

Scams in Banking sector A Case study with reference to PNB

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1.1 INTRODUCTION

Definition of Scam

A fraudulent scheme performed by a dishonest individual, group, or company in an attempt to obtain money or something else of value. Scams traditionally resided in confidence tricks, where an individual would misrepresent themselves as someone with skill or authority, i.e. a doctor, lawyer, investor.

Scam in Punjab National Bank and Key persons involved

The Punjab National Bank Fraud Case relates to a fraudulent letter of undertaking worth ₹11,356.84 crore (US\$ 1.4 billion) issued by the Punjab National Bank at its Brady House branch in Fort, Mumbai; making Punjab National Bank liable for the amount.

Key Persons: Nirav Modi, Ami Modi, Nishal Modi, Mehul Choksi, all partners of the firms, M/s Diamond R US, M/s Solar Exports and M/s Stellar Diamonds; along with PNB officials and employees.

Introduction to Punjab National Bank

Punjab National Bank is a public sector banking and financial service company headquartered in New Delhi, India. It was established in 1894. As of financial year ending 2019, it has 110 million customers, 7001 branches and 10681 ATMs across 764 cities.

It has branches in UK (PNB International Bank, with 7 branches in the UK), Hong Kong, Kowloon, Dubai, and Kabul. It has representative offices in Almaty (Kazakhstan), Dubai (United Arab Emirates), Shanghai (China), Oslo (Norway), and Sydney (Australia). In Bhutan, it has 51% of Druk PNB Bank which has 5 branches. In Nepal, 20% of Everest Bank Ltd (50 branches) is owned by PNB and PNB owns 84% of JSC (SB) PNB Bank in Kazakhstan (4 Branches).

PNB is a PSU under the Central Government of India and is regulated by the Reserve Bank of India Act, 1934 and Banking Regulation Act, 1949.

Reforms

On 1st March 2018, government approved the Fugitive Economic Offenders Bill to deter economic offenders from evading the process of Indian law by giving powers to the government to confiscate assets of a fugitive, including Benami assets of absconding loan defaulters. The bill covers a wide range of economic offenders which include: loan defaulters, fraudsters, individuals who violate laws governing taxes, black money, benami properties, financial sector, and corruption. On 12 March 2018, the government introduced the bill in the Lok Sabha.

In March 2018, the Reserve Bank of India scrapped banking instruments such as the Letter of understanding (LoU) and Letter of Comfort (LoC) that to plug a loophole and improve banks due diligence in trade credit. Some bankers said that LoUs and LoCs led to receiving banks depending completely on the issuing bank on creditworthiness.

Mission of PNB

Creating Value for all its customers, Investors and Employees for being the first choice for all stakeholders

Vision of PNB

To position PNB as the `Most Preferred Bank` for customers, the `Best Place to Work In` for employees and a `Benchmark of Excellence` for the industry

Products & Services Offered by Punjab National Bank

Punjab National Bank offers financial solutions and services in an array of sectors. All these services that are offered keep pace with the changing market trends in order to fulfil the needs and preferences of the customers. Some of the well-known sectors on which the main functions of the bank are based are

- Personal Banking
- Corporate Banking
- Agriculture finance services
- Industrial finance services
- Trade financial services
- Savings Fund Account
- Fixed Deposit scheme

- Current account
- Loan services
- Centralized Banking Solutions (CBS): CBS, an inter-branch networking and data-sharing platform helps to operate account from any city in India having CBS networked branches. Changing status from Customer of the Branch to Customer of the Bank, presently, there are over 2,616 CBS networked branches in 820 cities.
- NRI & Tourists: Currency exchange services are being provided by our Exchange Bureaus spread throughout the country.
- Online Tax Payment: PNB provides the facility of online payment of service tax, excise duty, DGFT, custom duty & all charges under MCA.
- Cash Management Service (CMS): PNB's CMS facilitates management of receivables and payments in technology driven environment, ensuring availability of funds at reduced cost, helping reconciliation at multi location accounts besides providing customized MIS.
- Mutual Funds & Insurance: The bank has tied-up with Principal Financial Group for providing Mutual Funds and Insurance services & also tied up for distribution & marketing of UTI Mutual Funds.
- NRI Services: NRE, FCNR, RFC, NRO Deposit a/c investment Management & Housing Loan facilities for NRI's.
- Foreign Exchange: PNB has 150 branches authorized for handling foreign exchange business and these branches have been provided with SWIFT connectivity to ensure faster realisation of funds.
- Money India: Send money to the loved ones in India through PNB's e-Money India service. Draft delivery across 4,038 locations and Bank
- Online Railway Reservation/Air Ticket Booking: PNB offers online booking & information through IRCTC payment gateway. Just click and travel comfortably.
- Depository Service: PNB Depository service provides the facility of having shares & securities in DEMAT form & executes transactions of sales & purchase hassle free electronically.
- Lockers: Now, customer can relax with assurance of having your locker at the PNB branch nearest to their home.
- Customer Care Facility: All the banking queries and problems are just a call away! PNB presents 24 hr. customer care facility.

