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A STUDY ON BANKING FRAUD IN INDIAN BANKING SYSTEM
A SPECIAL REFERENCE ON PUNJAB NATIONAL BANK (PNB) FRAUD, INDIA

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ABSTRACT

Fraud is any dishonest act and behavior by which one person gains or intends to gain advantage over another person. Fraud causes loss to the victim directly or indirectly. Fraud has not been described or discussed clearly in The Indian Penal Code but sections dealing with cheating. Concealment, forgery counterfeiting and breach of trust have been discussing which leads to the act of fraud. There is a widely accepted provision of bank guarantees known as a letter of undertaking (LOU) under which a bank can allow 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 for a bank's customer for making payment to its offshore suppliers in the foreign currency. PNB employees issued fake LoUs, 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. Bank fraud is a big business in today's world. With more educational qualifications, banking becoming impersonal and increase in banking sector have gave rise to this white-collar crime.

KEYWORDS: LoU, PNB Fraud, Nostro Account, RBI, CVC, NPA

I. INTRODUCTION

Bank

A bank is a financial institution licensed to receive deposits and make loans. Banks may also provide financial services, such as wealth management, currency exchange and safe deposit boxes. There are two types of banks: commercial/retail banks and investment banks. In most countries, banks are regulated by the national government or central bank

Central Bank

A central bank or monetary authority is a monopolized and often nationalized institution given privileged control over the production and distribution of money and credit. In modern economies, the central bank is usually responsible for the formulation of monetary policy and the regulation of member banks.

Punjab National Bank

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 far-sighted visionaries and patriots like Lala Lajpat Rai, Mr. E C Jessawala, Babu Kali Prasono Roy, Lala Harkishan Lal and Sardar Dyal Singh Majithia displayed courage in giving expression to the spirit of nationalism by establishing the first bank purely managed by the Indians with Indian Capital. During the long history of the Bank, 7 banks have merged with PNB.

The Core strengths of the Bank is the brand image with rich 122 years of performance, more than 10 crore customers, strong CASA base, consistently growing Operating Profit, low Cost of Deposits, increasing Small Ticket Advances through leveraging RUSU (Rural & Semi Urban) branches, stable Asset Quality and increased pace of digitalization.

MISSION PARIVARTAN, a transformational exercise for Business Excellence, initiated in Q1FY'18, spells various focus areas and strategies of the Bank for ensuring greater Efficiency, Productivity and Profitability for long term sustenance and giving the Bank an edge over its competitors. The Bank will continue to take initiatives in transforming People, Processes and Products through responsive and responsible banking and continue to serve the customers with the enhanced vigour and zeal to live to its tagline "the name you can bank upon" for all its stakeholders.

II. SIGNIFICANCE

Monetary Policy

Monetary policy consists of the actions of a central bank, currency board or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates. Monetary policy is maintained through actions such as modifying the interest rate, buying or selling government bonds, and changing the amount of money banks are required to keep in the vault (bank reserves).

The Primary Functions of RBI as Follows

1. To control the supply of money in the economy i.e. how much money is available for the industry or the economy

2. The cost of credit.' meaning, and what is the price that the economy has to pay to borrow that money

These two things (Supply of money and cost of credit) are closely monitored and controlled by RBI. The inflation and growth in the economy are primarily impacted by these two factors.

The various methods employed by the RBI to control credit creation power of the commercial banks can be classified into two groups, viz., quantitative controls and qualitative controls.
Quantitative controls are designed to regulate the volume of credit created by the banking system Qualitative measures or selective methods are designed to regulate the flow of credit in specific uses.

To control inflation and the growth, RBI uses certain tools like CASH RESERVE RATIO, STATUTORY LIQUIDITY RATIO, REPO RATE, and REVERSE REPO RATE

The current CRR is 4%. If RBI cuts CRR in its next monetary policy review then it will mean banks will be left with more money to lend or to invest. So, more money can be released into the economy which may spur economic growth.

Statutory Liquidity Ratio (SLR)
Besides CRR, Banks have to invest certain percentage of their deposits in specified financial securities like Central Government or State Government securities. This percentage is known as SLR.

This money is predominantly invested in government approved securities (bonds), Gold, which mean the banks can earn some amount as 'interest' on these investments as against CRR where they do not earn anything.

