Gem of the Indian Banking Fraud: A Case of Systemic Control Failures at Punjab National Bank

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Introduction

Punjab National Bank (PNB) is one of the largest public sector banks in India. The government owns 65.01% of its equity as on March 31, 2017 (PNB, 2017). According to Top Banker 2017 report of Dun and Bradstreet (2017, p 107), the PNB ranks third among all Indian banks and second among the Indian public sector banks in terms of business size (total of advances and deposits), which exceeds USD 160 billion as of March 31, 2017. The core strengths of the bank are its brand image with 122 years of experience, its more than 100 million customers, its strong deposit base, its consistently growing operating profit, and its low cost of operations, and its extensive rural and urban branch network, stable asset quality and rapid digitalization. As on March 31, 2017, PNB had an aggregate asset size of USD 111 billion, equity of USD 6.5 billion and net income of USD 204 million. The banks total capital ratio (regulatory capital to risk weighted assets) was close to twelve percent (PNB, 2017).

Before we delve into the details of the PNB fraud, we need to understand how the trade is financed by banks in India. Some frequently used terms in import-export finance are explained below.

**Letter of Undertaking (LoU) and Foreign Letter of Credit (FLC) (“hundi” in Hindi)**

A LoU is a letter of guarantee issued by a bank on behalf of its customers to foreign branches of other banks, who offer credit to these customers. A FLC is a guarantee from a bank that a particular seller based in a foreign country will receive a payment due from a particular buyer within a specified time period. The key difference between a LoU and a FLC is that an LoU cannot be discounted unlike a FLC. A LoU does not require the releasing of documents by the issuing bank. The credit risk exposure in a LoU is to the issuing bank and not to the buyer/seller of goods. LoUs and FLCs are “a contingent liability” from the accounting point of view of the bank. This means that a liability may or may not arise, depending on the outcome of a specific event. These contingent liabilities are disclosed in the financial statements or in the notes to the financial statements in the annual report depending on the probability of default and reasonable estimates. Inasmuch as being document credits, which equal the amount mentioned, that potentially expose the bank to substantial liability, LoUs and FLCs require approval of senior management of the bank. Generally, banks retain adequate security (depends on the creditworthiness of the customer) as collateral before issuing LoUs or FLCs.

**Nostro/Vostro Account**

A nostro account is an account of a local bank held with a foreign bank, usually in the currency of the foreign bank’s country. A vostro account is an account that a correspondent bank holds on behalf of another bank. For example, in the case of PNB, the PNB’s USD account with Standard Chartered Bank in Hong Kong is a nostro account for PNB. The same account is a vostro account for Standard Chartered Bank.

**Society for Worldwide Interbank Financial Telecommunications (SWIFT)**

SWIFT uses a standardized proprietary communications platform, such as Telex or WhatsApp, to facilitate the transmission of information, including payment instructions, among 11,000 financial institutions in 200 countries. SWIFT neither holds funds on its own, nor manages external client accounts. Financial institutions issue LoUs and FLCs through the SWIFT platform.

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Core Banking Solution (CBS)

CBS is a networking of branches which enable customers to use their accounts and avail of banking services from any branch of the bank in the CBS network, regardless of where the customer maintains his or her account. The customer is no longer a customer of just one branch. He or she becomes the bank's customer. PNB was using Finacle software developed by the Indian IT giant Infosys.

Why are LoUs or FLCs Used in International Trade Finance?

The Indian rupee ₹ is not a fully-convertible currency on a capital account. As per the current Reserve Bank of India (RBI) regulations, the maximum amount anyone can remit outside India in foreign currency is capped at USD 250,000 (RBI circular, 2016). This means that no Indian resident can buy or sell foreign currency in the open market beyond this amount. Accordingly, whenever an importer needs foreign currency to pay for imports, he or she has to go to the bank and apply for funds in a foreign currency. The importer has two options to obtain foreign currency funds from a bank in India. The first option is to obtain a foreign currency loan, which involves a time consuming, tedious and expensive process and the second option is to obtain a bank guarantee, which involves a relatively less expensive and faster process. Naturally, importers generally opt for the second option and request their banks to issue LoUs or FLCs, akin to bank guarantees.

