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A Critical Analysis of the Punjab National Bank Scam and Its Implications

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Abstract

At a time when the government is aiming for bank recapitalization, the PNB scam comes as a huge blow to the entire banking sector. The Rs 12,700 crore scam involves at least six banks, raising doubts over the internal safety of operations in financial firms. It may be noted that the PSBs lost at least Rs 227 billion to bank frauds in the last five years. The magnitude of PNB scam is very exorbitant and it has been happening for more than five years undetected. This poses serious questions into the internal operations and auditing processes. The apex bank of the country RBI is facing public wrath for not being able to detect the largest banking scam. It is high time that all PSBs should review their internal process and take appropriate actions. This paper aims to identify and analyze the factors that led to this massive scam. It uses the quality tool 5W2H for analysis. This paper also delves into auditing process of the banks and possible loop-holes that led to the fraud. This paper also summarizes the impact of scam on various banks and the economy as whole.

Keywords: PNB, Scam, Audit, RBI, 5W2H, LOU.

1. Introduction

World credit market faced a huge turmoil during the financial crisis of 2007 and many big banks as in [1] and financial institutions filed for bankruptcy including Lehman brothers [2]. The impact of crisis was profound and many banks and financial institutions in US faced massive credit crunch [3]. Economists have noted that recessions accompanied by banking crises tend to be deeper and more difficult to recover from than other recessions [4].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 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. The banks are already facing turmoil due to weak capital management. Eleven of India's twenty one listed government-owned banks are now under the Reserve Bank of India's watch due to large bad loans, weak capital levels and low return on assets. Together these banks account for over Rs. 3 lakh crore in bad loans of the total of Rs 8.4 lakh crore across India's listed banks [5]. When the government is planning to recapitalize the banks [6] the PNB scam comes as a huge blow.

This paper attempts to dissect the PNB scam through comprehensive analysis. It uses the quality management tool 5W2H which investigates the scam in-depth to reveal various internal and external factors associated with the scam. Banking sectors, jewellery sector and insurance sector were affected by the scam. This paper also aims to find the impact of the scam on various sectors of the Indian economy.

2. Literature Review

Mergers of giants in the banking industry gave birth to the concept of "too big to fail", which eventually led to highly risky financial objectives and financial crisis of 2008. In response to the 2008 crisis, Dodd Frank Act [7] gave birth to various new agencies to help monitor and prevent fraudulent practices. Volcker rule, a part of DFA, banned banks from engaging in proprietary trading operations for profit.

Indian banking system has already been plagued with growth in NPAs [8] during recent years, which resulted in a vicious cycle affecting its sustainability. Chakrabarty [9] Deputy Governor of Reserve Bank of India, noted in his speech that, while most numbers of frauds have been attributed to private and foreign banks, public sector banks have made the highest contribution towards the amount involved.

To maintain uniformity in fraud reporting, frauds have been classified by RBI based on their types and provisions of the Indian penal code, and reporting guidelines have been set for those according to RBI [10] and [11].Towards monitoring of frauds by the board of directors by banks of India [12], A circular was issued as per RBI [13] to cooperative banks to set up a committee to oversee internal inspection and auditing, and plan on appropriate preventive actions, followed by review of efficacy of those actions.

Key findings in RBI [12] included the stress of asset quality and marginal capitalization faced by public sector banks, and various recommendations to address these issues. Good governance and more autonomy [14] to be conferred to public sector banks to increase their competitiveness and to be able to raise money from markets easily.

In response to the common perception that increasingly strict regulations will make business opportunities take a hit. Basic principles [15] that can go a long way in preventing fraud, namely the principles of knowing the customer and employees as well as partners. He also pointed out the significance of a robust appraisal mechanism and continuous monitoring.

Great recession 2007 resulted in bankruptcy of many banks and financial institutions. The Great Recession which had its impact globally was associated with a severe financial crisis, but depositors were not rushing to the banks to withdraw their deposits.

Banks suffered losses [16] on a scale not witnessed since the Great Depression. It is precisely this special “risk evaluator” role that makes the banking industry particularly opaque. The opacity of the sector has probably increased in recent years due to the structural changes brought about by deregulation and financial innovation; changes that have made the industry significantly more complex, larger, more global and dependent on financial markets.

The bankruptcy of Lehman Brothers in 2008 [2] sent shockwaves through the entire global banking and financial system across numerous and unexpected transmission channels when the price bubble in the US housing market tied to the subprime mortgage market suddenly burst.