Higher reserve requirements such as SLR make banks relatively safe (as a certain portion of their deposits are always redeemable) but at the same time restrict their capacity to lend. To that extent, lowering of reserve requirement increases the resources available with a bank to lend and helps control inflation and propels growth.

Repo Rate

- When we need money, we take loans from banks. And banks charge certain interest rate on these loans. This is called as cost of credit (the rate at which we borrow the money).
- Similarly, when banks need money they approach RBI.
- The rate at which banks borrow money from the RBI by selling their surplus government securities to RBI is known as "Repo Rate."
- Repo rate is short form of Repurchase Rate. Generally, these loans are for short durations up to 2 weeks.
- It simply means Repo Rate is the rate at which RBI lends money to commercial banks against the pledge of government securities whenever the banks are in need of funds to meet their day-to-day obligations.
- Banks enter into an agreement with the RBI to repurchase the same pledged government securities at a future date at a pre-determined price. RBI manages this repo rate which is the cost of credit for the bank.
- Higher repo rate may slowdown the growth of the economy.
- If the repo rate is low then banks can charge lower interest rates on the loans taken by us.
- So, whenever the repo rate is cut, can we expect both the deposit rates and lending rates of banks to come down to some extent
- This may or may not happen every time. The lending rate of banks goes down to the existing bank borrowers only when the banks reduce their base rates (Base Rate is the minimum rate below which Banks are not permitted to lend) as all lending rates of banks are linked to the base rate of every bank. In the absence of a cut in the base rate, the repo rate cut does not get automatically transmitted to the individual bank customers. This is the reason why you might have observed that your loan EMI’s remain same even after RBI lowers the repo rates.

Banks check various other factors (like credit to deposit ratios etc.,) before reducing the Base rates.

Reverse Repo Rate

Reverse repo rate is the rate of interest offered by RBI, when banks deposit their surplus funds with the RBI for short periods. When banks have surplus funds but have no lending (or) investment options, they deposit such funds with RBI. Banks earn interest on such funds.

Current CRR, SLR, Repo and Reverse Repo Rates:

A term called as "Basis Points" is often used in monetary policy reviews.

What is Basis Point? …. 1% is equivalent to 100 basis points e.g.

If Repo Rate is 7.75% and RBI increases it by 25 basis point, then new rate will be 8% as 25 basis point will be equal to 0.25%)

Letter of Undertaking (LOU)

a) There is a widely accepted provision of bank guarantees known as a letter of undertaking (LOU) under which a bank can allow 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 for a bank's customer for making payment to its offshore suppliers in the foreign currency.

b) For raising the LOU, the customer (importer) is supposed to pay margin money to the bank that issues the LOU and accordingly, they are granted a credit limit. But in Nirav Modi's case, neither was there a credit limit, nor did he ever give any margin money, reported Reuters.

c) Once the letter of credit is acknowledged and accepted, the lender (foreign branch of Indian bank) transfers money to the nostro account of the bank that has issued the LoU. In this case, Nostro account is the Punjab National Bank's account held in another bank in a foreign country for the purpose of holding foreign currency.

d) As a matter of fact, letter of undertaking is a letter of credit issued by one bank (let's call it Punjab National Bank) that paves way for another bank (let's call it Allahabad Bank-AB) to give money to supplier of Punjab National Bank's customer. As mentioned earlier, the money is transferred by AB to supplier of PNB's customer via a Nostro account that PNB holds in AB in abroad.

e) The credit is ideally meant for short-term only. In the Nirav Modi-Mehil Choksi case, the term of loan was allegedly extended far beyond what is prescribed as per the rule book. Even the PNB and other lenders are slugging out over the loan term, which should not have been extended, says PNB, longer than 90 days.

History about Punjab National Bank (PNB)

Punjab National Bank was registered on 19 May 1894 under the Indian Companies Act, with its office in Anarkali Bazaar, Lahore, in present-day Pakistan. The founding board was drawn from different parts of India professing different faiths and of varying back-ground with, the common objective of creating a truly national bank that would further the economic interest of the country. PNB's founders included several leaders of the Swadeshi movement such as Dyal Singh Majithia and Lala Harkishen Lal, Lala Lalchand, Kali Prosanna Roy, E. C. Jessawala, Prabhu Dayal, Bakshi Jaishi Ram, and Lala Dholan Dass. Lala Lajpat Rai was actively associated with the management of the Bank in its early years. The board first met on 23 May 1894.The bank opened for business on 12 April 1895 in Lahore.

