

Case Study on Scam in Indian banking industry (Nirav Modi)

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Abstract

An efficient and good banking is the main requirement for smooth operation of the economy. The Indian banking system, it has begun to grow rapidly and also faced many challenges. Recent frauds have shown that the bank is vulnerable to many risk including fraud, embezzlement, scams etc. the research evidence has shown that growing number of scams have undermined the integrity of financial report. Banking scam is also known as banking fraud. At a time when the objective of bank is recapitalization, Scams are huge problem for overall banking sector. A default of Rs 12700 crore were found in PNB, it may be noted that the public sector bank lost at least 227 billion of the bank fraud in last five year. The credibility of third party such as auditing firm is also questioned in the study. Nirav modi is an Indian diamond merchant who owner of Getangali gems and Firststar diamond. Which was established in 2010 by its founder Nirav Modi. He was involved in PNB scam through the help of higher official of PNB Mumbai branch. RBI (Reserve Bank of India) is the apex bank of country is facing public outcry for not being able to find the banks scams. It is the time that all public sector bank must evaluate the internal process and take appropriate action. This study endeavors to cover issues such as bank fraud. The aim of this case study analysis is to identify and analyze the cause of the large scale scams and also delves into auditing process of bank and possible loops- holes that lead to the fraud. And the study finally propose some recommendation to reduce future Occurrence of fraud in Indian banking sector. There is a huge “scam” at Punjab National Bank which involve a lot of people

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Keywords: Banking scam, LOU, PNB, and RBI

THE SCAM, AND HOW IT STANDS-

- Punjab national bank announced a big scam of 11000cr + in a surprise to the stock exchange.
- And then, apparently sent a message to various bank accusing a now retired officer for presenting fraudulent LOU (Letter of undertaking) for over 6 year.
- At the same time, the blame was put on people who received funds, the company owned by jeweler named Nirav modi and in other case, those owned by Mehul Choksi, such as public listed Gitanjali gems.

THE CONCEPT AND ITS WORKING-

According to RBI, Fraud is defined as, “A deliberate act of omission or commission by any person, carried out in the course of banking transactions or in the books of accounts maintained manually or computerized system in banks, resulting in to wrongful gain to any person for a temporary period otherwise, with or without any monetary loss to the bank.

An efficient and good banking system is the requirement for the proper functioning of economy. The banking industry, since it has begun to grow rapidly is also facing many challenges because of it. Recent frauds have shown that the bank is vulnerable to many risk including fraud, scam etc., banking fraud is a criminal act. At a time when bank’s objective is recapitalization, scams are big problem for banking industry in general. A default of 12700 crore was found in PNB.

Nirav modi is an Indian diamond merchant, who is the owner of Gitanjali gem and Firestar. Nirav Modi wanted to import diamonds, so he had required money and, therefore, had requested to PNB for loan. But PNB put a clause that it will give you the loan but charge 10% interest. Nirav thought hard and said, no that is too much. Then, Nirav Modi decided to take loan from overseas bank because the interest rate of overseas bank was very low, the rate of interest was only LIBOR+2, and LIBOER was like 1.5%. PNB gave LOU (letter of undertaking) to Nirav Modi and his company without following proper procedure and without recording transaction in core banking transaction. A LOU (letter of undertaking is a guarantee by issuing bank to the receiving bank and the company that would commit to pay a certain sum of money on a specific date.

PNB claimed that Nirav Modi and his company got a loan worth 1.77 billion through a false bank guarantee. In this way Nirav got a loan from the foreign branch of Indian bank. In order to avoid detection they bypassed the lender’s internal message system.

Source-<https://www.businessstoday.in/sectors/banks/nirav-modi-case-pnb-fraud-11400-crore-scam-ed-cbi-raid/story/270708.html>

FRAUD EFFECT-

LIC LOSES VALUE ON ITS INVESTMENTS IN BANKS AND COMPANIES HIT BY FRAUD			
	LIC holding as of Dec 2017 (%)	Fall in share price (%)*	Decline in investment value (₹ crore)
Gitanjali Gems	2.88	40.25	11.9
PNB	13.93	22.27	1216.44
Union Bank of India	13.24	7.22	104.24
Allahabad Bank	13.17	10.25	65.81
TOTAL			1397.9

*Fall in share price since closing on Feb 12

Source: S Singh, (2018, Feb 17)

IMPORTANCE NOTES-

- The overseas bank gave money to the Nostro account of PNB. The loan was provided on the guarantee provided by PNB through the swift channel.
- The overseas bank was not interested in what Nirav Modi will do with the money. They had the trust that PNB would pay back even if Nirav become a bankrupt.