Background of Alleged Fraud at PNB

On January 29, 2018, PNB, filing a complaint with the Central Bureau of Investigation (CBI) (Federal Investigation Agency of India), alleged that Nirav Modi, Ami Modi, Nishal Modi and Mehul Choksi, all partners of Diamond R US, Solar Exports and Stellar Diamonds (all non-issuer companies), in collusion with two bank officials, committed fraud against PNB. Furthermore, they informed the CBI that at the bank’s office at Brady House in Fort, Mumbai, two of its employees, Gokulnath Shetty, retired Deputy Manager of PNB, and another official Manoj Kharat, issued fraudulent LoUs worth ₹ 2,807 million (about USD forty-three million) in 2017 to Hong Kong-based creditors on behalf of three firms associated with Nirav Modi and the Gitanjali Group (issuer company) (The Daily Pioneer, 2018). On February 14, 2018, within two weeks of the above complaint, the PNB filed a stock statement with Bombay Stock Exchanges maintaining that “The Bank has detected some fraudulent and unauthorized transactions (messages) in one of its branches in Mumbai for the benefit of a few select account holders with their apparent connivance. Based on these messages, other banks appear to have advanced money to these customers abroad. In the bank, these transactions are contingent in nature and (any) liability arising out of these on the bank shall be decided based on the law and genuineness of underlying transactions. The quantum of such transactions is about ₹ 114,000 million (about USD 1771.69 million), which is almost one-third of the net worth of the bank. The matter (has) already (been) referred to law enforcement agencies to examine and book the culprits as per (the) law of the land” (Krishna, 2018).

In response to this disclosure, the stock price of PNB nose-dived. Various law enforcement agencies started an investigation of the alleged fraud and the Institute of Chartered Accountants of India (ICAI) commenced an investigation of the integrity of PNB’s auditors. Subsequently, several officers of PNB, charged with fraud, were arrested.

The total amount of the fraud equates to forty-nine times that of the net profit posted by PNB for the quarter ending December 31, 2017, and exceeds, by more than twice over, the amount that PNB received from the government of India under bank recapitalization plans (₹ 54,730 million) during the financial year 2017–18. According to a statement issued by the Ministry of Finance (MOF), PNB had issued as many as 41,178 LoUs since 2011, of which 1,590 were given to Nirav Modi, Mehul Choksi and their associates (The Hindu Business Line, 2018).

This is not the first time that PNB had incurred huge losses due to employee-perpetrated fraud. In 1985, a general manager of PNB’s London Branch was arrested for alleged connivance in granting loans worth over ₹ 2,500 million without sufficient securities (Chawla, 2014). In August 2016, three officials of the Chandigarh branch of Indian Overseas Bank (IOB) were prosecuted for fraudulently issuing LoUs that incurred a loss of ₹ 3210 million (about USD fifty million) on IOB, PNB and the Bank of Baroda (BOB) (Ahmed, 2016). As per information obtained under the Right to Information Act (RTI), due to fraud, the PNB has cumulatively lost ₹ 65,620 million (about USD 1,000 million) in 389 cases in the five years ending March 31, 2017 (The Hindustan Times, 2018). A consortium led by Standard Chartered Bank had lent ₹ 68,000 million to The Winsome Diamond Group with PNB bearing the highest exposure of any single bank in the syndicate at ₹ 18,000 million. The loans were taken by three group companies: Winsome Diamond and Jewelers, Forever Precious Diamond and Jeweler, and Suraj Diamonds (Business Today, May 22, 2018).
The Alleged Orchestrators of the PNB Scandal

Nirav Modi, born in India and raised in the Belgian city of Antwerp, the world's diamond capital, is a third generation diamantaire. According to Forbes, Wharton-dropout Nirav Modi has a net worth of USD 1.73 billion. He is said to have developed his business acumen in the diamond trade under the stewardship of his maternal uncle, Mehul Choksi, who is also the CMD of the popular jewelry brand Gitanjali Gems. In 2010, Modi became the first Indian jeweler to be featured on the cover of Sotheby's and Christie's auction catalogues. He was featured among Forbes’ 100 richest Indians list in 2017. Nirav Modi, his wife Ami Modi (a U.S. citizen), brother Nishal, and Mehul Choksi are partners in Diamonds R US, Solar Exports, and Stellar Diamonds, which has shops in foreign locations, such as Hong Kong, Dubai, and New York. The Nirav Modi store in New York shares space with legendary brands, such as Chanel, Hermes, Prada, and Gucci. The store launch was graced by celebrity guests, such as then U.S. presidential contender Donald Trump, the Hollywood actress Naomi Watts, the Indian actress Priyanka Chopra, and the leading model Coca Rocha. Subsequently, Nirav Modi opened stores in London, Hong Kong, and Macau.