Bad accounting treatment of financial transactions, loose risk management policies and strategies led the financial conglomerate to its eventual collapse.

3. Objectives of the Study

Objectives of the study include

1. To analyze the Punjab National Bank scam critically using 5W2H analysis.

2. To study the impact of scam on stock market, banking sector and jewellery sector.

3. To study the impact of scam on PNB rating given by various Indian and global rating agencies.

4. Research Methodology

This paper uses secondary data. The fraud came to light in January 2018. All the Newspaper articles, national and international periodicals related to scam from January 2018 to March 2018 was reviewed. Bank stock market data was taken from Sensex and other data was taken from financial information News Company like Bloomberg. The methodology used for analysis of the scam is 5W2H.

5W2H is a quality management tool which aims at examining the problem with the aim to reach feasible solutions. This analyses the problem in parts and hence follows the divide and rule approach. This tool helps in gaining a clear perspective about the various constituents of a problem and thus helps in improving the overall process.

5W2H stands for 5 Ws and 2Hs or Who, What, When, Where, Whey How and How much. When working on improving a process this is a very simple tool to help think thorough improvement opportunities.

- **W**ho does this? This can lead to, could we do it with less people?
- **W**hat is done at this step? This can lead to, can we eliminate some of the steps?
- **W**hen does this start and finish? This can lead to, can we shorten the time it takes?
- **W**here is this work done? This can lead to, can we do this elsewhere or in various locations?
- **W**hy are we doing this? This can lead to, do we need to do this?
- **H**ow do we do this? This can lead to, is there another way to do this?
- **H**ow much does this cost? This can lead to, how much would this cost if we made these changes?

TABLE 1: 5W2H OF THE PNB SCAM

What?	What happened?	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 jeweler Nirav Modi to have caused this massive fraud using the bank officials.
	What is the problem?	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. A Nostro account is the account an Indian bank (here, PNB) has with an overseas bank.
	What is the scope of the problem?	1. 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. 2. This has affected the banking sector, jewellery sector and the insurance sector. 3. This also questions the credibility of the Public Sector Banks, the role of regulators namely RBI and SEBI
When?	When did it happen?	PNB filed a fraud complaint against Modi group firms with RBI on 29/01/18. O4/02/18 :CBI issues lookout notice against NiravModi 05/02/18 : PNB informs stock exchanges about the Rs 281 crore fraud involving the Modi group 14/02/18: PNB informs the stock exchanges of the magnitude of the fraud
	When did it start? When did it stop?	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.
	Is it continuous problem? Intermittent?	This problem had been happening for the past seven years with respect to NiravModi case. PNB had also been affected by the Winsome Diamond group scam in 2013. When it comes to scams, it is not new to the banking sector as it has witnessed different levels of frauds at different times. Hence this is a continuous problem.
	Is it linked to a specific customer	The PNB scam as such is linked to Nirav Modi, the billionaire in the middle of this controversy, is a

	usage?	luxury diamond jewellery designer who was ranked #57 in the Forbes list of India's billionaires in 2017. He is the founder and creative director of the Nirav Modi chain of diamond jewellery retail stores, and is the Chairman of Firestar International, the parent of the Nirav Modi chain, which has stores in key markets across the globe. The firms have Nirav Modi, his brother Nishal Modi, Mr. Nirav's wife Ami Nirav Modi, and Mehul Chinubhai Chokshi as partners.
Who?	Who faced the problem?	PNB has faced the problem amounting to 11,400 crores. According to banking circles, PNB will have to make good the lost money even though technically Allahabad Bank and Axis Bank took the exposure.
	Who reported the problem?	The problem was detected and reported by PNB to RBI and CBI.
	Who is the customer? Who is the final customer?	
	Who are the stakeholders?	Customers of the Bank Employees Board of Directors Auditors Creditors Regulators : RBI,SEBI The Government of India
	Who are the parties involved?	Former employees of the Bank who issued the money Nirav Modi Allahabad and Axis bank who honoured the payment
Where?	Where did it happen?	It had happened within the operating environment of PNB.
	Is it in-house or at customer?	It could be termed as in house because the swift transaction on request was cleared by the PNB officials. Hence we have a question on the authenticity of the system for Letter of Credits at PNB.
	Where is the stakeholder’s location?	The two employees of PNB directly used SWIFT - the global financial messaging service used to move millions of dollars across borders every hour — and bypassed the core banking system (CBS) which processes daily banking transactions and posts updates.
	Which other location should be considered?	The information exchange between CBS and Swift transactions has to be reviewed.
How many?	How many parts were involved?	Letter of credit Letter of Undertakings(which were faked) Swift Network
	How much is the loss	12,000 crore
How?	How did it happen?(step by	Operational risk (OR) indicates a failure in any of the banking systems, processes or people.