INTRODUCTION:

- Nirav modi borrowed loan from the overseas branch through LOU issued by PNB.
- This was done through SWIFT based LOU issued through PNB official.
- The parameter for evaluation was not identified in the main stream banking system.
- The bank official said that the officer who issued these LOU (Letter of undertaking) have retired in 2017. And the one who replaced him refuses the roll over the LOU which become due in January 2018 since he was not able to find the past transaction in the system.
- On 14 February 2018, Punjab National Bank (PNB) announced that it has discovered \$ 1.77-billion (around Rs 11,400 crore) worth of fraudulent transactions at one of its Mumbai branches.[5]

CHRONOLOGY OF THE CASE

- On 29/1/2018- PNB filed a scam complain against modi group.
- On 4/2/2018- CBI gives warning to Nirav Modi.
- On 5/2/2018-PNB informed stock exchange about the 281 crore scam involved in Modi group.
- On 14/2/2018- PNB informed the stock exchange of the magnitude of the scam.

Source : <https://economictimes.indiatimes.com/news/politics-and-nation/chronology-of-nirav-modis-case/articleshow/68636493.cms?from=mdr>

WHEN DID IT START AND WHEN DID IT STOP-

According to the FIR, two subordinate employees of PNB had been lending these unauthorized guarantees for seven years. In January, one of them had retired. And when, Modi companies demanded fresh guarantee then new employees of PNB ask for collateral security. They were told that it was never asked in the past. The bank began to inquire and found hundreds of guarantee relating to these companies.

ISSUES

- Why PNB did give guarantee without any collateral.
- If an ordinary person goes to bank and request for loan then the bank will ask for income proof and collateral. Only small personal loan and credit card are

available without any collateral. Then why was Nirav Modi not for any collateral?

- Another important thing is that bank offers two types of facilities, one is fund base and other is non fund base. Fund-based financial service includes loans provided by banks, overdrafts and other cash transactions. The bank does not deal with money or cash transactions in a non-fund-based financial service. Several examples of this type of service are bonds, letters of guarantees and letters of credit.
- Therefore it was clear that PNB assumed that the foreign bank has granted direct loan to Nirav Modi and that PNB only had to pay in the event that Nirav Modi defaulted. So in the eyes of PNB, it was always non fund base.

IMPACT ON PNB RATING

Moody's and Fitch's global rating companies have doubt about the creditworthiness of PNB. Moody's and Fitch's have placed the bank under rating watch, a kind of critical investigation before a possible rating downgrade or a cut in outlook. Moody's Investors Service has put under review for downgrade PNB's local and foreign currency deposit rating of Baa3/P-3 and foreign currency issuer rating Baa3. Likely financial impact of the fraudulent transactions is the key driver for the Review for downgrade.

The primary driver for today's rating action is the risk of weakening of the bank's standalone credit profile, as a result of the discovery of a number of fraudulent transactions." [4]

Impact on Banks

Union bank of India- The bank lost -5.8 per cent that led to Rs 633 crores of erosion in market cap between 12 February closing and 15 February closing.

Allahabad Bank: The bank's stock price lost over -9.9 per cent till 15 February 2018. Its market cap is eroded by over Rs 484 crores.

Axis Bank: Share price of the bank lost -3.4 per cent till 15 February 2018 and its market value fell by over Rs 4,800 crores.

SBI: The share price tanked -3.34 per cent and its market value fell by Rs 8,329 crores between 12 February 2018 and 15 February 2018.

Source- <https://www.businesstoday.in/markets/stocks/nirav-modi-case-pnb-fraud-affects-stocks-of-union-bank-allahabad-bank-sbi-axis-bank/story/270786.html>

CONCLUSION

- PNB scam has exposed several bank to credit risk. They must need to examine how the process got diluted. And how some employees in collusion with client could lead to scam of large amount of money for such a large time without raising any red flag.
- It is mandatory for the bank that, they should improve their risk management system. The bank had been continuously hit by scam which show that the internal risk management system is very weak and non-planned.

- The role of the regulator bank is also under question now. Though RBI has come up with many risk management process for bank. RBI should also authorize the bank to deal with fraudsters in a swift manner there by reducing redtapism.
- Why was the Nostro account not reconciled? The government should suspend the auditor and fire top management.
- The government should sell the property of Nirav Modi and recover money.
- Find out such instances where collateral cover is very low.

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