The Limits of Audi Alteram Partem in Banking Fraud Regulation

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Introduction

The doctrine of *audi alteram partem*, meaning "hear the other side," is one of the foundational principles of natural justice. It ensures that no person is condemned unheard and that every individual whose rights or interests are likely to be affected by an administrative decision is given an opportunity to present their case. Indian administrative law has long treated this doctrine as an essential safeguard against arbitrariness, abuse of power, and unfairness. Courts have repeatedly emphasized that fairness is a basic component of the rule of law and that administrative authorities cannot exercise power in a manner that destroys individual rights without procedural protection.[1]

However, despite its importance, the doctrine has never been considered absolute. Courts have consistently maintained that natural justice is flexible and context-dependent.[2] Its application depends upon the nature of the action, the urgency involved, statutory objectives, and the balance between individual rights and public interest. This tension between fairness and efficiency became particularly significant in the context of banking fraud regulation after the Reserve Bank of India issued the Master Directions on Frauds, 2016.[3]

The RBI Directions created a framework for early detection and reporting of banking frauds. Under this mechanism, banks were empowered to identify suspicious borrower accounts, conduct forensic audits, classify accounts as fraudulent, and report them to investigative agencies such as the CBI. Since fraud classification carried severe civil and reputational consequences, borrowers began challenging these actions before courts, arguing that they violated the principles of natural justice because no hearing was granted before fraud declaration.

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[1] *State Bank of India v. Rajesh Agarwal*, MANU/SC/0308/2023, para 29.

[2] Id.

[3] Reserve Bank of India, *Master Directions on Frauds – Classification and Reporting by Commercial Banks and Select FIs*, DBS.CO.CFMC.BC.No.1/23.04.001/2016-17 (July 1, 2016), https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=10477.

The Supreme Court dealt extensively with these issues in *State Bank of India v. Rajesh Agarwal* (2023)[4], *State Bank of India v. Amit Iron Pvt. Ltd.* (2026)[5], and *Central Bureau of Investigation v. Surendra Patwa* (2025)[6]. Together, these judgments shaped the modern legal position regarding the extent to which *audi alteram partem* applies in banking fraud matters while classifying the borrower's account as fraudulent by banks, NBFCs etc. While *Rajesh Agarwal* introduced procedural safeguards into the RBI framework, *Amit Iron* clarified that fairness does not necessarily require oral or personal hearing. *Surendra Patwa* further separated administrative fraud classification from criminal proceedings and reinforced the idea that criminal investigations cannot be delayed by excessive procedural requirements.

These judgments establish that the doctrine of *audi alteram partem* is adaptable; in the context of banking fraud, it is satisfied by a written representation rather than a mandatory oral hearing.

RBI Fraud Framework and the Role of the Fraud Committee

To understand why the Supreme Court adopted this approach, it is important to first understand about the directions issued by RBI on fraud. The RBI issued the Master Directions on Frauds, 2016 with the primary objective of ensuring early detection, reporting, and prevention of frauds in the banking system. The purpose behind these directions was not merely recovery of money but also protection of the financial system, maintenance of depositor confidence, and prevention of systemic banking risks.[7]

Under the framework, banks are required to continuously monitor borrower accounts for suspicious conduct through mechanisms such as Early Warning Signals (EWS). These warning signs may include diversion of funds, fake stock statements, undisclosed liabilities, irregular movement of money, inflated assets, cheque bouncing, or manipulation of financial records. Once such warning signs are detected, the account may be classified as a Red Flagged Account (RFA), after which the bank usually orders a forensic audit.[8]

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[4] *State Bank of India v. Rajesh Agarwal*, MANU/SC/0308/2023 : (2023) 6 SCC 1.
[5] *State Bank of India v. Amit Iron Pvt. Ltd.*, MANU/SC/0324/2026 : 2026 INSC 323.
[6] *Central Bureau of Investigation v. Surendra Patwa*, 2025 INSC 572.
[7] *State Bank of India v. Amit Iron Pvt. Ltd.*, MANU/SC/0324/2026 : 2026 INSC 323, para 16.
[8] *State Bank of India v. Amit Iron Pvt. Ltd.*, MANU/SC/0324/2026 : 2026 INSC 323, paras 18–20.

At this stage, the role of the Fraud Monitoring Group (FMG) and the Special Committee of the Board for Monitoring and Follow-up of Frauds (SCBF), commonly referred to as the fraud committee, becomes crucial. The FMG examines suspicious conduct and analyses the forensic findings. Thereafter, the fraud committee evaluates whether the borrower's conduct actually amounts to fraud under the RBI framework.[9] If satisfied, the committee authorizes fraud classification and reporting to RBI and investigative agencies.