PNB has the distinction of being the first Indian bank to have been started solely with Indian capital that has survived to the present. (The first entirely Indian bank, Oudh Commercial Bank, was established in 1881 in Faizabad, but failed in 1958.)

PNB has had the privilege of maintaining 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.

In 1900 PNB established its first branch outside Lahore in India. Branches in Karachi and Peshawar followed. The next major event occurred in 1940 when PNB absorbed Bhagwan (or Bhugwan) Dass Bank, which had its head office in Dehra Dun.

At the Partition of India and the commencement of Pakistani independence, PNB lost its premises in Lahore, but continued to operate in Pakistan. Partition forced PNB to close 92 offices in West Pakistan, one-third of its total number of branches, and which held 40% of the total deposits. PNB still maintained a few caretaker branches. On 31 March 1947, even before Partition, PNB had decided to leave Lahore and transfer its registered office to India; it received permission from the Lahore High Court on 20 June 1947, at which time it established a new head office at Under Hill Road, Civil Lines in New Delhi. Lala Yodh Raj was the Chairman of the Bank.

In 1951, PNB acquired the 39 branches of Bharat Bank (est. 1942). Bharat Bank became Bharat Nidhi Ltd. In 1960, PNB again shifted its head office, this time from Calcutta to Delhi. In 1961, PNB acquired Universal Bank of India, which Ramakrishna Jain had established in 1938 in Dalmianagar, Bihar. PNB also amalgamated Indo Commercial Bank (est. 1932 by S. N. N. Sankaralinga Iyer) in a rescue. In 1963, The Burmese revolutionary government nationalized PNB's branch in Rangoon (Yangon). This became People's Bank No. 7.After the Indo-Pak war, in September 1965 the government of Pakistan seized all the offices in Pakistan of Indian banks. PNB also had one or more branches in East Pakistan (Bangladesh).

The Government of India (GOI) nationalized PNB and 13 other major commercial banks, on 19 July 1969. In 1976 or 1978, PNB opened a branch in London. some ten years later, in 1986, the Reserve Bank of India required PNB to transfer its London branch to State Bank of India after the branch was involved in a fraud scandal. That same year, 1986, PNB acquired Hindustan Commercial Bank (est. 1943) in a rescue. The acquisition added Hindustan's 142 branches to PNB's network. In 1993, PNB acquired New Bank of India, which the GOI had nationalized in 1980. In 1998 PNB set up a representative office in Almaty, Kazakhstan.

Contingent Transaction

A contingent transaction is the advertisement for sale, lease or rent, or the actual sale, lease or rental of any merchandise, service or rights or privileges at a price or with a rebate or payment or other consideration to the purchaser which is contingent upon the procurement of prospective customers procured by the purchaser, or the procurement of sales, leases or rentals of merchandise, services, rights or privileges to other persons procured by the purchaser. State law declares contingent transactions as **unlawful,** rendering any obligation incurred by the buyer completely null and void.

III. PURPOSE/OBJECTIVES OF THE RESEARCH STUDY

1. To Find out Illegal Secret Mechanism Behind Punjab National Bank Fraud
2. To Notify What Government of India & PNB has done after PNB Fraud in Indian Banking System

IV. LITERATURE REVIEW

Fraud is any dishonest act and behavior by which one person gains or intends to gain advantage over another person. Fraud causes loss to the victim directly or indirectly. Fraud has not been described or discussed clearly in The Indian Penal Code but sections dealing with cheating. Concealment, forgery counterfeiting and breach of trust has been discussing which leads to the act of fraud.

In Contractual term as described in the Indian Contract Act, Sec 17 suggests that a fraud means and includes any of the acts by a party to a contract or with his connivance or by his agents with the intention to deceive another party or his agent or to induce him to enter in to a contract.

Banking Frauds constitute a considerable percentage of white-collar offences being probed by the police. Unlike ordinary thefts and robberies, the amount misappropriated in these crimes runs into lakhs and crores of rupees. Bank fraud is a federal crime in many countries, defined as planning to obtain property or money from any federally insured financial institution. It is sometimes considered a white-collar crime.