- PNB Gold Coin: PNB gives opportunity to dazzle the well-wishers, patrons, partners and acquaintances with the mystical charisma of PNB's 999.9 fineness pure 24-carat gold coins and to convey the true value of
- Electronic Clearing Service (ECS) & Electronic Funds Transfer (EFT): Avail ECS for quick movement of funds in a paperless mode & EFT to ensure an expeditious transfer of funds by using electronic media.
- Wealth Management Service: PNB provides customized financial advisory services for individuals that includes Mutual Funds, insurance, Retirement Planning, Tax planning, & Debt Management to customers for wealth maximization.
- Online Bill Payment: Pay telephone, mobile, electricity, insurance & several other bills 24 hours, 365 days, from the desktop.

Current Scenario of Punjab National Bank

With its presence virtually in all the important centres of the country, Punjab National Bank offers a wide variety of banking services which include corporate and personal banking, industrial finance, agricultural finance, financing of trade and international banking.

- Among the clients of the Bank are Indian conglomerates, medium and small industrial units, exporters, non-resident Indians and multinational companies.
- The large presence and vast resource base have helped the Bank to build strong links with trade and industry.
- The Bank was recently ranked 21st amongst top 500 companies by the leading financial daily, Economic Times.
- PNB's attempts at providing best customer service has earned it 9th place among India's Most Trusted top 50 service brands in Economic Times A.C Nielson Survey.
- PNB is also ranked 368 amongst the top 1000 banks in the world according to "The Banker" London.
- The bank has been conscious of its social responsibilities by financing agriculture and allied activities and small-scale industries (SSI). Considering the importance of small-scale industries bank has established 31 specialised branches to finance exclusively such industries.
- Strong correspondent banking relationship which Punjab national Bank maintains with over 200 leading international banks all over the world enhances its capabilities to handle transactions world-wide.

- Besides, bank has Rupee Drawing Arrangements with 15 exchange companies in the Gulf and one in Singapore. Bank is a member of the SWIFT and over 150 branches of the bank are connected through its computer-based terminal at Mumbai.
- With its state-of art dealing rooms and well-trained dealers, the bank offer's efficient forex dealing operations in India. The bank has been focussing on expanding its operations outside India and has identified some of the emerging economies which offer large business potential.
- Bank has set up representative offices at Almaty: Kazakhstan, Shanghai: China and in London. Besides, Bank has opened a full-fledged Branch in Kabul, Afghanistan.
- Keeping in tune with changing times and to provide its customers more efficient and speedy service, the Bank has taken major initiative in the field of computerization.
- All the Branches of the Bank have been computerized. The Bank has also launched aggressively the concept of "Any Time, Any Where Banking" through the introduction of Centralized Banking Solution (CBS) and over 2000 offices have already been brought under its ambit.
- PNB also offers Internet Banking services in the country for Corporates as well as individuals. Internet Banking services are available through all Branches of the Bank networked under CBS.

Growth and development of Punjab National Bank

To evolve and position the bank as a world class, progressive, cost-effective and customer friendly institution providing comprehensive financial and related services: integrating frontiers of technology and serving various segment of society especially the weaker section of the society: committed to excellence in serving the public and excelling in the corporate values. Corporate excellence emanates from good corporate governance exercised by adopting standard of transparency, accountability, professionalism, social responsiveness, and ethical business practices with this in view, the has been making efforts for adopting the best practices. The bank commitment towards corporate governance is to bestow greater transparency and openness in the management and to ensure best performance by staff at all the levels to maximize the operational efficiency. Adopting the corporate governance as a work ethos, the bank is committed to enhancing the stakeholder's value.

Future Plans of Punjab National bank

To provide excellent professional services and improve its position as a leader in the field of finance and related service, build and maintain a team of motivated and committed workforce with high work ethos; uses latest technology aimed at customer satisfaction and act as effective catalyst for socio-economic development. The bank is committed to its corporate mission to provide excellent professional services and improve its position as leader in the field of financial an related services, build, maintain a team of motivation and committed workforce with high work ethos, use latest technology, aimed at customers and act as an effective catalyst of socio- economic development. Punjab National Bank has focused quite a bit in rural areas, which is needed for our country. Their ATMs are given the facility of English, National Language Hindi and the local language of the state. They also provide mobile top-up facility

