



Impact of PNB Scam on Banking Sector and Investors in India: An Empirical Study

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Abstract:

On 14th February, 2018 Banking Industry of India registered a big scam in the form of Letter of Understanding (LoU) scam of PNB. The PNB is second largest public sector bank in India with good market capitalization. The size of this scam is near about Rs.11400 crore, Mr. Nirav Modi's firms sought the LoU to get buyers' credit from foreign banks whereby they can finance diamond imports to India.

In this paper, the researchers have discussed the case study of Punjab National Bank (PNB) and its impact on banking sector and investors in India.

Keywords:

PNB Scam, Letter of Understanding, Buyer's Credit.

Introduction:

The Punjab National Bank (PNB) is one of the leading nationalized banks in India. The operations of PNB are not limited to India as it is Multinational bank. PNB operates in UK, Hong Kong, Australia, Dubai, Bhutan, Kazakhstan, China, Nepal and Bangladesh. PNB had consolidated total assets INR 7.321 trillion and deposits of INR 6.362 trillion and total net profit of bank was Rs. 902 crores in September, 2017. PNB's founders included several leaders of the Swadeshi movement. PNB is the first Indian bank which started solely with the Indian capital and survived till date. On 19th May, 1894 PNB was registered under the Indian Companies Act. The business of bank was started on 12th April, 1895.

During the history of 122 years, the 7 different banks have merged with PNB. PNB have total 6941 domestic branches and 9753 ATMs all over India. The total numbers of customers of PNB is 10 crore as on today. The gross and net NPA of PNB was 13.31% and 8.44% as on September, 2017 respectively. It is very less as compared to other nationalized banks in India.

Objective of the Study:

To study the impact of PNB scam on banking sector and investors in India.

Research Methodology:

Data published in different newspapers, several articles and many websites is referred to background study. Informal discussions with the Experts in Banking Sector, practicing Chartered Accountants and Investment Consultants, finance faculty members were held with the help of semi-structured questionnaire.

Scam in PNB:

The Punjab National Bank's Brady House Branch in Mumbai issued fraudulent Letter of Undertaking (LoU) worth of Rs. 11,400 crores in favour of Diamond Trader Mr. Nirav Modi's firms. His firms sought the LoU to get buyers' credit from foreign banks whereby they could finance diamond imports to India. This LoU was taken towards guarantee for overseas lenders (banks) to get money from them. Here, foreign branches of three Indian banks – Allahabad Bank, Axis Bank and Union Bank of India, provided credit to Mr. Nirav Modi's firms based on the PNB LoUs.

Primary report of PNB indicates that the LoU was issued without proper authorization. This means that some officials in the bank have done a favour to Mr. Nirav Modi. To understand the entire issue behind the scam, a proper understanding of concepts like Buyers' credit and LoU is needed. The whole scam came into limelight when Mr. Nirav Modi failed to make repayment on time due to financial trouble. Initial enquiry shows that LoUs were issued back date from 2012-13. The non-payment implied that the default burden fell on the shoulders of PNB (not on the three Indian banks) as LoU was a financial guarantee in case of non-payment by the Mr. Nirav Modi. PNB has alleged that two of its employees "fraudulently" issued LoUs and "transmitted SWIFT instructions to the overseas branches of Indian Banks" to raise buyers' credit for Mr. Nirav Modi's firms.

Buyer's Credit:

In simple words, Buyer's Credit is a loan facility extended to an importer by a bank or financial institution to finance the purchase of [capital goods](#) or services. Buyer's credit is an useful mode of

financing in international trade. Usually, for bulk purchases the importers (foreign buyers) hardly pay cash, while the capability to extend considerable amounts of long-term credit to their buyers is having by few exporters only. A facility of buyer's credit involves a bank that can extend credit to the importer, as well as an export finance agency based in the exporter's country that guarantees the loan. The buyer's credit includes cross-border legalities and multiple parties. Generally, it is only available for large export orders, with a minimum threshold of a few million dollars.