The number of bank frauds in India is substantial. It in increasing with the passage of time. All the major operational areas in banking represent a good opportunity for fraudsters with growing incidence being reported under deposit, loan and inter-branch accounting transactions, including remittances.

Bank fraud is a big business in today's world. With more educational qualifications, banking becoming impersonal and increase in banking sector have gave rise to this white-collar crime.

This banking fraud can be classified as follows

- Fraud by Insiders
- Fraud by Others

V. DATA ANALYSIS

The Required data collected for writing this article is primary as well as secondary through Virtual and Direct Interacting with different Personnel

VI. FINDINGS

It began with diamond firms approaching PNB for opening letters of credit for import of rough stones. As per the terms of the LC, a common banking tool, PNB would pay the overseas suppliers on behalf of Nirav Modi's firms within a certain period (typically three months) and recover the money from Modi. It's a market practice to extend the LC if the client (i.e., NM) is unable to cough up the money at the end of the LC tenure.

Fake LoUs were issued

This is done on the basis of letters of undertaking given by the local bank (which in this case is PNB). PNB employees issued fake LoUs, 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.

Based on unauthorized LoUs, the PNB employees misused the SWIFT network to transmit messages to Allahabad Bank and Axis Bank on fund requirement. In using SWIFT, one has to log into the network to fill up fields like the account number and SWIFT code, following which it is endorsed by a supervisor. The process is completed when the bank receiving the message confirms and the details are validated. While all this was done using SWIFT passwords, the transactions were never recorded in the bank's core system — thus keeping the PNB management in the dark for a long time.

The other question that crops up is: who were the suppliers? In the closely-knit world of diamonds, the overseas suppliers of rough stones and the final exporters of diamonds (after these are cut and polished in Surat) are often members of the clan, if not same family. According to PNB's statement to enforcement agencies, the funds so raised for payment of import bills have not been utilized for such purposes in many cases.

According to banking circles, PNB will have to make good the lost money even though technically Allahabad Bank and Axis Bank took the exposure. "It is not known whether Axis and Allahabad still have the loans on their books or they have offloaded some of it to other banks," said another banker.

According to a confidential note from PNB to some banks, similar modus operandi was used by the same officials in companies belonging to Mehul Choksi-promoted Gitanjali Gems, Gili India and Nakshatra, while issuing LoUs/ LCs. The transactions were initially routed through the CBS system but subsequently changes were made in the LCs by substantially increasing the amount and transmitted through SWIFT without reporting this to CBS.

According to the note, LoUs were opened for pearl import for which total time period allowed by RBI is 90 days. Some of the overseas branches of Indian banks overlooked the rule. PNB has alleged "clear criminal connivance" of group companies of Modi and Gitanjali with some officials of PNB and other banks. In what could lead to a feud between PNB and other Indian banks, the former has complained that some of the branches of other Indian banks have not shared key documents related to the credit with PNB.

It appears the overseas buyers' credit against LoUs was used to retire import bills or replenish maturing credit.

Allahabad Bank has also issued a confidential note to other banks on the modus operandi of the fraud.

What has the Government done about it?

On January 28, the PNB had complained to the CBI about the fraud. The agency, in turn, approached Interpol to issue a notice for locating Nirav Modi, his wife Ami, brother Nishal and Uncle Mehul Choksi, all of whom had left India early in January. Soon after, the Indian government suspended the passports of Nirav Modi and Choksi.

While Prime Minister Narendra Modi has not spoken about the fraud, Finance Minister Arun Jaitley sought to pass the buck. "A question for managements itself is whether they were found lacking? And, on the face of it, the answer seems to be yes, they were," he was quoted as saying by The Economic Times. "They were also found lacking in being able to check who among them was a delinquent."

Speaking at the 41st Annual Meeting of the Association of Development Financing Institutions In Asia and the Pacific on February 20, Jaitley asked, "What were the bank's auditors doing? If both internal and external auditors have looked the other way and failed to detect the fraud, then chartered accountants must introspect."

It was left to Defence Minister Nirmala Sitharaman to publicly articulate the government's position. She tried to throw the fraud at the Opposition's door by suggesting the wife of Congress leader Abhishek Manu Singhvi was a shareholder in a realty firm that had leased premises to a company associated with Nirav Modi.

