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# **An Introduction to the Theory of Concentric Circles of Law and Fraud through the Study of Internal Frauds and Internal Fraudsters in the Banking Industry**

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## **ABSTRACT**

The present paper studies the various dimensions of the internal frauds committed in the Banking industry. Based on the findings of the study, the researcher has attempted to construct the possible profile of an internal fraudster. Further, the data has also led the researcher to come up with a new theory which covers all the facets of the existing fraud theories which are fraud triangle, fraud diamond, fraud pentagon, fraud hexagon and fraud octagon. The new theory covers the aspects of fraud as well as law and hence the theory is named as the ‘concentric circles of law and fraud.’

**KEY WORDS:** Law, fraud, concentric circles of law and fraud, bank frauds, internal frauds, occupational frauds, internal fraudster, fraud triangle.

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## **INTRODUCTION**

*Why do you lock the locker?*

*Why do you verify the encumbrance before accepting a property as security?*

*Why do you have a staff accountability policy?*

*Why do you have a whistle blower policy?*

These are a few questions I asked different bankers. All the answers pointed out that it these were precautionary measures and due diligence exercised by the Banks. The next question was ‘why?’ The answer is the most obvious one – Banks feel that if there are no precautions in place, if there is no due diligence, if staff accountability is not fixed, if there is no protection for whistle blowers, then frauds will occur. If frauds occur it will put the Bank at stake. The repute of the Bank will be tarnished. The Bank will be at loss. The smooth functioning of Banks will be tampered with. It is at this juncture, the need for a study into the facet of bank frauds and the necessity to build an armour to prevent such frauds arise. This thought has strongly cemented the foundation of the research for this paper.

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## **HYPOTHESES**

That Banks are victims of frauds and that the major league of such frauds involves an insider of the bank who is highly qualified, least suspected and acts disloyal under the guise of loyalty which depicts internal frauds as a greater threat to Banks than external frauds.

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## **RESEARCH METHODOLOGY**

The researcher, has opted for ‘mixed’ methodology of research which covers both qualitative and quantitative methodology. Doctrinal and non-doctrinal research is involved in the study. The sampling method was snowball sampling and the specific research tools opted are:

1. Conversational Interviewing
2. Questionnaire
3. Case study
4. Observation Method

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## INTERNAL FRAUDS IN BANKS

Fraud is a criminal deception or the using of false representations to obtain an unjust advantage or to injure the rights or interests of another.<sup>1</sup> Bank fraud is the losses sustained by Banks as a result of frauds exceed the loss due to robbery, dacoity, burglary and theft – all put together.<sup>2</sup> Let us now examine why has this study focused on internal frauds in banks. Internal frauds or occupational frauds in banks are frauds committed by the bank members themselves by misusing their official capacity for illegal gains. During the conversational interview, each of the respondents were asked if the biggest scam of their Bank had the active involvement of an insider and most of them answered in the affirmative. Let me paraphrase the words of one of the respondents:

*“Insider frauds are real nightmares. The frauds committed by an insider has caused more loss to than bank than the entire frauds that occurred in the financial year xxxx-yyyy. Such frauds remain the biggest frauds our Bank has ever witnessed.”*

It was also seen in the research that most bankers agree that in every fraud, some sort of staff lapse is involved. This clearly struck the thought of the researcher that if bank frauds are to be reduced and gradually wiped off, the rectification should commence internally. The researcher decided to focus on internal frauds after distilling the secondary data.

While conducting this research, the researcher collected primary data and secondary data. In order to know the statistics on the number of frauds, amount involved and the nature of Banks, the best source of data was the Annual Reports published by the Reserve Bank of India (RBI). RBI is the central bank of the country and the authority responsible for the regulation of the banking system of the country. In the statistics published by RBI, the fraud with maximum number and highest amount involved is advanced related frauds. To curb this menace, RBI in hand with other agencies of the Government are constantly working on improvising of law.

There were ten different categories of frauds that were elucidated in the Annual Reports of RBI. But none of them we internal frauds or frauds committed bank employees. Even in advance related frauds, the researcher is sure in the light of the primary data collected that, a good number of them would have been committed by fraudsters within the Bank or by external parties with the active connivance of fraudsters within he Bank.

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## FINDINGS OF THE STUDY

The findings of this study have shown that, when compared to external frauds, internal frauds are a bigger threat to Banks. In terms of loss caused to banks, internal frauds inflict higher damage than external frauds. However, when it comes to the number of bank frauds, external frauds are more in number than internal frauds. However, when the number of frauds and the loss caused are weighed against each other, the results of the study clearly established that even though the number of internal frauds is lesser than external frauds, it is capable of causing huge loss to the victim bank. Every time an internal fraud is detected, the Banks modify the internal control mechanisms. Then, the internal fraudsters find lacunae in the internal mechanism and try to break the law i.e. internal control. Then the Bank again modifies their internal framework and the cat and mouse between the internal fraudster and bank continues ripples. The other findings of the study are:

