INTRODUCTION

The Punjab National Bank scam relates to a fraudulent letter of undertaking worth Rs 10,000 crore issued by the bank.

The key accused in the case were jeweller and designer Nirav Modi, his maternal uncle Mehul Choksi, and other relatives and some PNB employees. Nirav Modi and his relatives escaped India in early 2018, days before the news of the scam became public. PNB scam has been dubbed as the biggest fraud in India's banking history.

Bankers used fake Letters of Undertakings (LoUs) at PNB's Brady House branch in Fort, Mumbai. The LoUs were opened in favour of branches of Indian banks for import of pearls for a period of one year, for which Reserve Bank of India guidelines lay out a total time period of 90 days from the date of shipment.

This guideline was ignored by overseas branches of Indian banks. They failed to share any document/information with PNB, which were made available to them by the firms at the time of availing credit from them.

Nirav Modi got his first fraudulent guarantee from PNB on March 10, 2011 and managed to get 1,212 more such guarantees over the next 74 months.

The Enforcement Directorate (ED) recovered bank token devices of the foreign dummy companies used by the fugitive diamond trader to transfer the fraudulent funds.

The probe agency found that Nehal Modi, brother of Nirav Modi had destroyed the devices and had even secured a server located in the United Arab Emirates (UAE) soon after the scam broke out. These dummy firms had been receiving the fraudulent PNB LoUs and were based out in the British Virgin Island and other tax havens.

The enforcement agency has so far seized movable and immovable properties to the tune of Rs 2362 crore in the PNB fraud case.

PNB employees misused the SWIFT network to transmit messages to Allahabad Bank and Axis Bank on fund requirements. While all this was done using SWIFT passwords, the transactions were never recorded in the bank's core system — thereby keeping the PNB management in the dark for years.

On 29 January 2018, PNB lodged a FIR with CBI stating that fraudulent LoUs worth Rs 2.8 billion (Rs 280.7 crore) were first issued on 16 January. In the complaint, PNB had named three diamond firms, Diamonds R Us, Solar Exports and Stellar Diamonds.

As of 18 May 2018, the scam has ballooned to over Rs 14,000 crore.

Who is Nirav Modi?

Nirav Modi is a luxury diamond jeweller and designer who was ranked 57 in the Forbes list of billionaires in 2017. He is also the founder of the Nirav Modi chain of diamond jewellery retail stores.

Modi is the Chairman of Firestar International, the parent of the Nirav Modi chain, which has stores in key markets across the globe.He has 16 stores in diverse locations such as Delhi, Mumbai, New York, Hong Kong, London and Macau.
He is currently in the United Kingdom and is seeking political asylum in Britain.

Causes of Nirab Modi PNB fraud case

The Nirav Modi fraud case stemmed from a combination of several interconnected factors that allowed the scam to occur on such a large scale. The primary mechanism exploited by Modi and his associates was the Letter of Undertaking (LoU), a financial instrument used to obtain short-term loans. LoUs were supposed to be issued with the bank's approval and proper documentation. However, in this case, Modi's companies used them to obtain unauthorized loans from foreign branches of other banks, facilitated by certain employees at Punjab National Bank (PNB). These employees bypassed the usual procedures and issued LoUs using the SWIFT messaging system, which is typically employed for secure international financial transactions. Unfortunately, these transactions were not recorded in PNB's core banking system, which allowed the fraud to go unnoticed for an extended period.

Several employees within PNB were complicit in this fraud, and their role in bypassing established protocols enabled the fraudulent activity to continue without detection. The manipulation of the bank's internal systems, particularly the lack of integration between the SWIFT system and the core banking database, was a critical vulnerability. Transactions that went through SWIFT were not logged in the bank's central system, leaving them invisible to internal controls, auditors, and higher management. This created an environment where large sums of money were being moved without oversight, and the fraudulent loans could accumulate over several years before anyone noticed.

The absence of stringent internal controls at PNB played a major role in the fraud's persistence. The bank's auditing processes failed to detect the irregularities despite the sizable sums involved. Internal audits did not flag the missing entries, nor did they challenge the lack of transparency in the handling of these transactions. As a result, the fraud continued for years without raising alarms. Additionally, there were significant regulatory lapses that allowed this situation to unfold. At the time, the Reserve Bank of India (RBI) had not mandated the integration of SWIFT with core banking systems. This gap allowed transactions made via SWIFT to remain outside the purview of the bank's main accounting system, creating an enormous blind spot in the bank's financial operations.

Rather than using the loans for legitimate business activities, Modi and his associates diverted the funds for personal enrichment and to expand Modi's jewelry business. This diversion of funds from their intended purpose revealed that the loans were never meant to support trade or genuine business operations. Instead, they were meant to line the pockets of those involved. Another factor contributing to the fraud was the insufficient scrutiny of Modi's companies' financial health. Banks, particularly public-sector ones like PNB, often relied too heavily on the reputation of borrowers, especially high-profile individuals and businesses, instead of conducting in-depth credit assessments. This overreliance on reputation, rather than a thorough examination of the financial viability of Modi's businesses, allowed the loans to be granted without proper checks and balances.