Special Achievements

- Award by BFSI Digital Innovation Award 2019 in the Enterprise Mobility Category
- Best Bank for CSR
- Ease Reforms Excellency Awards 2019
- Best in Financial Inclusion
- Social Banking Excellence Awards 2018-Second Runner Up under Priority Sector for Large Class
- IBA Banking Technology Awards 2019-Runner up in the category "Most Customer Centric Bank using Technology
- Top Rankers Excellence Awards for Entrepreneurial Path Breaker-Shri Sunil Mehta , MD & CEOPNB
- Skoch Order of Merit Award for implementing E-Mail Security in the Bank
- Skoch Order of Merit Award for Security Incident and Event Management Tool
- Skoch Silver Award for Security Incident and Event Management Tool in the Bank
- Skoch Order of Merit Awards
- PIM
- ATM Switch Migration
- Finacle X Upgrade
- M-Touch
- Aadhar Excellence Award-2nd Best Public Sector Bank for Total Aadhar Generation and Update.

1.2 Need for the Study

There are various scams happened in the country and impacted economy. There are 39 listed banks in India and shares of 34 listed banks fell between 12 February 2018 and 15 February 2018. Sudden drop in prices decreased the market capital of these 34 listed bank stocks to 36,380 crores. PNB eroded investor's wealth worth Rs 8,077 and its stocks were decreased by 20.6 % between 12 February and 15 February of 2018. The value of PNBs fraudulent transactions are nearly 50 times the bank net profit which is Rs 230.11 crores announced in the 3rd quarter of FY18. UCO Bank, Allahabad Bank, Axis Bank, Union Bank of India and SBI were directly affected by the fraudulent transactions as they have offered credit based on LoUs issued by PNB. The Rs 11,400 crore banking fraud of Nirav Modi and Mehul Choksi that has hit Punjab National Bank along with other banks also impacted another state-owned entity Life Insurance Corporation. LIC, which is the single largest institutional investor in all these four entities has lost nearly Rs 1,400 crore over. Global Credit rating agencies reviewed the the rating of PNB due to the massive fraud in the bank. Moody's and Fitch raised doubts on the Punjab National Bank's creditworthiness and placed the bank under rating watch.

1.3 Scope

The study is confined to PNB scam only

1.4 Objectives

- To know and understand the nature of scams and its immediate impact on economy
- To find out the parties involved in the fraud/scam of PNB
- To evaluate the causes of PNB scam
- To know the post scam consequences and government action initiated to curve the fraudulent

1.5 Research Methodology

Secondary data has been used for this research. Data has been collected from authenticated websites, newspapers and journals. The critical analysis of data in conjunction with findings of various reports and articles in websites, journals & newspapers along with the comments of financial experts appearing in newspaper in the first quarter of 2018, were studied in a holistic manner to arrive at an independent analysis of the probable underlying causes of deterioration in the asset quality and overall performance of Indian banks.

1.6 Limitations

Only one scam has been studied(The Rs 11,400 crore banking fraud of Nirav Modi and Mehul Choksi that has hit Punjab National Bank)

CHAPTER - II

2.1 Review of Literature

1. **Gauri Bhatia** in an interview to CNBC on 10 June 2016 told about Nirav Modi that he is soft spoken and understand much like his jewellery design. A passion for diamonds and an understanding of luxury helped Nirav Modi create a successful jewellery company in the space of just five years. Pieces designed by him have been worn by international celebrities including Kate Winslet and Aishwarya Rai.
2. **Kiran Sharma & Nupur Shaw** in an article published on 16 Feb 2018 in Nikkei Asian Review informed that Jeweller's aggressive expansion plan hit hard by alleged \$1.8bn.
3. **Jeffords et al. (1992)** examined 910 cases submitted to the "Internal Auditor" during the nine-year period from 1981-1989 to assess the specific risk factors cited in the Treadway Commission Report. Approximately 63% of the 910 cases are classified under the internal control risks. Similarly, Calderon and Green (1994) made an analysis of 114 actual cases of corporate fraud published in the "Internal Auditor" from 1986 to 1990. The study found that professional and managerial employees were involved in 45% of the cases.
4. **Willson (2006)** examined the causes that led to the breakdown of „Barring" Bank, in his case study. The collapse resulted due to the failures in management, financial and operational controls of Baring Banks. However, **Bhasin (2007)** examined the reasons for check frauds, the magnitude of frauds in Indian banks, and the manner in which the expertise of internal auditors can be integrated in order to detect and prevent frauds in banks. In addition to considering the common types of fraud signals, auditors can take several „proactive" steps to combat frauds. One important challenge for banks, therefore, is the examination of new technology applications for control and security issues.
5. **Ganesh and Raghurama (2008)** conducted survey on about 80 executive from Corporation Bank and Karnataka Bank Ltd of India, were requested to rate their subordinates in terms of development of their skills before and after they underwent certain commonly delivered training programs. Responses revealed that for the 17 skills identified, there was improvement in the skills statistically. The paired t-

test was applied individually for the seventeen skills, and all these skills have shown statistical significance. Moreover, a study to investigate the reasons for bank frauds and implementation of preventive security controls in Indian banking industry was performed by Khanna and Arora in 2009. The study seeks to evaluate the various causes that are responsible for bank frauds. The result indicate that lack of training, overburdened staff, competition, low compliance level are the main reasons for bank frauds.”