The consequences of fraud classification are extremely severe. The borrowers may be denied future institutional finance, blacklisted within the banking system, subjected to reputational harm, exposed to insolvency proceedings, and investigated by law enforcement agencies such as the CBI. In *Rajesh Agarwal v Reserve Bank of India and Ors*, the Telangana High Court recognized that these consequences resemble "civil death" because they seriously impair the borrower's ability to conduct business and access credit.[10]

The Rajesh Agarwal Judgment (2023)

The first major challenge to this framework came in *State Bank of India v. Rajesh Agarwal* (2023). The controversy in this case arose because the RBI Master Directions did not expressly provide borrowers any hearing before fraud classification. Borrowers argued that declaring an account fraudulent carried severe civil consequences and therefore violated natural justice if done without hearing them.[11]

The Supreme Court accepted this argument to a considerable extent. The Supreme Court held that fraud classification was not merely an internal administrative exercise because it carried serious civil consequences, including blacklisting and reputational damage.[12] The Supreme Court therefore read the principles of natural justice into the RBI framework and held that borrowers

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[9] RBI Master Directions on Frauds, Clause 8.9; *State Bank of India v. Amit Iron Pvt. Ltd.*, MANU/SC/0324/2026 : 2026 INSC 323, paras 38–39.
[10] *Rajesh Agarwal v. Reserve Bank of India and Ors*, MANU/TL/0419/2020, paras 7–8.
[11] *Rajesh Agarwal v. Reserve Bank of India and Ors*, MANU/TL/0419/2020, paras 10.1–10.7.
[12] *State Bank of India v. Rajesh Agarwal*, MANU/SC/0308/2023 : (2023) 6 SCC 1, paras 37–43.

must receive notice, opportunity to explain the allegations, disclosure of the conclusions of the forensic audit report, and a reasoned order before fraud classification.[13]

Accordingly, the Supreme Court held that principles of natural justice had to be read into the RBI Directions. Before classifying an account as fraudulent, banks were required to issue a show cause notice, disclose the conclusions of the forensic audit report, provide an opportunity to explain, consider the borrower's response, and pass a reasoned order.

However, even while recognizing borrower rights, *Rajesh Agarwal* also made an important distinction between administrative action and criminal proceedings. The Supreme Court clarified that principles of natural justice apply before fraud classification since the decision substantially affects the borrower's civil rights and reputation. At the same time, no hearing is required before registration of an FIR or initiation of criminal investigation because criminal proceedings stand on a different footing.

Thus, while *Rajesh Agarwal* strengthened procedural fairness, it did not make natural justice absolute.

The Regulatory Shift: The Master Directions, 2024

Following the procedural gaps highlighted in *Rajesh Agarwal*, the RBI systematically overhauled its framework by issuing the *Reserve Bank of India (Fraud Risk Management in Commercial Banks) Directions, 2024*. Unlike the 2016 Master Directions, which were silent on natural justice, the 2024 framework explicitly embedded procedural fairness into the classification process.[14]

Under Chapter II, Clause 2.1 of the 2024 Directions, banks are now mandated to implement a Board-approved policy that ensures compliance with the principles of natural justice through a structured mechanism. This minimum standard includes:

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[13] *State Bank of India v. Rajesh Agarwal*, MANU/SC/0308/2023 : (2023) 6 SCC 1, paras 65 and 79.

[14] Reserve Bank of India, *Master Direction – Fraud Risk Management in Commercial Banks (including Regional Rural Banks) and All India Financial Institutions – Directions, 2024*, RBI/2024-25/31, DOR.STR.REC.13/21.04.048/2024-25 (July 15, 2024), https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=12702.

1. **Detailed Show Cause Notice (SCN):** Issuance of an SCN providing complete details of the transactions or events forming the basis of the contemplated fraud declaration.
2. **Mandatory Response Window:** Providing the borrower, promoters, and executive directors a reasonable time of not less than 21 days to respond to the SCN.
3. **Structured Evaluation:** A well-laid-out system for examining the borrower's responses prior to classification.
4. **Reasoned Order:** The issuing of a speaking order conveying the final decision, containing the relevant facts relied upon, the borrower's submissions, and the reasons for the classification.

This explicit codification of procedural rights in 2024 fundamentally altered the landscape, setting the stage for the Supreme Court's subsequent evaluation in *Amit Iron* regarding the necessity of extending these rights even further to include personal hearings.

Delay and Inefficiency in Fraud Regulation

One of the strongest reasons why *audi alteram partem* should not always apply in its fullest sense in banking fraud matters is the problem of delay. Banking fraud is not an ordinary administrative issue; it involves sophisticated financial transactions, movement of public money, and rapid diversion of assets. If banks are compelled to provide extensive oral hearings to every borrower, promoter, and director before fraud classification, the process may become excessively slow and ineffective.