Mehul Choksi is an Indian businessman and the owner of Gitanjali Group, a retail jewelry company with 4,000 stores in India. He was allegedly involved in a stock market manipulation in 2013 (Srinivas and Ghosal, 2013).

How the Fraud was Uncovered?

On May 31, 2017, Gokulnath Shetty who was allegedly involved in fraudulent LoUs, retired from PNB, having worked at the Brady House branch for nearly seven years, despite RBI’s guidelines stating that staff should rotate every three years (Quora, 2017). PNB initially discovered fraudulent LoUs guarantees, some apparently used to pay off older loans coming due on January 16, 2018, when a representative of Modi’s firm sought a new LoU to support further overseas borrowing. “They wanted the process to continue”, “But the old employee was not there, and the new ones said no to these practices”. Scrutinizing the bank’s records, including old SWIFT messages, the new bank employee uncovered the full scale of the problem, leading to a stunning stock exchange announcement on February 14, 2018. Nirav Modi, Mehul Choksi, and their families had already left India in early January 2018, just days before the first of Choksi’s many LoUs from the previous year came due (Dubey, 2018).

PNB’s Brady House Fort Mumbai branch, where the fraud took place, is a mid-size corporate branch that can give credit up to ₹ 500 million (around USD 7.5 million). Such branches are generally headed by an Assistant General Manager (AGM). Following Figure 1, a typical organizational hierarchy in a public sector bank shows the position of AGM in the overall management structure of the bank.

Figure 1: Organizational Hierarchy of Public Sector Bank of India

(Source: Created by the authors)
Out of more than 6,000 branches, PNB has only twenty-five large- and medium-sized corporate branches, including the one at Brady House, where the fraud took place. Notwithstanding that such branches are subjected to a higher level of managerial control, regulatory oversight and supervisory review than smaller branches, fraud of this magnitude nonetheless remained undetected for more than seven years.

**What Was the Fraud’s Modus Operandi?**

There were two types of fraud that took place at PNB. In the first type, Nirav Modi, Mehul Choksi, and their companies secured LoUs without proper authorization and without collateral colluded with officials from PNB’s Brady House branch in Mumbai in the issuance of fraudulent LoUs. In the second type, FLCs were issued to importers (Nirav Modi and Mehul Choksi) for importing diamonds. The value of these FLCs was later modified and recorded in SWIFT and in FLC documents at a higher value than the actual amount posted in PNB’s CBS. These LoUs and FLCs were used to obtain loans abroad ostensibly to pay for imports. According to investigators, the two submitted forged papers related to imported jewelry. Once the funds were released to suppliers overseas, the suppliers, believed to be fronts for Nirav Modi and Choksi group firms, promptly sent the money back to India into accounts of shell firms owned by the duo through fictitious transactions.

Investigations have revealed that the companies involved in the transactions abroad were bogus firms with their directors having been previously employed by Nirav Modi and Mehul Choksi. Two firms Firestar Diamond and Gitanjali Gems laundered the misappropriated funds (Singh, 2018). Investigators have discovered that, in many instances, Choksi brought money from overseas into the account of his company Gitanjali Gems. He subsequently diverted these funds into accounts of various dummy (shell) companies describing the transfers as unsecured loans, from where money was siphoned off through various means, including cash withdrawals. Most of the twenty dummy firms are based in Hong Kong and Dubai. Investigators found that of the ₹ 123,000 million, Nirav Modi was responsible for transactions amounting to ₹ 65,000 million, while the remaining ₹ 58,000 million belonged to Mehul Choksi. According to the RBI rules, the validity of a LoU is ninety days from the day of shipment. However, the foreign branches loaned money against the LoUs, for a year in violation of the RBI’s guidelines (Money Control, 2018).