6. **Chiezey and Onu (2013)** evaluated the impact of fraud and fraudulent practices on the performance of 24 banks in Nigeria during 2001-2011. The relationship between fraud cases and other variables were estimated using Pearson product moment correlation and multiple regression analysis was used. The paper recommended that banks in Nigeria need to strengthen their internal control systems and the regulatory bodies should improve their supervisory role.
7. **Das and atta (2014)** in a study on NPAs of Public Sector Banks in India, found that there was a significant variation between NPAs of the public-sector banks from 2008 to 2013. The objective of the study was to find whether there is any difference in the NPA occurrence between the various banks during the period of the study. They analysed the NNPA of State Bank of India and its Associate Bank, applied the ANOVA test using the SPSS.
8. **Satpal (2014)** in a study comparison of NPAs in Public and Private sector banks in the new age of technology, found that operating efficiency of banks is adversely affected due to NPAs and NPAs of public sector banks are comparatively higher than those of private sector banks. He highlighted that problem of recovery was more with large borrowers than with small borrowers. He suggested that government should make provisions for faster resolution of pending cases and reduce mandatory lending to priority sectors. The objectives of his study were to study NPA trend of last five years of private and public-sector banks and to make a comparative study of NPAs of public and private sector banks. The research methodology adopted involved use of descriptive research design and analytical study, non-probability convenience method of sampling and use of secondary data of a sample of three public and three private sector banks.
9. **Balasubramaniam (2011)** in a study on Non-Performing Assets and Profitability of Commercial Banks in India: Assessment and Emerging Issues concluded that level of NPAs with all banks was high in the period of study (2000-01 to 2009-10) and banks would be expected to bring down their NPAs, by adopting good credit appraisal procedures, effective internal control systems along with efforts to improve asset quality in their balance sheets. He brought out that maintaining profitability is a

challenge for commercial banks, especially in a highly competitive era and opening up of banking business to NBFCs and Foreign banks in general, which assumes significance in a period of rising interest rates and operating costs of borrowers in general. Balasubramaniam also brought out that banks would make efforts to mobilise funds in order to comply with provisioning norms and capital adequacy requirements while meeting Basel III standards which will be brought in by RBI shortly. However, the Capital requirements would be large considering the varied structure of banks and financial institutions operating in the economy and their NPA levels. He observed that, the capital market environment currently prevailing in the economy (in 2011) would pose problems for the capital mobilisation by the banks. Finally, he highlighted the emergence of new and private sector banks led by ICICI Bank and HDFC Bank, with their high capital adequacy ratios, enhanced proportion of common equity

10. Krishna (2004) in a study for Non-Performing Assets in Public Sector Banks found that between the years 1992 to 2002 there has been a marginal decline in the NPAs of the banks and calculated a trend showing a further predicted decline in NPAs over next three years (2002 -2004) at a marginal rate. The objectives of the study were to understand meaning and nature of NPAs, Examine the causes for NPAs in Public Sector Banks and to project the NPAs in Public Sector Banks over a future period of three years. In the methodology, she explained the NPAs in the Indian context, found that actual NPAs have risen in the period of study, although as a percentage of net advances there was an indication of marginal decline. The causes identified by the researcher were primarily directed lending and social banking to priority sectors. Another reason identified was the large amount of loans granted under various government schemes like IRDP, SUME, SEPUP, RREP, PMRY etc, which became unrecoverable due to failed programmes, manipulation by agencies involved in implementation of these programs and non-reliability of the target audience.