This concern became a central issue in *State Bank of India v. Amit Iron Pvt. Ltd.* (2026). After *Rajesh Agarwal*, several High Courts interpreted the judgment as requiring mandatory personal hearings and complete disclosure of forensic audit reports. Banks argued that such an interpretation would paralyze the fraud detection mechanism created by the RBI.[15]

The Supreme Court accepted this concern. The Supreme Court noted that fraud cases often involve multiple borrowers, consortium lending arrangements, large financial structures, and huge public exposure. Requiring oral hearings in every case would create enormous logistical and administrative burdens on banks. Senior officials who are otherwise responsible for core banking

[15] *State Bank of India v. Amit Iron Pvt. Ltd.*, MANU/SC/0324/2026 : 2026 INSC 323, paras 6–11.

functions would spend excessive time conducting hearings, thereby delaying decision-making and fraud reporting.[16]

The Supreme Court also referred to alarming RBI statistics regarding the staggering volume of banking frauds involving thousands of crores of public money. Specifically, the Supreme Court noted that in the financial year 2024-25 alone, the total amount involved in reported frauds reached ₹36,014 crores, with public sector banks accounting for a massive ₹25,667 crores of that figure. In such circumstances, speed becomes essential. Delays caused by extensive procedural formalities may ultimately defeat the purpose of the RBI framework itself. .[17]

Therefore, the Supreme Court in *Amit Iron* clarified that fairness could sufficiently be achieved through written notice, opportunity to submit written representation, consideration of that reply, and a reasoned order. Personal hearing was held to be unnecessary in most cases.

Risk of Asset Diversion and Destruction of Evidence

Another important reason why *audi alteram partem* cannot always apply fully in banking fraud matters is the danger of asset diversion and destruction of evidence. Financial fraud is fundamentally different from ordinary administrative misconduct because it often involves concealment of transactions, manipulation of records, and movement of funds across multiple entities.

The RBI and banks argued before the Supreme Court that if borrowers are given extensive advance procedural opportunities, they may use the delay to:

1. siphon funds,
2. transfer assets,
3. manipulate accounts,
4. influence witnesses,
5. abscond from jurisdiction, or

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[16] *State Bank of India v. Amit Iron Pvt. Ltd.*, MANU/SC/0324/2026 : 2026 INSC 323, paras 30–33.
[17] *State Bank of India v. Amit Iron Pvt. Ltd.*, MANU/SC/0324/2026 : 2026 INSC 323, paras 36–37;Reserve Bank of India, *Annual Report 2024-25* (2025), https://www.rbi.org.in/Scripts/AnnualReportPublications.aspx?Id=1436.

6. destroy documentary and digital evidence.[18]

The Supreme Court in *Amit Iron* accepted these concerns. It recognized that fraud detection requires urgency and confidentiality. If suspected borrowers are forewarned too early through prolonged oral hearings, the very purpose of fraud regulation may be frustrated.

This reasoning also appears in *Surendra Patwa*, where the Supreme Court reiterated that no hearing is required before registration of an FIR because criminal investigations require secrecy and prompt action.[19] The Supreme Court relied upon earlier precedents such as *W.N. Chadha*, where it was held that prior hearing before investigation would obstruct justice and defeat the criminal process.[20]

Thus, the risk of evidence destruction and asset diversion justifies limiting the application of natural justice at preliminary stages.

Fraud Classification Is Regulatory, Not Criminal Conviction

Another major reason why *audi alteram partem* should not apply in its fullest form is that fraud classification is essentially regulatory and administrative in nature. It is not equivalent to criminal conviction.[21]

This distinction was repeatedly emphasized in *Rajesh Agarwal*, *Amit Iron*, and *Surendra Patwa*. Fraud classification primarily serves regulatory objectives such as:

1. protecting public money,
2. preventing further lending,
3. alerting other banks,
4. enabling early investigation,

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[18] *State Bank of India v. Amit Iron Pvt. Ltd.*, MANU/SC/0324/2026 : 2026 INSC 323, para 33; Reserve Bank of India, *Master Directions on Frauds – Classification and Reporting by Commercial Banks and Select FIs*, DBS.CO.CFMC.BC.No.1/23.04.001/2016-17, cl. 8.11.1 (July 1, 2016), available at https://www.rbi.org.in/Scripts/BS_ViewMasDirections.aspx?id=10477.
[19] *Central Bureau of Investigation v. Surendra Patwa*, 2025 INSC 572.
[20] *Union of India v. W.N. Chadha*, MANU/SC/0149/1993 : 1993 Supp (4) SCC 260.
[21] *State Bank of India v. Rajesh Agarwal*, MANU/SC/0308/2023 : (2023) 6 SCC 1, para 30.

