is again a big step taken by RBI for making the process fair in nature.

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<sup>6</sup> [https://www.rbi.org.in/Scripts/BS\\_ViewMasDirections.aspx?id=12702](https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=12702)

<sup>7</sup> [https://www.rbi.org.in/Scripts/BS\\_ViewMasDirections.aspx?id=12702](https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=12702)

<sup>8</sup> [https://www.rbi.org.in/Scripts/BS\\_ViewMasDirections.aspx?id=12702](https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=12702)

The most important change which highlights the shift from reactive to proactive measures is Early Warning Signals and Red flagging of account. These will help to trace any fraud at its early stage as well as ensures timely action needed to be taken against such fraud.

Another most important proactive step reflected under clause 3.3.2 was to formulate Data Analytics and Market Intelligence (MI) Unit by taking into consideration of risk outline, dimensions, complexity and their work is to store and operate all the information which is needed to detect the early warning signals for fraud as well as take the preventive step against such fraud.

Another most important grey area of previous circular get cured here as the present direction outlines the framework for money mules related transactions as well as non credit related transactions or other banking transactions which was not discussed in the early circular and ,all these said transaction will also be regulated and governed under Early Warning Signal procedure.

For making more preventive procedure in the present Direction under clause 4.1.1, the Banks are accountable to design certain outline for appointing external auditor for the purpose of investigation in the case where a credit facility or loan account being red flagged and this outline consists of data which reflects the auditor's competency.

The most important clause which reflects the drastic shift is the clause 4.4.2 of earlier direction which sets the threshold amount for special committee to proceed with their investigation which is for all such frauds which amounts 1 lakh and above now get abolished under the new direction.

Another clause states about the staff accountability in cases where fraud amounting to rupees 3crore and above took place. Here staffs represents all higher management like whole time director, as well as all level of officials including ex officials will be accountable for such fraud, for the same the past direction was silent.



## Conclusion

‘Prevention is always better than cure’ it is a general phrase used by us in day to day life, the same must get apply here also as there were a lot of grey areas in the earlier guideline, and the principle of natural justice was also get hindered by the earlier master directions. But when we see the new circular which is passed by RBI, it seems to be a great preventive step taken by the RBI. As the circular covers all such area which will help to reduce the level of fraud taking place in the said sector and this is because of considering the observation made under the abovementioned case. As earlier the provisions were more reactive which was not sufficient enough to reduce the fraud taking place in the said sector.

Now collectively the principle of natural justice has also get adopted by adding the clauses like serving show cause notice has become compulsory in nature, as well as the importance of independent and non executive directors become more crucial for the purpose of detecting fraud which made the system transparent and reduces the arbitrariness of the authority. In addition to this the responsibility over senior management has also become crucial by making them responsible for conducting periodic review.

As well as advancement in terms of technical grounds for the purpose of fraud detecting also gets scrutinized by adding clauses in relation to ‘Early Warning Signals’ and ‘Red Flagging’ of suspected accounts. Role of external auditor makes the investigation fair and reliable in nature. As well as inclusion of clauses in relation to data analytics as well as market intelligence make the process more reliable. Also when we look upon the threshold limit which was earlier 1 lakh, get abolished under present direction in case where special committee needed to start their investigation, this reflects another preventive measures in regard to fraud detection as it can be traced at early stage only and risk for loss of large amount will also get lesser in this case.

All these huge changes are highly required as in today’s world digitalization is on the peak and replacing the traditional mode of payments or transaction, so for making this mode secure and reliable, scrutiny is highly required and for the same all these steps will be helpful and not only this but also these preventive measures will be able to control the fraud cases in a better and organized way in comparison to those reactive measures under earlier direction.