![Figure 2: Modus Operandi of PNB’s Fraud](Source: Created by the authors)
Nirav Modi and Mehul Chowksi (the duo) firms approach PNB India for issuance of LoUs in their favor. PNB India issue the LoUs in favor of firms owned by the duo. The LoUs issued from PNB India are unauthorized and communicated to the overseas banks on SWIFT system. The overseas banks, on the basis of LoUs issued from PNB India, provide loans to PNB India and transfer money in PNB’s Nostro accounts overseas. From PNB’s Nostro accounts payments are made to the duo’s foreign suppliers. Most of these foreign suppliers are shell firms of the duo which transferred money back to India through fictitious transactions in different companies owned by the duo. The LoUs issued from PNB India are used to partly clear the previous dues and remaining for fresh loans to firms owned by the duo. This circular rotation of unauthorized LoUs went on until it was finally detected in February 2018.

**Why the Fraud was Not Detected for so Long?**

Banks in India are highly regulated by regulatory agencies, such as the MOF, the RBI, and the Securities and Exchange Board of India (SEBI), in accordance with the Stock Exchange Listing Regulations, Banking Regulations, and Foreign Exchange Management Act (FEMA). Perusal of PNB’s annual reports reveals that the bank’s internal controls include a credit audit and review, an internal audit, an IT audit, a management audit, a compliance review and a vigilance review. This is in addition to statutory audits, concurrent audits, tax audits, RBI inspections, FEMA audits and many more special purpose audits. Furthermore, there are various committees of the board, such as the Risk Management Committee, the IT Strategy Committee, the Special Committee of the Board for Monitoring Fraud Cases and the Audit Committee (PNB Annual Report, 2016, and 2017).

LoU guarantees were issued on the SWIFT messaging system. SWIFT requires a maker-verifier-approver chain control in place. Separate individuals with separate passwords are required to process the LoU; however, it is evident that the various checks and authorizations (if at all) had been completely compromised. The maker, verifier, and approver worked in collusion. The maker had access to all the passwords. There was no link or interface between CBS and SWIFT. The SWIFT transactions were not captured as banking transactions in CBS unless manually entered into CBS or vice versa. There was no rotation or transfer of staff at the SWIFT desk for almost eight years. No LoUs related documentation was retained at the bank and all documents were returned to the client, against banking rules. An LoU allowed the customer, Nirav Modi and his associates, to raise money from other Indian banks’ foreign branches (Allahabad Bank, Bank of India, United Bank, State Bank of India, and Axis Bank) in the form of a short-term credit to pay offshore suppliers in foreign currency. By rolling over credit, Nirav Modi had ensured that subsequent LoUs repaid the cash due on earlier LoUs, similar to a round tripping process, akin to a Ponzi scheme. No default resulted until January 2018. Initially, LoUs with small dollars amount proliferated but, gradually, the amount and number of LoUs increased. It also appears that the reverse confirmation process of LoU was also compromised.

The buyer’s credit was discounted by the bankers without any counter verification by the issuing branch. Indian banks continued discounting FLCs, for almost eight years, without suspecting any malfeasance with respect to a multitude of amendments to these FLCs. The bank never questioned why all amendments were effectuated only through SWIFT. The banks engaged in no other communications (Yadav, 2018).

The PNB Treasury Department’s daily reconciliation process overlooked the nostro accounts’ LoUs and FLCs. Apart from this daily monitoring process, moreover, management’s monitoring, the credit monitoring, internal audits, special audits, statutory audits and RBI inspections collectively failed to detect the alleged multi-year fraud.

In spite of an elaborate internal control and oversight mechanism in place, the issuance of unauthorized and fraudulent LoUs continued and remained undetected for more than seven years. Apparently, it is a case of systemic failure. Responsible authorities failed to adhere to the checks and balances that were put in place to provide fail-safes to undergird the integrity of the regulatory processes. It is still an open question whether senior management was aware of the fraud or not.