CHAPTER - III

3.1 Company and Industry Profile

- PNB was registered on 19 May 1894 under the India Companies Act in Anarkali Bazaar, Lahore (current day Pakistan).
- Punjab National Bank, India's first Swadeshi Bank, commenced its operations on April 12, 1895 from Lahore, with an authorised capital of Rs 2 lac and working capital of Rs 20,000.
- The Bank was established by the spirit of nationalism by establishing the first bank purely managed by Indians with Indian Capital.
- Founding board was from different parts of India who were part of swadeshi movement. Its Founding members are Dyal Singh Majithia and Lala Harkishen Lal, Lala Lalchand, Kali Prosanna Roy, E. C. Jessawala, Prabhu Dayal, Bakshi Jaishi Ram, and Lala Dholan Dass.
- Board's first meeting was held on 23 May 1894. PNB was opened for business on 12 April 1895 in Lahore.
- PNB is the first Indian bank to start solely with Indian capital that has survived to the present.
- PNB maintained accounts of national leaders such as Mahatma Gandhi, Jawahar Lal Nehru, Lal Bahadur Shastri, Indira Gandhi, as well as the account of the famous Jalianwala Bagh Committee.
- As on Financial year ending 2015, PNB had 68,290 employees.
- As on 31 March 2013, it had 919 employees with disabilities.
- Average age of bank employees as on Financial year ending 2015 was 46 years.
- The bank reported business of INR 11.65 crores per employee and net profit of INR 8.06 lakhs per employee during the FY 2012-13.
- The company spent Rs 5,751 crores towards employee benefit expenses during the financial year 2015.
- The Business figures of the Bank as on 31st March 2019 is given as under:

| Parameters (Amt in Rs. Crore) | Mar'17 | Mar'18 | Mar'19 | Gr.% Mar'19/Mar'18 |
|----------------------------------|---------|---------|---------|-----------------------|
| Gross Global Business | 1063455 | 1113523 | 1182224 | 6.2 |
| Gross Domestic Business | 957323 | 1030681 | 1145511 | 11.1 |
| Global Deposit | 621704 | 642226 | 676030 | 5.3 |
| Domestic Deposits | 565573 | 600387 | 654536 | 9 |
| Gross Global Advances | 441751 | 471297 | 506194 | 7.4 |
| Gross Domestic Advances | 391750 | 430294 | 490975 | 14.1 |
| CASA Deposits | 260016 | 263247 | 285040 | 8.3 |
| CASA as % to Domestic Dep | 45.94 | 43.8 | 43.51 | - |
| | FY'18 | Q4FY'19 | FY'19 | Gr.% Mar'19/Mar'18 |
| Operating Profit | 10294 | 2861 | 12995 | 26.2 |
| Net Profit | -12283 | -4750 | -9975 | - |

Source: Punjab National Bank Website

Table: 1

In terms of Bottom Line parameters, during FY'19, the Bank's Operating Profit stood at Rs.12995crore. Net Interest Income stood at Rs.17156crore showing YoY growth of 15.0%. Efforts towards Cost Optimization resulted in decline in operating expenses by 14.6%. Resultantly, Domestic Net Interest Margin (NIM) increased to 2.59% in FY'19 from 2.42% in FY'18. The Bank has been rationalizing its overseas operations which have resulted into shrinking of overseas business.

- BRANCH, ATMs AND BC NETWORK

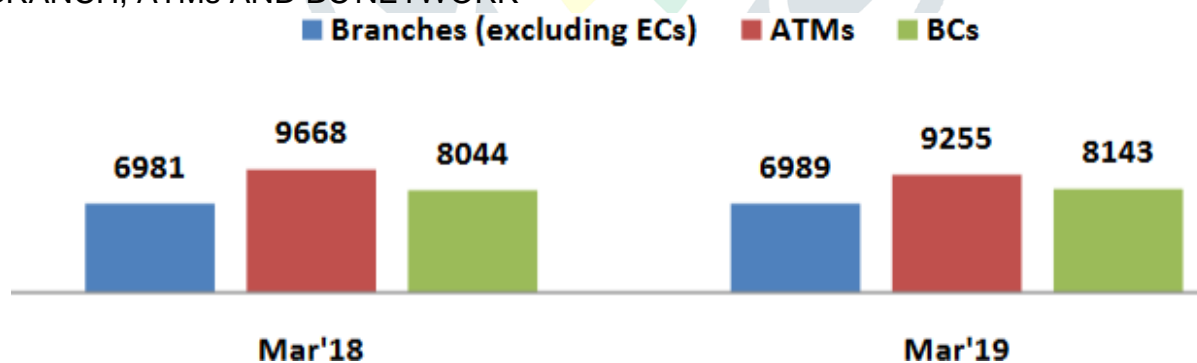


Figure: 1

3.2 Frauds & Scams

Introduction

The Second largest PSU Bank in India on Feb 14th, 2018 reported fraudulent transactions worth Rs 11,400 crore to stock exchanges and law enforcement agencies. The scam which initially was estimated to 11,400 crore, now added up to Rs 12,700 crore

is nearly one-third of the Net worth of Punjab National Bank(PNB) is now termed as a country's biggest banking fraud.

Basic Facts

On 14 February, state-owned Punjab National Bank (PNB) disclosed that it has discovered \$ 1.77-billion (around Rs 11,400 crore) worth of fraudulent transactions at one of its Mumbai branches. In a complaint to the Central Bureau of Investigation, the bank had named the firms and people associated with billionaire jeweller Nirav Modi to have caused this massive fraud using the bank officials.