	step explanation)	A major operational risk had occurred at PNB. Two bank officials of PNB had been issuing Letter of Credits for a long period to Nirav Modi without any collateral, which amounted to a fraud of Rs.11,400 crores.The swift messaging system had bypassed the core banking system and operated. There is neither proper internal coordination nor any internal control or monitoring process. This has resulted in the operational risk.
	Can we reproduce it?	
Why?	Why is it a problem?	The internal banking system is not systematic and is prone to fraudulent activities. PNB is now responsible for the fraud amount. The customers are panicked that their money in the bank may be under risk while the bank has assured to honor all its bona fide commitments.
	Is it a must or nice to have?	It is mandatory to have the standard operating system of responsible and responsive banking.

5. Impact on Stock Market

There are thirty nine listed banks in India. Share prices of the thirty-four listed banks fell between February 12 and February 15. The sudden volatility in the prices eroded the market cap of these Thirty four stocks by over Rs 36,380 crores. Benchmark BSE Bankex lost 1.2 per cent. PNB eroded investor's wealth worth Rs 8,077 crores and its stock tanked 20.6 per cent between February 12 and February 15 2018.

A. Impact on banks

The value of PNBs fraudulent transactions are nearly 50 times the bank's Q3FY18 net profit of Rs 230.11 crores. There are five banks that have been directly affected by the fraudulent transactions [19] as they have offered credit based on the LoUs issued by PNB. These banks are UCO bank, Allahabad Bank, Axis Bank, Union Bank of India, and SBI. Table 1 shows the bank's exposure to the PNB scam in crores [19].

Table 2: Credit Risk Exposure Of Public Sector Banks

S.No	PUBLIC SECTOR BANKS	EXPOSURE (cr)
1	UCO Bank	2635
2	Allahabad Bank	2400
3	Axis bank	200
4	Union Bank of India	1920
5	SBI	1360
Source: BloombergQuint Note: Compiled by the authors		

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. From the Table 1.

It can be seen that the bank's exposure in PNB fraud is about Rs 1920 crores. The bank suffered a net loss of Rs 1,249.85 crores in Q3FY18. Its Gross NPAs stood at 13.03 per cent in Q3FY18 compared to 11.7 per cent in Q3FY17.

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. Table 1. shows the bank's exposure in PNB fraud is around Rs 2400 crores.

In Q3FY18, the bank reported a 5.4 per cent reduction in total income with net loss of Rs 1263.79 crores. Its gross NPAs jumped to 14.38 per cent in Q3FY18 compared to 12.51 per cent in Q3FY17.

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.

Table 1. shows that the bank's exposure in PNB fraud is around Rs 200. In Q3Y18, the bank's interest income grew by 5.6 per cent.

However, its total income fell by 1.3 per cent due to reduction in other income. It reported a 25.3 per cent growth in net profit. Bank's gross NPAs stood at 5.3 per cent in Q3FY18 compared to 5.2 per cent in Q3FY17.