**Why the Auditors were Unable to Detect the Fraud?**

Internal audits overlooked reconciliation of SWIFT transactions involving FLC and LoU guarantees with the transactions recorded in the bank’s CBS. No red flag was ever raised by IT auditors for the non-integration of SWIFT and the CBS. External auditors did not verify the authenticity of messages pertaining to financial transactions in the SWIFT MT700 series.
The entries of inward and outward remittances that are done through the nostro account have to be recorded in the books of the bank (a nostro mirror account). In the event that this did not happen, an audit process, which requires reconciliation of the two accounts, should have uncovered these anomalies. Apparently, the reconciliation of entries in the nostro account statement with those in the nostro mirror account of the bank did not happen.

According to the guidance note on bank audits issued by the ICAI, the auditor has to determine whether a system of periodical reconciliation is in place and whether confirmations from the foreign banks are obtained on a periodic basis, through physical confirmations, SWIFT messages, emails, etc. Initial investigation observed this practice was compromised at auditors’ end (Guidance Note on Bank Audit, 2018).

External auditors of branches, as well as these at the head office of the bank, are required to submit a Long Form Audit Report (LFAR) in addition to their regular statutory audit report on the accounts of the branch/bank. This LFAR requires the auditors to answer specific questions on the internal control system/processes in place in the audited entity, be it in the branch or other offices of the bank including the head office. One of the areas of reporting in the LFAR is bank reconciliations and nostro balances. It is highly unlikely that external auditors missed this important area during the course of their audit which mandates that they specifically report on it (Tax Guru, 2018).

Currently investigation is still in progress and insufficient information is available in public domain about the extent of the negligence or collusion on the part of the auditors or the bank’s management that might contribute to an understanding of why this fraud remained undetected for so long. However, it can be tentatively surmised that this fraud is attributable to a failure of operational risk management and internal controls.

**Early Warning Signs Ignored**

The PNB fraud could have made headlines over a year ago. In July 2016, Bangalore-based entrepreneur, Hari Prasad had written to the Prime Minister’s Office (PMO) drawing the attention of the authorities to what he thought could lead to a huge fraud. Prasad had filed a First Information Report (FIR) with the Central Police Station in Bangalore from where the matter eventually reached the CBI. The PMO forwarded the complaint to the Registrar of Companies (ROC) to look into the matter. However, the ROC in its email to Hari Prasad replied that his grievance had been “disposed of” (Ranipeta, 2018).

The senior management of PNB "misrepresented" the factual position on LoUs to the RBI and ignored its warnings when credit facilities worth over USD 2 billion were fraudulently cleared by its branch in Mumbai. PNB's then MD and CEO Usha Ananthasubramanian and her top officials also failed to prevent the fraud, despite having previous knowledge of the modus operandi. Ms. Usha was the MD and CEO of PNB when a similar case of LoU fraud was reported from IOB, Chandigarh, in 2016. Credits were issued by PNB's Dubai branch on the basis of these guarantees. The modus operandi in the IOB case was similar to this of the Nirav Modi case. Hence, the senior management of PNB had presumably complete knowledge of the methods used by fraudsters to cheat banks using LoUs. After the IOB fraud had surfaced, the RBI issued guidelines and circulars to prevent such frauds from happening in banks. These guidelines were, apparently, not implemented in PNB in their entirety (Business Today, February 16, 2018).

The RBI had sent a questionnaire to the officials seeking to know the status of the LoU issuing process in their bank. In response, the PNB maintained that all was well in the bank. Senior officials of PNB did not implement the circulars and caution notices issued by the RBI regarding safeguarding SWIFT operations, through which messages were sent to overseas banks to issue loans to the companies of Nirav Modi. Reconciliations of CBS and SWIFT messages were not done, despite repeated caution notices from the RBI. This oversight allowed then deputy manager of PNB’s branch to issue these guarantees through SWIFT and bypass any scrutiny by the bank (Live Mint, 2018).

**Aftermath of the Fraud**

In as much as the INR 2.11 trillion recapitalization of PSU banks, planned prior to the discovery of massive fraud at PNB, may be inadequate to stimulate lending and the growth (The Economic Times, October 27, 2017).