Problem at PNB

- PNB employees issued fake LoUs(In international banking system,Letter of Undertaking(LOU) is a provision of bank guarantee, under which a bank allows its customer to raise money from another Indian bank's foreign branch in the form of a short term credit.
- The LOU serves the purpose of a bank guarantee), on the back of which foreign branches of a few Indian banks —including Axis and Allahabad Bank —gave dollar loans to PNB. These foreign currency loans were used to fund PNB's Nostro accounts and from these accounts funds moved to certain overseas parties.
- PNB is left holding bank guarantees worth Rs 11,400 crore which it has to pay to, among others, State Bank of India, Allahabad Bank and Union Bank. These payments are due over the next few months
- This has affected the banking sector, jewellery sector and the insurance sector.
- This also questions the credibility of the Public Sector Banks, the role of regulators namely RBI and SEBI.
- According to the FIR, two junior employees of PNB had been sending these unauthorised guarantees for seven years. Then one of them retired.
- In January, when representatives of Modi firms asked for a fresh guarantee, the new PNB employee in that position asked for collateral security. On being told that this was never asked for in the past, the bank started investigating and found hundreds of guarantees relating to these firms.

CHAPTER - IV

4.1 Analysis

Objective 1: Nature of Scam & Impact on economy

Nature of Scam

Nirav Modi wanted to import pearls and diamonds, design exquisite world-class jewellery and sell them. He needed money to buy the pearls and diamonds. He did not want to opt for a rupee loan, and rightly so as it is expensive and there is foreign currency risk. He wanted foreign currency loan. That's cheap. Besides, he had a natural hedge against currency fluctuations as he was earning in foreign currency by exporting jewellery.

Nirav decided to take bank loans without having any loan account and other attendant paraphernalia such as sanctioned limits, collaterals, etc. To circumvent all these, he arranged a guarantee from PNB in the form of LoU for cheap short-term foreign currency loans meant for importers. Ideally, the LoU-issuing bank asks for a margin, which could be as much as 100% or even more. Why would an importer offer such a high margin? It would, because this is typically kept with the LoU-issuing bank in the form of a fixed deposit, the return from which is far higher than the cost of the foreign currency loan. Simply put, an importer can arbitrage between high domestic deposit rates and low foreign credit rate. For some reason, PNB, it seems, did not ask for margin. And, this is the beginning of the \$1.77 billion fraud that shook the Indian banking system.

In 2011, a SWIFT message (code: MT 799) was sent from PNB's Mumbai branch to some of the Indian banks overseas offering LoUs, committing to pay them the principal plus interest on behalf of Modi companies. Without batting an eyelid, a few Indian banks extended buyer's credit. We presume the money flowed into PNB's Nostro account. A bank keeps a Nostro account in foreign currency in another bank overseas for use of foreign exchange and trade transactions. PNB debited the money by paying to the exporter, the entity which was selling diamonds to Modi. Theoretically, Modi should have sold the polished diamonds and jewellery and paid back PNB on every due date for each LoU, and PNB would have paid back the banks overseas for their buyer's credit. Had this been the case, there would not have been any fraud.

Nirav continued this facility for seven years without paying any money. Instead of paying his own money, he probably asked PNB (read Gokulnath Shetty) to open another LoU, which could cover the principal plus interest of the previous LoU. Backed by new LoUs, he would get fresh and higher buyer's credit, which would enable him to clear the previous loans and the chain continued.

Kite flying

In banking parlance, such a practice is called kiting or kite flying. When people use one or more credit cards to withdraw cash at an ATM and pay dues on another credit card, they do the same thing. This way, Modi (and Choksi) may have spawned hundreds of LoUs (investigative agencies peg the figure at 293) and PNB's liability to the issuers of buyer's credit ballooned. It's a sort of ponzi scheme which chit funds run—they continue to pay high interest rates to depositors till the flow of new money continues and once the flow stops, their operations come to a halt. Here, too, Modi kept on opening LoUs to repay old facilities; the game came to a sudden halt when Shetty's successor at PNB's Fort branch refused to open a new LoU without a margin.

Impact on Economy

India's jewelry exporters expect tighter lending to douse any recovery in overseas sales this year, stoking fears that buyers will shift to rivals China and Thailand.

After India's biggest bank fraud came to light, jewelers have struggled to get credit to run their businesses. Borrowing costs have risen as the \$2 billion banking fraud allegedly perpetrated by diamantaire Nirav Modi unraveled and the central bank stepped in, banning short-term financing in foreign currency to limit the damage to the financial system. The fallout from the fraud has been worsened by a debt crisis at a local lender.

To global investors, India's economy may seem a bit like a raw mango these days—enticing from a distance but bitter to taste; good for pickles, and not much more.