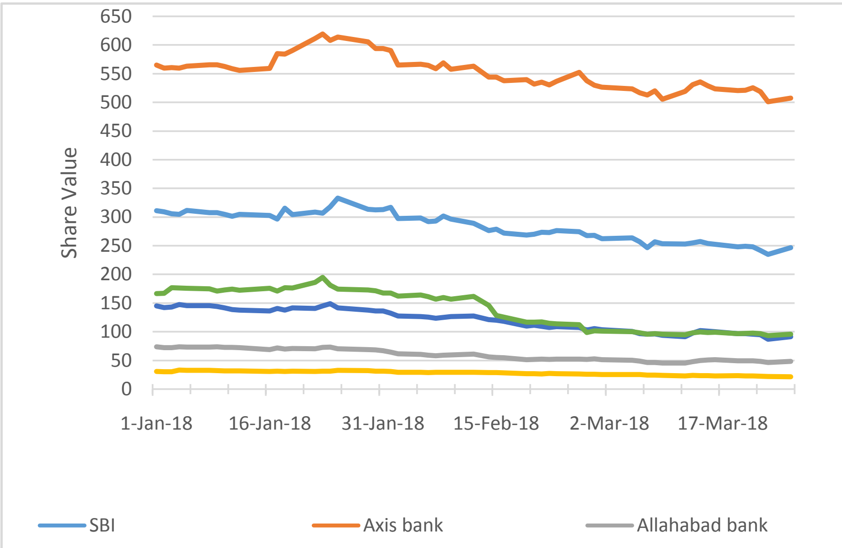
SBI: The share price tanked -3.34 per cent and its market value fell by Rs 8,329 crores between 12 February 2018 and 15 February 2018. Table 1. shows that SBI’s exposure to the PNB fraud as 1360 crore. In Q3FY18, the bank suffered a net loss of Rs 2416 crores compared to Rs 2610 crores profit in Q3FY17. Its gross NPAs jumped from 7.23 per cent in Q3FY17 to 10.35 per cent in Q3FY18.

Trends on bank stocks Jan-Mar 2018

Fig 1. shows the trends of share prices of bank stocks having exposure in the PNB scam namely SBI, Axis bank, Allahabad bank, Union bank of India, UCO bank and Punjab national bank for the time period Jan 2017 to march 2018. From the figure it is clear that all the banking stocks show a downward trend post Feb 14th, 2018.

It can be seen that downward trend is more pronounced in PNB, SBI and Axis bank.

The growth of the GNPA’s and banking scam are the major reasons for the downward trend.



Source : Compiled by the authors from secondary data

Fig 1. Trends On Bank Stocks JAN-MAR 2018

B. Impact on LIC

The Rs 11,400-crore banking fraud allegedly perpetrated by companies of Nirav Modi and Mehul Choksi that has hit Punjab National Bank along with other banks also had its impact on 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 the last three trading sessions on its investments in these companies.

As on December 31st, 2017 LIC owns 13.93 per cent shares in PNB, 13.24 per cent shares in Union Bank of India, 13.17 per cent shares in Allahabad Bank and 2.88 per cent shares in Gitanjali Gems as on December 31, 2017. Incidentally, LIC's holding in all these four entities is the single largest institutional holding and, therefore, it is the biggest loser as an investor in these companies following the crash in share prices after the fraud came to light. Table 2. shows estimated loss of LIC on account of PNB scam.

Table 2: Estimated Loss of Lic on Account of the Pnb Scam

S.No	Institution	Shareholding of LIC (%)	Fall in Share price (%)	Decline in Investment Value (cr)
1	Gitanjali Gems	2.88	40.25	11.9
2	PNB	13.93	22.27	1216.44
3	Union Bank of India	13.24	7.22	104.24
4	Allahabad Bank	13.17	10.25	65.81
Source: Indian Express				

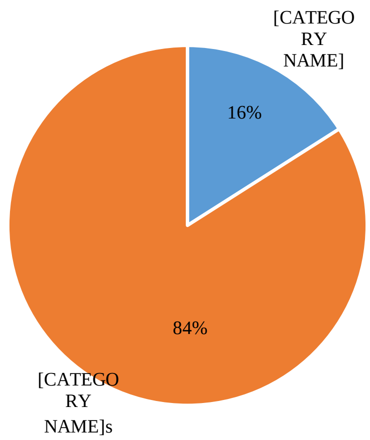
From the Table 2. it is evident that LIC incurred an estimated loss of Rs 11.9 crore on account of fall in share price of Gitanjali Gems, that on account of its holding in PNB and Union Bank of India loss amounts to Rs 1,216 crore and Rs 104 crore respectively. The loss in value of holding in Allahabad Bank amounts to Rs 65.8 crore.

From the table 2 it is clear that the aggregate loss in investment value for LIC, on account of exposure in these four companies over 3 trading sessions starting February 14 amounts to nearly Rs 1397 crores.

c. Impact on Jewellery Stocks

Shares of Gitanjali Gems plunged up to 19 per cent post Punjab National Bank's declaration of nearly Rs 11,400-crore fraud. Meanwhile, some of other jewellery stocks also witnessed a similar fate with PC Jeweller slumping 19.50 per cent to Rs 303.00, Tribhovandas Bhimji Zaveri (TBZ) 4.32 per cent to Rs 110.60, and Thangamayil Jewellery 2 per cent to 558.55 on BSE. Rajesh Exports fell 1.34 per cent to a low of Rs 808.70 on the BSE.