The RBI has further tightened reporting norms for Non-Performing Assets (NPAs) has adverse economic implications. Stricter regulatory requirements effectuated by the RBI may make bank executives extremely cautious about issuing fresh loans with the effect of further squeezing private investment, already rather tepid. Such will also lead to higher costs of borrowing (Basu and Bawa, 2017).
Lending instruments like the LoU, have been struck down by the regulator. The LoU ban is likely to hurt importers as well as some exporters. If foreign trade weakens, the current account deficit will widen and increase the cost of government borrowings. That, in turn, will strain public spending and the fiscal health. The rupee may weaken, fueling inflation (Nair, 2018).

Within days of the uncovering of fraud by the PNB management, the stock price of PNB nosedived from ₹ 161.65 on February 13, 2018 to ₹ 75.60 on May 16, 2018, a decline of more than fifty percent shown in Graph 1:

**Graph 1: Share Price Movement of PNB**

(Source: www.nseindia.com, Accessed on May 1, 2018)

The stock price of Gitanjli Gems, the company owned by Nirav Modi and Mehul Choksi, declined from ₹ 62.85 on February 13, 2018 to ₹ 4.05 on May 15, 2018, a decline of more than ninety percent shown in Graph 2:

**Graph 2: Share Price Movement of Gitanjali Gems**

(Source: www.nseindia.com, Accessed on May 1, 2018)
Various law enforcement agencies—including the CBI, Enforcement Directorate (ED), as well as the Income Tax Department—started investigating the affairs of PNB to assign a responsibility for the massive fraud and to recover money lost by the PNB (Chitravanshi and Tiwari, 2018).

The Ministry of Corporate Affairs (MCA) has ordered an investigation into the affairs of 107 companies and seven Limited Liability Partnerships (LLPs) belonging to Nirav Modi and Mehul Choksi, to be carried out by the Serious Fraud Investigation Office (SFIO) under the provisions of § 212(1)(c) of the Companies Act, 2013 and § 43(3)(c)(i) of the LLP Act, 2008 (Narayan, 2018).

ED and CBI conducted raids at various premises of Nirav Modi and Mehul Choksi and seized assets valued at more than USD 900 million. PNB fired eighteen of its employees and is currently considering legal action against some of them to recover the monetary loss to the bank caused by their fraudulent actions (Chennabasaveshwar, 2018).

CBI arrested an internal auditor of the bank since he was "allegedly responsible for auditing the systems and practices" of PNB’s Brady House branch and for reporting any problems to the regional audit office (The Economic Times, February 28, 2018).

The Disciplinary Directorate of the ICAI has issued Show Cause Notices to all Central Statutory Auditors of PNB. Similarly, the Central Statutory Auditors who had done quarterly reviews of PNB have also been issued Show Cause Notices. The auditor of Gitanjali Gems has also been issued a Show Cause Notice in the same matter. Further, the ICAI made a list of the statutory auditors of the Brady House branch during 2011–12 and 2016–17 and asked them to appear before its Board of Discipline (ICAI, 2018).

The Companies Act 2013 empowers the government of India to set up a new regulatory agency named National Financial Reporting Authority (NFRA) to look into matters of professional or other misconduct and also to suspend Chartered Accountants (CAs) and accounting firms from practicing for six months to ten years if found of guilty of fraud. The ICAI has been strongly resisting this move of the government. The government of India has now approved draft rules that delimit the NFRA’s jurisdiction and functions, of which the NFRA is shortly to be apprised (Ministry of Corporate Affairs, 2018).

The Government of India has dismissed Usha Ananthasubramanian as MD and CEO of Allahabad Bank on August 13, 2018. The President of India has granted sanction to prosecute Usha in the PNB case. Before moving to Allahabad Bank, Usha headed PNB between August 2015 and May 2017. She was the executive director of PNB from July 2011 to November 2013 (The Economic Times, August 20, 2018).

Nirav Modi, his wife, his brother, and Mehul Choksi are on the run abroad. The CBI issued an Interpol notice against them. Law enforcement agencies are investigating the role of other PNB’s senior management in the fraud.

Goldman Sachs downgraded its forecasts for India’s economy for the fiscal year 2018–19 to 7.6% from eight percent in the wake of fraud at PNB, warning that it could spark tighter regulation of the banking sector, which in turn would constrain credit growth (Srivastava, 2018).