Letter of Understanding:

A LOU or Letter of Understanding is a formal document which includes the terms and conditions of understanding of a contract which mostly has been negotiated up to this point only in spoken form. It reviews the terms and conditions of an agreement for a service, a project or a deal and is often written as a step before a more detailed contract is issued. In universal banking system, Letter of Undertaking (LOU) is a provision of bank guarantee, under which a bank allows its customers to raise money from another Indian bank's foreign branch in the form of a short term credit. It serves the purpose of a bank guarantee. However, the customer is supposed to pay margin money to the bank issuing the LOU to be able to raise the LOU and accordingly, he is granted a credit limit.

The LOU in the cases of the PNB case means that the PNB will pay the amount if Mr. Nirav Modi doesn't pay the loan obtained from the issuers of buyers of credit (Axis bank etc.).

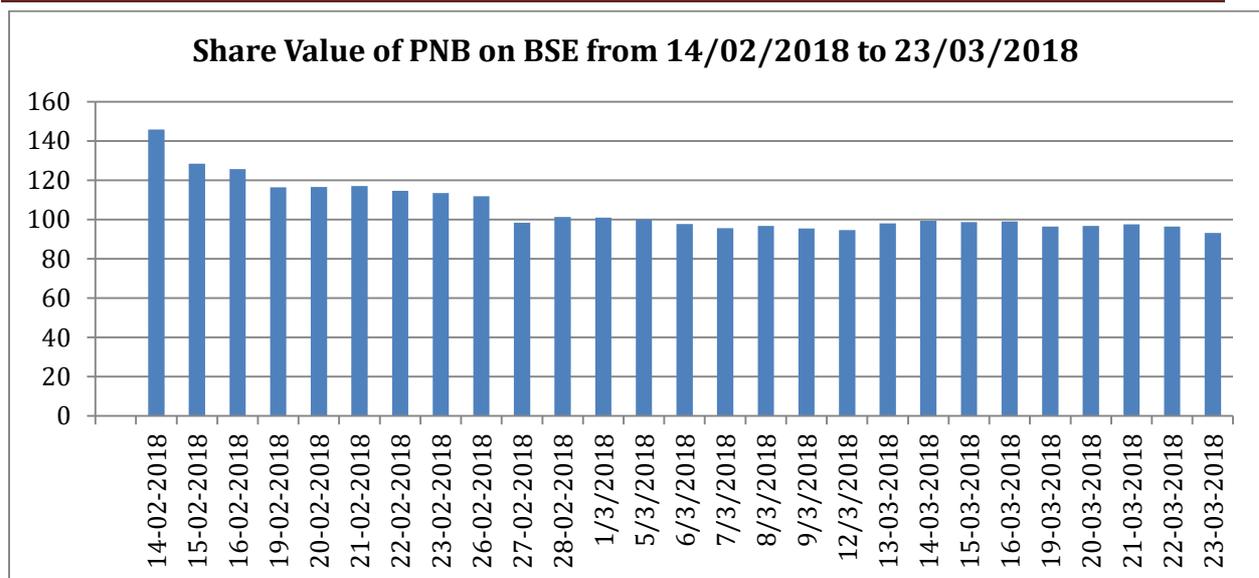
Impact on Investors:

- The PNB is a second largest public sector bank in India having a market capital of Rs.30477.40 crores.
- The announcement of fraud came into public, PNB share went down by 10% on 14th February, 2018. Rs.4,000 crores investors' money considering the magnitude of the scam which is nearly one third the market capitalization of PNB.
- The decreasing prices of the shares will further directly impact the mutual fund schemes that are holding shares of PNB. Many mutual fund houses had invested in PNB. It is a part of the equity portfolio of 117 mutual fund schemes. Especially, equity oriented schemes hit much more to this scam.
- The PNB share went down up to 36 % in last one month (from 14.2.2018 to 23.3.2018). The share price of PNB hits 52 weeks low as Rs.93.15 on 23.3.2018. The more than Rs.13,000 crores of investors' wealth has been wiped out.
- The below table shows the details about PNB share trading on BSE in one month (from 14.2.2018 to 23.3.2018) regarding open, high, low, close and volume.