That Goldman Sachs cut India's economic growth estimate from 8% to 7.6% for financial year 2019 may not be a surprise after the swell of bank scams that have washed over headlines in the last few weeks. The global investment bank has cited the \$2 billion fraud at the state-run Punjab National Bank (PNB) among the reasons for slashing the projections for the world's fastest-growing major economy.

Goldman fears the fraud is just the beginning of a prolonged period of pain for the Indian economy. "Markets and investors are questioning whether the problem is more systemic," the analysts wrote in the note to clients.

Indeed, in the days following the revelation that billionaire jewellers Nirav Modi and Mehul Choksi duped India's second-largest government bank, the PNB stock has lost more than a quarter of its market value. Other public sector bank scrips have tumbled, too.

One, it has been established that the scam at PNB was not the first—and won't be the last. If more skeletons tumble out, the banks' soured loans, nearly Rs10 lakh crore (\$150 billion) at last count, may turn out to be higher. India is already among the worst in

the world in terms of bad loans.

Two, now that a portion of bad loans has been revealed to be frauds, the money recoverable from borrowers is likely to be far lesser than previously projected. According to Goldman Sachs, banks may write off up to 65% of the bad loans. This estimate is more than double of the \$46 billion that the prime minister's economic advisor, Bibek Debroy, had estimated last month during an interview with Quartz.

Three, not all PSU banks drowning in bad loans may have the strength to withstand the crisis. Most of the 21 lenders were struggling for capital even before the frauds were unearthed. That would mean more of taxpayer money being poured into them before all the dirt is flushed out.

Four, the \$32 billion recapitalisation of PSU banks, planned before the frauds came out, may be inadequate to kickstart lending and the growth cycle. So, despite more government investment, these banks may be happy to just stay afloat. The amount of fresh capital they could use to lend to good businesses may be far less.

Five, with the grave governance gaps being exposed now, the leash on these banks has been tightened as expected. The Reserve Bank of India's (RBI) new norms mandate that banks must declare non-performing assets (NPAs) sooner than before, and submit weekly reports to the regulator. This could increase the pace of rising bad loans and stop banks from hiding them to make the books look better.

Six, the cracking of the whip by the RBI may make bank executives extremely cautious about fresh loans, as a former RBI governor told Quartz on March 20. Wary lenders may further squeeze private investment, already rather tepid. It will also lead to a higher cost of borrowing.

Seven, an aversion to select sectors has been among the major fallouts of the PNB fraud, particularly the gems and jewellery sector which contributed 13% to the country's exports in fiscal 2017. Lending instruments like the letter of undertaking (LoU) have been struck down by the regulator. The LoU ban is likely to hurt importers as well as some exporters.

Eight, if foreign trade weakens, the current account deficit will widen and increase the cost of government borrowings. That, in turn, will strain public spending and the fiscal health. The rupee may weaken, fuelling inflation.

Nine, all of this will portray a clumsy picture to ratings agencies, taking the sheen off India's image as a global investment destination. For the Narendra Modi government, desperate for an upgrade in credit ratings, the wait may get longer.

Aside from the frauds and their cascading effects, even authorities' reactions have been far from reassuring. Those responsible for India's state-run banks have been found bickering following the deep crisis.

The damning impact of a such blame-game was highlighted by the former RBI governor. "Both RBI and the government should be very conscious that this is an international issue. The image of India is at stake," the former governor told Quartz. "There may be differences in view. You should not be talking through the media to the people of India. This has definitely spoilt India's reputation as a rising power internationally."

Objective 2: Parties involved in the fraud/scam of PNB

The fraud was allegedly organized by jeweller and designer Nirav Modi. Nirav, his wife Ami Modi, brother Nishal Modi and uncle Mehul Choksi, all partners of the firms, M/s Diamond R US, M/s Solar Exports and M/s Stellar Diamonds; along with PNB officials and employees, and directors of Nirav Modi and Mehul Choksi's firms have all been named in a chargesheet by the CBI.

The bank initially said that two of its employees at the branch were involved in the scam, as the bank's core banking system was bypassed when the corrupt employees issued LOUs to overseas branches of other Indian banks, including Allahabad Bank, Axis Bank, and Union Bank of India, using the international financial communication system, SWIFT. The transactions were noticed by a new employee of the bank. [7] The bank then complained to the CBI, who is currently investigating the scam apart from ED and RBI. On a later date, CBI named key officials Usha Ananthasubramanian, former CEO of PNB, executive directors KV Brahmaji Rao and Sanjiv Sharan in a chargesheet holding them responsible for failure to implement several circular and caution notices issued by the RBI regarding the reconciliation of SWIFT messages and core banking systems.