**Remedial Measures Undertaken**

RBI has discontinued the practice of issuance of LoUs/FLCs for trade credits for imports into India. Importers can continue to raise money via FLCs which have more international acceptance. FLCs involve more paperwork and the due diligence is more stringent than this of LoU. Existing LoUs are to be phased out gradually (NDTV, 2018).

RBI has directed banks to reconcile transactions in nostro accounts on real time/near-real time basis, so that any abnormal transaction is noticed immediately (Shukla and Das, 2018).

All banks have been required to ensure automatic linkage/interface between CBS and SWIFT by the end of April 2018. RBI’s directive to banks to ensure that RBI’s rule of staff rotation after every three years is to be applied stringently (Business Standard, 2018).

The Central Vigilance Commission (CVC) questioned senior PNB and RBI officials. RBI requested the MOF to have control in the appointment of senior management and the board of directors in public sector banks (Tiwari, 2018).

Banks have put in place an additional layer of approval for outward SWIFT messages. Swift transactions are restricted to being undertaken between 9:00 a.m. and 8:00 p.m. All SWIFT messages (financial transactions) are to be sent to the bank’s centralized server and verified with CBS. Only then are the messages to be further transmitted (Hindu, 2018).
Rules for issuing FLCs and bank guarantees have been tightened further in terms of augmentation of required documentation and collateral (Hindu, 2018)

As per the statements of PNB’s non-executive chairman Sunil Mehta, PNB has further strengthening its internal control processes, importing new technology, involving data analytics and artificial intelligence, into risk processes (Live Mint, 2018).

**Conclusion and Recommendations**

In hindsight, there are five major lessons for the banking sector from PNB’s LoU fraud:

**Lesson 1:** Follow the rule books—PNB could have stopped the fraud if it had followed the checks and controls in place. In the PNB case, if the maker, checker, and authorizer control had been followed in the SWIFT messaging platform, the fraud would not have taken place. A daily SWIFT report needs to be generated and monitored by senior management as a standard practice.

**Lesson 2:** Overhaul risk management systems—PNB should be the trigger to overhaul the manner in which risk management systems work within the Indian banking system. The risk management system in PNB failed to work with respect to basic checks and balances. SWIFT and CBS of the banks are linked as instructed by the RBI (Source). Employees must be transferred strictly as per the law, without any failure. Job rotation must be done every six months for each employee. As in PNB’s case, Gokulnath Shetty was working in the same branch for more than seven years until he retired in May 2017.

**Lesson 3:** Importance of operational risk management—Banks need to better manage their operational risks. Credit risk and market risk are related to potential losses from lending and investment activities, respectively. Losses occur in the case of a loan default or if the value of an investment plummets. Operational risk indicates failure in banking systems, processes or people (or any combination thereof). It has an impact on a broad range of products and businesses—in contrast to credit risk or market risk, which affects specific transactions. Business managers are behaviorally inclined to emphasize credit risk and market risk while short-shifting operational risk and compliance. In the PNB, magnifying operational risk, gaping holes appeared in the process of checking a transaction before disbursing a non-funded loan.

**Lesson 4:** Skill development—Beyond banks, various agencies, such as the ICAI and the IIBF, as well as auditors and regulators, need to improve their knowledge of the banking business. With the growing size and number of banking institutions, complexities in business, the EU’s General Data Protection Regulations (2018) and the heavy use of IT, auditors also need to make use of emerging technologies including, but not limited to audit management software, big data, block chain technologies and data analytics in their audit processes. Adoption of audit management software facilitates standardized processes, which, in turn, improve the quality and consistency of audits.

The RBI should also closely look at, and direct banks to take cognizance of, some of the points listed in the corporate governance report submitted by the Kotak Committee to the SEBI. In an effort to facilitate a better understanding of, and proactive management with respect to, banks’ risks, bank boards must possess modern and sophisticated risk management expertise. Furthermore, boards, rather the CEOs, must appoint concurrent auditors to avoid potential conflicts of interest.