- Majority of the people working in the banking sector would have come across fraud at least once in their banking career.
- In banks, external frauds are more in number when compared to internal frauds.
- In most of the Bank frauds, some sort of staff lapse is involved.
- The most common internal fraud in bank is Corruption.
- The second most common internal fraud is cash on hand.
- Register disbursements and payroll are the least common frauds.
- The most common method of committing occupational frauds in the Banking and financial services industry is through asset misappropriation.
- The same is followed by the methods of corruption & financial statement fraud.
- In Banks, internal frauds are mostly detected through tips and internal audits.
- More internal frauds in Banks are committed by persons who hold a tenure of more than five years in the Bank.
- The most effective anti-control mechanisms that are adopted in the Banking and financial institution is external audit of financial statements.

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## PROFILE OF THE FRAUDSTER AND ANTICIPATION OF FRAUD

Through a meticulous analysis of the primary data and secondary data, the researcher has constructed a possible the profile of an internal fraudster in Banks. This is not an absolute profile free from errors. The profile is built on the majority case basis and by analyzing the data collected. The profile of the occupational fraudster who commits frauds in banks mostly embrace the following:

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<sup>1</sup> P. Ramanatha Iyer, ‘Concise Law Dictionary’ 3rd Edn(2011) pg. 476;Sec.17 Indian Contract Act, 1872

<sup>2</sup> Dr. Gupta and Agrawal, ‘Forensic Science in Criminal Investigation and Trial’ (2013) pg.1324.

- The fraudster would have completed more than five years in the victim bank.
- The fraudster committed frauds while working at a Branch wherein there is close contact with customers and cash dealings.
- The approximate age of the fraudster is between 30 to 40.
- The fraudsters are mostly men.
- The fraudster commits fraud in active collusion with another colleague or an outsider.
- The fraudster is one of the best employees of the Bank, trusted and educated with at least a master's degree.
- The most common behavioural red flag is that the fraudster as such or the branch would show an exceptional growth.

The findings of the study indicate that the imparting of proper training will enable the anti fraudsters in a bank to spot the patterns and anticipate possible frauds and the respective area of operations. This finding is well cemented by the findings of the research. The different facets of the internal frauds in Banks are also discussed in this paper. With the help of this kind of data, if the employees of Bank or the anti-fraud team of the bank is given sufficient training, it will enable them to anticipate the potential frauds and prevent them. This will reduce the number of frauds in due course.

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## THE THEORY OF CONCENTRIC CIRCLES OF LAW AND FRAUD

The results of this study revealed that the current theories of fraud are defective and deficient. The triangle theory of fraud lacked all the elements of fraud whereas the fraud diamond, fraud pentagon, fraud hexagon and fraud octagon lack a common point of connection among the different elements of fraud. It is also seen that the theories are silent about law and prevention.

In order to overcome this difficulty, a new theory is developed in this study. The theory is called as the concentric circles of law and fraud. This theory shows the common point of connection among the different elements of fraud, how law is made, how fraudster breaks the law and how the law keeps amending itself to adapt to the needs of the day. The theory elucidates an inner criminal element as the center point, various factors that prompt fraud commission as the radii, and law as the line drawn around it which makes it a circle. When the internal fraudsters extend one or more of their factors and the law gets modified to prevent them, it gives the pattern of ripples i.e. concentric circles. As the shape is circle and the factors of fraud are the radii, any factors that may be added in the future can be included without altering the basic shape or outline of the theory. From the academic point of view, the theory is easy to learn and brings down the burden of learning more theories every time a new factor responsible for fraud is added.

Finally, the application of this theory is not confined to Banking industry. The researcher proposes this theory as a theory applicable to internal frauds or occupational frauds in general. However, the data which led to the formulation of this theory is confined to data collected from Banking sector only.

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## CONCLUSION

A strong foundation holds the life of a building. Likewise, bank employees constitute the foundation gives life and strength to a Bank. If the foundation is weak, the building will fall. Hence it is extremely necessary that internal frauds are to be prevented. However, in the light of the data collected, the researcher feels that adequate attention is not given to this aspect and hence, focused on this area of bank fraud.

It is necessary that not only the base is strong but also the fencing around the building should also be strong to protect the banks from frauds. The theory of concentric circles of law and fraud is a comprehensive theory that covers not only an internal fraudster, but also leaves an idea of extending the same to frauds perpetrated by an external fraudster. Another major highlight of the theory is that it also deals with anti-fraudster and the law of prevention of frauds. The application of this theory is not confined to Banking industry. The researcher proposes this theory as a theory applicable to internal frauds or occupational frauds in general. This is a theory that may have a blanket application to all sorts of occupational frauds.

In short, the study of internal frauds in the Banking industry has led to the introduction of the theory of concentric circles of law and fraud. The present paper is only an introduction. The theory will be explained in detail by the researcher in a separate research paper with all its different dimensions. The researcher submits this piece of anti-fraud work as a salutation to the universal anti-fraud community.