Banks as an aftermath of fraud [18] have raised their guard while lending to jewelers. This could impact credit flow to the industry or cause delays in extending advances.



Source : Compiled by the authors from secondary data

FIG 2: Revenue Share of Firestar Damonds and Gitanjali Gems

Figure 2 shows revenue share of Firestar Diamonds and Gitanjali gems in the gems and jewellery market in India. From the figure it can be seen that one-sixth of the market share has been held by the failed firm Firestar diamond and Gitanjali Gems. It accounted for nearly Rs1.17 lakh crore of organised gems and jewellery. This could make a dent on the trade which accounted for 13% of India's total experts in the financial year 2017.

CARE in its report (2018) stated that shutdown of the two companies would have an impact of 5% to 6% on the diamond and jewellery foreign trade over the next year, i.e. 2018-19. According to CARE including the massive unorganized market, the sector rakes in an annual revenue of Rs3.9 lakh crore.

D. Impact on PNB Rating

Global credit rating agencies are reviewing the ratings of Punjab National Bank for a possible downgrade in light of the massive fraud on the bank which came to light on Wednesday. Moody's and Fitch have raised doubts on the Punjab National Bank's creditworthiness and have placed the bank under rating watch, a kind of scrutiny before a possible rating downgrade or a cut in outlook. Moody's Investors Service [17] has put under review for a downgrade of PNB's local and foreign currency deposit rating of Baa3/P-3 and foreign currency issuer rating Baa3. Moody's in a release has stated that the likely financial impact of the fraudulent transactions is the key driver for the review for downgrade. The primary driver the rating action being the risk of weakening of the bank's standalone credit profile, as a result of the discovery of a number of fraudulent transactions."

CRISIL, an Indian rating agency has given AAA rating on the bank meaning the instrument issued or institution is of highest safety. CRISIL was the latest to revise the bank's rating when it revised the outlook on 18 public sector banks including PNB to stable from negative on January 25 citing support from the government's recapitalization. After the

CARE has AA+ rating on the bank. It has stated that this is a material event to update the rating according to the SEBI guidelines for rating agencies. Rating agencies are still trying to gauge the exact impact of the the largest banking fraud in the country. Each rating agency will try to reach out to PNB to clarify the bank's liabilities and impact on provisions which could dent the bank's profits and erode an already depleted capital base.

India Ratings and ICRA the two other ratings companies have a AAA and a AA+ rating on PNB. Bother these ratings were last revised in July and June respectively. The rating agencies have put ratings of various instruments of Punjab National Bank under review.

6. Conclusion

The Punjab National Bank fraud has exposed many banks to credit risk. There is a need to investigate how the process got diluted, and how a few employees in connivance with clients could lead to a fraud of large amounts of money for such a long time without raising any red flags.In the PNB case, the process of checking a transaction before disbursing a non-funded loan was not robust enough. This was an Operation Risk lacuna, which translated into a CR (credit risk)-related loss. As explained earlier in the 5w2h analysis, the internal operations of the bank should follow a standard operating procedures with effective control measures.

Another compliance failure that facilitated the Rs 11,400 crore scam was the unmonitored usage of the SWIFT financial messaging system. The collateral free swift transactions which had been taking place with the co-conspirators of the banks and Nirav Modi had eluded the eyes of other officials. It is also surprising that it had not been identified even during the external audit process, for a period of seven years.

The risk management system of the bank should be improved. The bank had been constantly hit by frauds which indicates the internal risk management is very fragile and non-planned. Monetary loss could be prevented with proactive follow-up with the concerned paying/intermediary banks, the incident has reinforced the fact that the various stakeholders have not learnt the lessons yet.

The role of the regulator of the banks is under question now. Though RBI has come up with various risk management processes for banks, RBI should empower the banks to deal with fraudsters in a swift manner thereby avoiding unwanted redtapism.

More than the large amount involved, the reputation of the banking industry is at stake, especially at a time when global attention is focused on stabilising bank reforms and greater efficiency of the financial sector is expected. Massive capital infusion through recapitalisation bonds is intended to resurrect the public sector banks (PSBs) that are burdened by a huge pile of non-performing assets (NPAs) and low capital adequacy. The government may have to rework its capital infusion plan in the light of these frauds.

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