Date	Open	High	Low	Close	Volume
14-02-2018	160.00	160.00	144.70	145.80	5284239
15-02-2018	137.00	139.70	125.55	128.35	17210918
16-02-2018	125.05	128.40	120.60	125.65	11728033
19-02-2018	122.70	123.40	113.60	116.40	9895137
20-02-2018	113.50	118.40	111.00	116.55	11208862
21-02-2018	117.80	119.50	115.60	117.10	4666212
22-02-2018	114.80	116.70	113.70	114.65	2797680
23-02-2018	114.40	116.85	112.35	113.40	3101753
26-02-2018	113.45	114.95	110.25	111.90	3230607
27-02-2018	107.80	107.80	96.10	98.35	14907301
28-02-2018	94.00	102.25	92.00	101.35	16783225
01-03-2018	100.85	103.70	98.80	101.00	9355509
05-03-2018	100.00	102.35	98.70	100.05	4729664
06-03-2018	101.00	102.00	96.75	97.75	3444175
07-03-2018	96.00	96.90	94.10	95.55	4394544
08-03-2018	95.70	97.45	94.35	96.70	3508436
09-03-2018	96.80	97.50	94.95	95.50	2708817
12-03-2018	95.50	96.30	91.30	94.60	3668501
13-03-2018	94.00	102.60	93.30	98.00	8904196
14-03-2018	94.00	100.20	93.35	99.35	7064871
15-03-2018	99.35	101.00	98.00	98.65	4266330
16-03-2018	98.10	102.20	97.60	98.95	4668155
19-03-2018	98.50	100.35	96.00	96.45	2832413
20-03-2018	96.00	97.50	95.25	96.75	1853986
21-03-2018	97.15	99.05	97.15	97.60	1586651
22-03-2018	97.60	97.95	95.65	96.45	1503262
23-03-2018	95.00	95.20	92.70	93.15	2715588

Source:

http://www.moneycontrol.com/stocks/hist_stock_result.php?ex=Bandsc_id=PNB05andmycomp=PNB



Graphical Interpretation:

The above graph indicates that, price of PNB share on BSE has continuously decreased. On 14th February, 2018 the closing price of PNB share was Rs.145.80 and on 23rd March, 2018 price fell up to Rs.93.15. The share price of PNB is decreased up to 36.11% in one month (from 14.2.2018 to 23.3.2018) due to scam of Mr. Nirav Modi.

Generic Observations:

The following are the generic observations applicable to all kinds of banks' scams (BOM, PNB, IDBI etc.), PNB Scam discussed in this paper is not an exception to these Generic Observations.

1. Generally, the transfers of bank employees take place after every three years. But it is found that the transfers of the employees involved in the scam do not take place for many years. (In case of PNB the transfer of the bank employees who were involved in the scam did not take place for more than seven years)
2. Corruption comes from the top and it percolates till the bottom. Hence, employees at the middle level and lower level do not deny or take any action against wrong doings in the system.
3. Few employees may not be aware about bad practices prevailing in the system. Few may be aware about the same but they ignore the same as they perceive that it is going on regularly since long back. Few employees will be involved in the scam as per the direction of higher authorities. They knew that nobody will take action against them as they will be backed by higher authorities, if required.
4. Banks do not show actual NPA. Hence, later on scams may take place. Many branches are giving new loans in order to recover old loans from the amount of new loans to avoid NPA. Basically, without recovery of old loan, new loan should not be sanctioned and disbursed. But, it is not happening in practice in many banks. Crop loans and loans given to the giant corporate are the best examples of the same.
5. There is scarcity of willingness to implement proper systems, rules and regulations for transparency because of which scams are indirectly encouraged.
6. Employees who want to work as per the rules and who don't want to get involved in scam are either transferred or disciplinary actions are taken against them, out of malice.

Conclusion:

With respect to Banking Sector:

The Net worth of the PNB decreased and it will continue to decrease further. As a result, its Book Value and Marketing Value per Share will also decrease.

With respect to Investors:

PNB scam has started showing its bad effects already. Market value of PNB per share is decreased by 36.11% during the period of 14.2.2018 to 23.3.2018.

Recommendations:

1. Ministry of Finance and RBI should take strict action against the PNB officials, responsible for the scam immediately.
2. PNB should block all the accounts of concerned persons and take custody of all assets of defaulters of PNB immediately to create the confidence among the investors.
3. Government should take care of the investors. PNB and Government should change the Board of Directors and Auditors of the bank. Also they may appoint an '**Official Administrator**' to regulate and control present important banking transactions.

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