**Lesson 5:** Review of the disclosure and compliance framework—The government, in its policy-making capacity, should evaluate the gaps in its policies leading to systemic failures. While any business is prone to failures, there should be minimal scope for failures attributable to non-business risks. The MCA must review the reporting disclosure standards of corporate entities, including banks. Rather than increasing the amount of compliance required in a knee-jerking fashion, however, the MCA must holistically review the disclosure and compliance framework with a view to rendering it more effective.

Were these lessons inculcated a decade ago, the trade finance fraud perpetrated against PNB would not have been feasible or, in the alternate, would not have been sustainable over a multi-year period without detection. It is truism that, regardless of banking ownership structure (public/private) or jurisdiction, scrupulous regulatory oversight, effective risk management and vigilant internal control are vital to minimize the incidence of fraud. At the same time, however, it is incumbent on bank staff to implement regulations, risk management and internal control in the day-to-day performance of their vocational tasks. Apart from effective regulation, risk management and internal control, therefore, it is essential that bank staff understand the serious consequences of bank fraud in all its possible manifestations and take full responsibility for the huge costs involved in any acts of malfeasance and misfeasance on their part. Ultimately, bank staff must be cognizant that they are
stakeholders in the banking system who assume the role of conscious stewards of bank assets and on whom it is incumbent to thwart the perpetration of fraud by any rogue element in the future.

This fraud has similarities to many other frauds in banks like Wells Fargo and Citi Bank of the U.S. where the root cause has been the delinquent behavior of employees. In those cases, it was found that the banks’ internal control and risk management processes fail to capture this delinquent behavior early enough to minimize or avoid any losses.

**Contribution of the Case**

Maintaining integrity of trade finance is essential in emerging economies like India that have a major component of growth driven by exports. Which rules, regulations and policies to put in place by the central banking authority are essential to maintain this integrity? This case is especially relevant to other emerging economics that would behoove of lessons learned in this case study to avert frauds of a similar nature. It delimits best practice in the issuance of LoUs and FLCs and the cost to the banking system in particular and the economy in general when such practices are fLoUted. From this case, students can gain perspective on the mechanics of trade finance through LoUs and FLCs and the legal and regulatory architecture and audit controls needed for early and prompt detection of fraudulent transactions. It also instills in students the indispensable role of bank staff as stakeholders in the banking system with their being enfranchised with stakes sufficiently large to disincentive self-dealing.

**Limitations of this Study**

This case study is prepared for educational purposes based on secondary sources, all publicly available, such as newspapers, magazines, websites, circulars of the RBI, and guidance notes of the ICAI. Neither co-author has access to confidential information on PNB and other parties and entities under investigation. Nor have either co-author availed of primary sources not having interviewed any party involved in the management of PNB, the audit of PNB, or any party or the investigator charged with fraud. The evolution and unfolding of the PNB fraud are covered only until October 20, 2018. That investigations are still on-going means that means that critical developments after that date, should they manifest, cannot be included in this case study.
References


The Live Mint. 2018. There were many learnings from fraud, says PNB chairman Sunil Mehta. May 4. Accessed on October 5, 2018 at: https://www.livemint.com/Industry/gE2FK0fXdSlacZrO289VWL/There-were-many-learnings-from-fraud-says-PNB-chairman-Suni.html


Case Requirements

Based on the following questions, write a report to the Board of Directors to help them understand what went wrong. Groups of three to four students will be formed in class. Each group will be assigned one or more question to prepare a presentation to the class.

Discussion Questions:

1. Internal controls are at the heart of any organization. Discuss the role of the senior management and the board of directors to maintain effective internal controls. Offer any other proactive steps to be taken by the bank to make internal controls more effective.

2. Discuss the modus operandi of the PNB fraud? Can technology, such as Blockchain, provide the solution to the problem?

3. Critically evaluate the role of the auditors in banking operations? If internal controls were effective would the PNB fraud be avoided?

4. Discuss the role of the regulators in setting effective controls for the bank? What recommendations can be offered to regulators to avoid such frauds in the future?

5. Discuss the traits required of internal and external auditors for banking operations. What kind of recommendations may be offered to the Institute of Chartered Accountants of India and the Institute of Banking and Finance in India to make audit professionals more capable to conduct the audit and better address such bank fraud?