Objective 3: Cause of the Scam

PNB fraud may be because of few rogue employees but the major concern is widespread risk-control and monitoring lapses in many areas of the bank, the bank's own internal probe has found. PNB alleged that a handful of staff at a single Mumbai branch issued fake bank guarantees over several years to help two jewellery groups controlled by Nirav Modi and his uncle Mehul Choksi.

REASONS BEHIND THE SCAMS

- Nirav Modi exported rough stone form foreign countries worth crores of rupees.
- The employees at PNB Brady House branch fraudently issued a LoU for 365 days without making any provisions for collateral and bypassing Core Banking System (CBS).
- The Nirav Modi's three companies named Diamond R US, Solar export and Stellar diamond allegedly raised loans from Axis Bank, UCO Bank and Allahabad Bank by

showing LoU.

- The firm also raised funds from Indian bank's overseas branch for paying to the suppliers.
- Nirav modi's firm again requested the bank to issue another LoU but the officials refused on ground that the company has to keep collateral with bank but Modi's firm argued that no such money was kept on margin for the previous LoU
- After that PNB officials started scanning the records and didn't find any such transactions and then filed a complaint with CBI.
- The failure of Auditors – Auditors failed to detect any frauds which took place in PNB Brady branch, Mumbai
- Not linkage of SWIFT with CBS – Society for Worldwide Interbank Financial Telecommunication (SWIFT) and Core Banking System (CBS) was not linked with each other.
- Management Failure – The management system was very weak and couldn't detect any fraud because the Deputy Manager of branch himself was involved in the fraud.
- No rotation of Employees – According to Reserve Bank of India (RBI) guidelines ,every employees working in banks should be rotated from one position to other position in every three years but the same was not done in the PNB Brady Branch.

Objective 4: Post scam consequences and government action initiated to curve the fraudulent

On 1 March 2018, the government approved the Fugitive Economic Offenders Bill to deter economic offenders from evading the process of Indian law by giving powers to the government to confiscate assets of a fugitive, including Benami assets of absconding loan defaulters. The bill covers a wide range of economic offenders which include: loan defaulters, fraudsters, individuals who violate laws governing taxes, black money, benami properties, financial sector, and corruption. On 12 March 2018, the government introduced the bill in the Lok Sabha.

In March 2018, the Reserve Bank of India scrapped banking instruments such as the Letter of understanding (LoU) and Letter of Comfort (LoC) that to plug a loophole and improve banks' due diligence in trade credit. Some bankers said that LoUs and LoCs led to receiving banks depending completely on the issuing bank on creditworthiness

Measures should be taken to avoid scam

- Multi Factor Authentication.
- Monitor Transactions.
- According to RBI guidelines, every commercial banks should link their CBS with SWIFT by April 2018.
- Implementation of Anti-Money Laundering. Rotation of employees in every three years.
- NFRA is established by government which is an independent regulator for the auditing profession.
- Better Management Control.
- Cyber Analytics/Cyber Security.
- Fraud Monitoring.
- Customer identification, authentication and risk assessment.

CHAPTER-V

5.1 Findings

- Potential Loss to PNB is reported to be up to Rs 11000 Crore. Enforcement Directorate is looking into the case of fraud that the CBI has registered against Modi.
- designer Nirav Modi. Nirav, his wife Ami Modi, brother Nishal Modi and uncle Mehul Choksi, all partners of the firms, M/s Diamond R US, M/s Solar Exports and M/s Stellar Diamonds; along with PNB officials and employees, and directors of Nirav Modi and Mehul Choksi's firms have all been named in a charge sheet by the CBI.
- PNB fraud may be because of few rogue employees but the major concern is widespread risk-control and monitoring lapses in many areas of the bank, the bank's own internal probe has found. PNB alleged that a handful of staff at a single Mumbai branch issued fake bank guarantees over several years to help two jewellery groups controlled by Nirav Modi and his uncle Mehul Choksi.
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5.2 Suggestions

- All the banks should review their critical systems and processes including the IT segment regularly.
- Ethical banking practices should be preferred. Disclosures to RBI, SEBI and other regulators should be made with consistent periodicity.
- Banks should ensure that there are adequate systems and controls in place to identify potential risks and that they are being followed at all relevant branches. SWIFT-CBS linking must be made mandatory for all LoUs.

5.3 Conclusion

In February 2018 Indian government's Central Bureau of Investigation started an investigation of Nirav Modi based on a complaint from PNB alleging Modi and his partners defrauded the bank about Rs 280 Crore by conspiring with bank officials to fraudulently obtain letters of undertaking for making payments to overseas suppliers. Rs 280 Crore is the fraud that has been alleged to date. Potential Loss to PNB is reported to be up to Rs 11000 Crore. Enforcement Directorate is looking into the case of fraud that the CBI has registered against Modi. Banks plays important role in economy and if there is no proper regulatory mechanism it may impact economy.

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