ISAS Brief

No. 558 – 2 March 2018

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The Punjab National Bank Fraud in India: Failure of Institutional Controls and Oversights

In mid-February 2018, India was rocked by the revelation of a US$1.77 billion (S$2.34 billion) fraud case at a single branch of one of the country's largest state-run banks, Punjab National Bank (PNB). The PNB scandal reflects the failure of institutional controls and oversight mechanisms. The correctives must emerge from a strong enforcement of ethical standards of institutional behaviour.

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On 14 February 2018, India's second-largest state-owned lender, Punjab National Bank (PNB), informed the stock exchange authorities that it had detected a fraud amounting to US$1.77 billion (S$2.34 billion) at one of its branches in Mumbai. The person in the centre of the fraud is Nirav Modi, a billionaire jeweller, who coincidentally left the country as soon as the news broke, and is in hiding now in New York in the United States.

In an effort to understand the implications of the PNB investigations in India, it is useful to deconstruct the process by which the fund flows took place. Modi, wanting to import diamonds to design a high-end collection, approached PNB for funds to import the diamonds. In an ordinary case, the bank would provide a Letter of Undertaking (LOU) to the client that

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would allow him to raise money from another bank's foreign branch in the form of a short-term loan. The foreign branch would provide the funds to the client for the payment to his suppliers in foreign currency. The importer is expected to sell the products and make the payments to the lending bank. If he does not do so, the bank that issued the LOU would have to honour the commitment. Normally, the bank that issues the LOU would ask for a cash margin, usually 100 per cent. In Modi's case, there was no scheduled credit limit and no margin was demanded. The entries in respect of the LOUs issued were not recorded in the bank's core banking system. The LOUs were issued by the branch officials without the approval of competent authorities and the necessary documents for import. According to the guidelines of the Reserve Bank of India (RBI), the buyer's credit for the import of gems should not exceed 90 days from the shipment date. In this case, however, they were rolled over repeatedly. This went on for a shocking seven years from 2011. A total of 151 LOUs were issued in 2017 alone.

In January 2018, the partnership firms of the Nirav Modi group (no connection to the Prime Minister) approached PNB's Brady House branch in Mumbai with a further request for a buyer's credit. The bank officials asked for a 100 per cent cash margin. The firms claimed that they had, in the past, been allowed cash without margin. On scrutiny, it was discovered that the earlier approvals had been made fraudulently. Eight LOUs worth ₹2,800 million (S$56 million), due for payment on 25 January 2018, were issued for the Hong Kong branches of the Allahabad Bank and Axis bank, both banks with headquarters in India.

On 14 February 2018, PNB intimated the stock exchanges that the fraud amount was ₹11,394 crore (S$2.34 billion) and added that the figure could further rise.

Several points are of note in the PNB scandal.

The first is the lack of internal controls and processes in PNB, which allowed for the repeated infringement of rules for a period of seven years without it being detected. It appears inconceivable that branch-level officials with limited powers could have perpetrated such a major fraud on the banks without the knowledge of the higher management of the bank. And if indeed the higher management was unaware of what was going on, it speaks of poor managerial supervision and control.

The second is the role of the auditors. The bank accounts are audited by an independent auditor periodically and there is also a mandated due diligence check. Again, it is surprising that the matter remained undetected for more than seven years.

The third is the responsibility and role of the regulator, the RBI. The regulator should surely have noticed continuous foreign exchange outgo of over US$2 billion (S$2.65 billion) over this period, without receipt of export earnings. The RBI has certainly been remiss in its regulatory oversight.

The last is the larger question of whether this is an isolated case, or whether there are other such scams lurking elsewhere in the Indian banking system. There has been a detailed report of the Bank of Baroda branch in South Africa colluding with the Gupta family to illegally transfer government funds to their offshore accounts, when all other banks there refused to do so. It is reported that they were very close to the deposed South African President, Jacob Zuma. There are also issues of LOUs with Gitanjali gems, a relative of Modi, as well as another firm which manufactures ballpoint pens. The worry is that there are several other scams waiting to be discovered. It is interesting that a number of these relate to public sector banks where the Indian government has a majority and appoints the management.

Public sector banks have been reeling under the burden of non-performing assets that relate to loans given to projects, which have not been repaid, either because the projects have not been completed as scheduled, or where the promoters have taken away a substantial part of the funds. Such scams would add to the burden of the banks' poor capital adequacy.

The issues that are surfacing relate to an underlying malaise in the publicly-owned banking system in India, and that institutional oversight has repeatedly failed to detect misdemeanors.

The reasons could be several. There is certainly evidence of corruption in several aspects of the banking system, whether in granting loans to ineligible borrowers or in circumventing systems and procedures to avoid detection. The frustration of the public is that far too few of the culprits are brought to book and punished, as establishing a conspiracy that includes the higher reaches of management and, perhaps, their political masters is not easy. The culprits who are affixing the final approval are not necessarily those to blame – they are probably acting on instructions that are illegal.

The surprising point is the rapidity of the deterioration. Until 2004, there were very seldom incidents where banks were instructed by their political masters to overlook due diligence – there is enough evidence that this has been on the increase after 2004. The laxity has spread through the system. There has been damage to the image of the banking and business systems, and the shares of PNB have fallen by more than 20 per cent.

The positive point is that there are robust systems in place. These mechanisms include regular internal audits as well as periodic audits by the RBI. All foreign exchange exposures are expected to be reported to the RBI on a regular basis and the system is geared to throw up open (uncovered) exposures. This is in addition to statutory audits and oversights by the Board of Directors. Once the government cracks the whip on adherence, the corrective mechanisms will fit into place to prevent further incidents. Clearly, the RBI has to take the lead in this.

The PNB balance sheet is quite strong, as it is one of the few banks with a large rural presence in Punjab, where there are a lot of depositors – both from agriculture as well as from the remittances of overseas workers. There is little danger to the bank or the banking system. However, the PNB scandal is a call to the India government and the regulators to get their act together.

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