5. and maintaining banking stability.

It does not determine criminal guilt. Criminal liability is determined separately through investigation, trial, and judicial adjudication.

The Supreme Court in *Surendra Patwa* clearly held that fraud classification and criminal proceedings operate in completely different legal spheres. Even if a fraud classification order is later set aside for procedural defects, FIRs and criminal investigations can continue independently because registration of an FIR merely sets criminal law into motion.[22]

Therefore, demanding trial-like procedural safeguards at the administrative stage would blur the distinction between regulation and criminal adjudication.

RBI's Institutional Expertise and Public Interest

The Supreme Court also recognized the RBI's institutional expertise in financial regulation. The RBI is a specialized statutory authority entrusted with maintaining banking stability, protecting depositors, and supervising financial institutions. Courts generally show deference to expert regulatory bodies in matters involving technical economic policy.

In *Amit Iron*, the Supreme Court accepted the RBI's argument that the fraud framework was designed after considering practical realities of banking operations and fraud detection.[23] The RBI intentionally structured the process around written notice, written response, forensic audits, and internal committee review because such a system balances fairness with efficiency.

Excessive judicial insistence on oral hearings and extensive disclosure requirements could undermine the RBI's ability to combat financial fraud effectively. Banking regulation requires speed, discretion, and technical expertise. Courts therefore recognized that some flexibility in procedural requirements is necessary to preserve the effectiveness of the regulatory framework.

Public interest also played a central role in these judgments. Banking frauds involve public money, depositor confidence, and economic stability. Where enormous sums of public money are at risk,

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[22] *Central Bureau of Investigation v. Surendra Patwa*, 2025 INSC 572.
[23] *State Bank of India v. Amit Iron Pvt. Ltd.*, MANU/SC/0324/2026 : 2026 INSC 323, paras 26–34.

the collective interest of the financial system may outweigh the borrower's demand for extensive procedural formalities.[24]

Separation Between Administrative Action and Criminal Proceedings

The clearest distinction emerged in *Central Bureau of Investigation v. Surendra Patwa* (2025). After *Rajesh Agarwal*, several High Courts had begun quashing FIRs and criminal proceedings merely because fraud classification violated natural justice.

The Supreme Court strongly rejected this approach. It held that administrative fraud classification by banks and criminal proceedings conducted by investigative agencies such as the CBI are entirely distinct processes governed by different legal principles.

The Supreme Court emphasized that:

1. fraud classification is administrative,
2. FIR registration is criminal,
3. banks and RBI conduct the former,
4. investigative agencies conduct the latter.[25]

Thus, even where fraud classification is set aside for non-compliance with natural justice, criminal investigation may still continue independently. The Supreme Court once again reiterated that no prior hearing is required before registration of FIR because criminal law cannot be obstructed by procedural delays.

This distinction became crucial because it prevented borrowers from using procedural defects in administrative action as a shield against criminal investigation.

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[24] *State Bank of India v. Amit Iron Pvt. Ltd.*, MANU/SC/0324/2026 : 2026 INSC 323, paras 16–17.
[25] *Central Bureau of Investigation v. Surendra Patwa*, 2025 INSC 572.

Conclusion

The doctrine of *audi alteram partem* remains one of the most important safeguards against arbitrary administrative action. However, the Supreme Court through *Rajesh Agarwal*, *Amit Iron*, and *Surendra Patwa* has clarified that the doctrine cannot be applied mechanically in classifying the borrower’s account as fraudulent.

While *Rajesh Agarwal* catalyzed the introduction of procedural safeguards, leading the RBI to explicitly codify the right to notice and reasoned orders in the Master Directions, 2024, *Amit Iron* clarified the outer limits of these rights. The Supreme Court affirmed that the 2024 framework's guarantee of a written representation is sufficient, and fairness does not mandate an oral hearing. *Surendra Patwa* further protected the system by separating administrative fraud classification from criminal proceedings, ensuring that criminal investigations are not frustrated by procedural challenges at the administrative stage.

These judgments collectively recognize that banking fraud regulation involves competing concerns. Borrowers are entitled to procedural fairness because fraud classification has severe civil and reputational consequences. At the same time, excessive procedural formalities may delay fraud detection, weaken regulatory efficiency, endanger public money, and obstruct criminal investigation.

Ultimately, the Supreme Court adopted a balanced approach in which fairness is preserved without sacrificing efficiency, public interest, and the practical realities while classifying the account of the borrower as fraudulent.