Curiously, the government has opposed petitions in the Supreme Court seeking a court-monitored enquiry by a Special Investigation Team into the fraud. Attorney General KK Venugopal argued that an investigation by the Central Bureau of Investigation was already underway so there was no need for another one. The court directed the government to file a reply and adjourned the matter to March 16.

Indeed, the CBI and the Enforcement Directorate have been quite active, raiding properties associated with Nirav Modi and Choksi, sealing stores and seizing everything from luxury cars to boxfuls of imported watches. There were reports of the agencies recovering Rs 5,100-crore worth of Nirav Modi’s assets but they appeared to be of doubtful veracity.

The CBI has booked Nirav Modi for fraud and arrested five officials of companies associated with him and Choksi – Vipul Ambani and Arjun Patil of Firestar International, Kapil Khandelwal of Nakshatra Group, Niten Shahi of Gitanjali Gems, and Kavita Mankikar, the authorised signatory of three companies accused of fraud.

It has also arrested three PNB officials – Gokulnath Shetty, a deputy manager at Brady House branch, Manoj Kharat, who operated the SWIFT financial messaging system, and Rakesh Jindal, head of the bank’s Brady House branch from 2009 to 2011 and currently general manager of credit at the bank’s head office in Delhi. They had issued Letters of Undertaking without getting proper approvals and without making entries in the core banking system, the software used to support a bank’s most common transactions and which acts as a record keeper, Mint reported, quoting the PNB’s complaint.

On Friday, the Enforcement Directorate issued fresh summons to both Nirav Modi and Choksi, asking them to appear before it on February 26. Replying to an earlier summons, Nirav Modi had informed the agency he could not appear before it because his passport had been suspended, reported PTI.

What has the PNB DONE?

In a letter to the PNB on February 15, a day after the bank acknowledged the fraud publicly, Nirav Modi claimed the bank’s “overzealousness” had hampered his ability to clear his dues. “The erroneously cited liability resulted in a media frenzy, which led to immediate search and seizure of operations, which in turn resulted in Firestar International and Firestar Diamond International effectively ceasing to be going-concerns,” he wrote, according to PTI. “This, thereby, jeopardized our ability to discharge the dues of the group to the banks.”

Replying to the letter on Thursday, PNB accused Nirav Modi of laundering money. “You were getting LoUs issued illegally and in an unauthorized way through few bank officials,” The Economic Times quoted the bank as having written. “At no stage such facilities were extended by our bank to the three partner firms. When these illegal activities surfaced, they pointed out towards apparent violation of FEMA and money laundering aspect.”

It also asked Nirav Modi to come up with a plan to return the money. “Your commitment and undertaking for sparing of the total liability was not backed by providing upfront amounts and timelines,” the bank said in its letter, NDTV reported, quoting PTI. “However, should you have any concrete and implementable plan, do revert.”

Separately, in a clarification to stock exchanges, the bank claimed it had “followed all lawful avenues available to us as per law of land to recover our dues”.

The bank has now appointed the auditor Price water house Coopers to investigate the alleged fraud, The Economic Times reported, asking it to collect evidence against Nirav Modi and quantify the bank's losses from the alleged fraud.

VII. CONTRIBUTION OF THE STUDY

- Independent specialized cadre
- Internal rating agency
- Use of latest technology
- Monitoring outlier movement at regional level
- Strong punitive measures for third parties
- Strong laws to prevent fraudulent financial reporting

VIII. CONCLUSION

It is observed that PSBs fare better than PVBs in terms of total number of bank frauds. However, the total amount involved is much higher in PSBs as compared to the private sector. This can be attributed to large size of loans which PSBs offer to customers. Credit related frauds have the maximum impact in all the banking frauds in India because of the high amount involved and the cumbersome process of fraud detection followed by CVC (Central Vigilance Commission).

The frauds may be primarily due to lack of adequate supervision of top management, faulty incentive mechanism in place for employees; collusion between the staff, corporate borrowers and third-party agencies; weak regulatory system; lack of appropriate tools and technologies in place to detect early warning signals of a fraud; lack of awareness of bank employees and customers; and lack of coordination among different banks across India and abroad. The delays in legal procedures for reporting, and various loopholes in system have been considered some of the major reasons of frauds and NPAs (Non-Performing Assets).

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