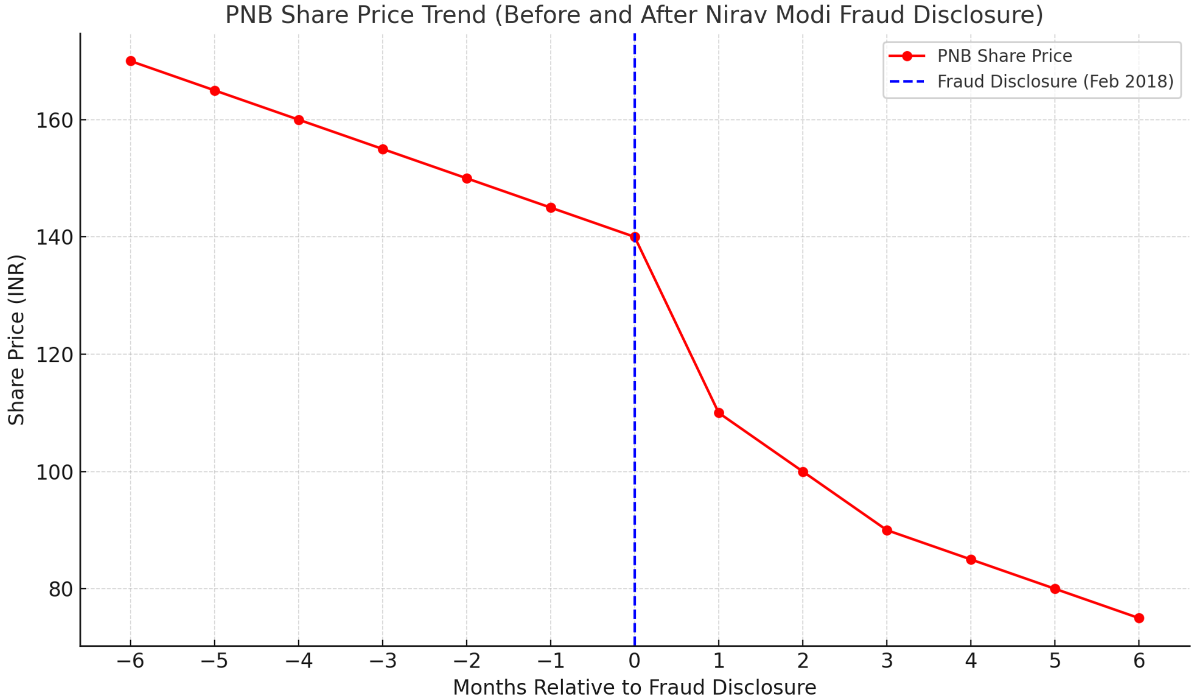
PNB’s failure to integrate their SWIFT system with their core banking infrastructure was a critical issue that allowed the fraud to be concealed. Had the systems been properly integrated, the unauthorized loans would have been automatically recorded and flagged in the bank’s accounting system. This technological gap, combined with the lack of scrutiny over the loans, made it easy for the perpetrators to move large sums of money without raising any immediate red flags.

Finally, the case also exposed significant negligence by external auditors, who failed to detect the discrepancies in PNB's financial records. The auditors, who were supposed to examine the bank’s transactions for irregularities, did not identify the missing entries or the unusual nature of the loans. Their failure to uncover the fraud in the bank's books allowed the scam to continue undetected for several years.

In summary, the Nirav Modi fraud was made possible by a series of systemic failures, including weak internal controls, the exploitation of financial instruments without proper documentation, collusion with bank officials, and regulatory gaps in the banking system. These combined to create an environment where a complex fraud could unfold without being detected for a long period of time.

Impact on economy

The scam came to light in 2018 involving transactions around 12,700 Crore through the misuse of Letter of Undertaking (LoUs) issued by Punjab National Bank (PNB). PNB scam is the greatest bank scam in India. Reserve Bank of India (RBI) which is the Apex bank of the country, facing public call for not being able to find the bank's scam. The study investigates fraud regulatory oversight failures and systemic weaknesses that enabled the scam to occur. It highlights shortcomings in risk management, compliance and oversight that allowed the fraud to go unnoticed for a period. Additionally, it assesses the effectiveness of reforms and policy changes implemented post scam. By examining a series of events and their aftermath this paper uncovers broader implications for India's banking system such as erosion of trust strengthening framework and reputational damage faced by affected financial institutions. It also discusses economic reforms introduced following the scam to gauge their effectiveness in preventing financial misconduct in the future. This study underscores the importance of enhancements in governance, transparency and accountability to rebuild and uphold confidence in India's banking sector.



The Nirav Modi-Punjab National Bank (PNB) fraud case, amounting to ₹14,356 crore, surfaced in 2018 and had widespread consequences for the Indian economy, financial sector, and regulatory environment. This case involved the fraudulent issuance of Letters of Undertaking (LoUs) by PNB employees at its Brady House branch in Mumbai, which facilitated Nirav Modi and his associates to obtain overseas credit without adequate collateral. The scam highlighted systemic weaknesses in the banking system, including lack of proper checks and balances, inadequate oversight, and vulnerabilities in internal processes.

PNB, India's second-largest public sector bank at the time, suffered substantial financial losses, with its net profit turning into a net loss of ₹12,283 crore in FY2018. Its share price plummeted by over 40% within weeks of the fraud coming to light, eroding investor confidence. The scandal further exacerbated the problem of non-performing assets (NPAs) in India's banking sector, which were already at alarming levels, crossing ₹10 lakh crore by 2018. Public sector banks, which held around 70% of India's banking assets, were disproportionately affected, given their existing vulnerabilities and exposure to corporate loans.

The Reserve Bank of India (RBI) responded by tightening regulations and banning the use of LoUs and Letters of Comfort (LoCs) for trade finance, which had been prone to misuse. Additionally, it mandated banks to implement stricter auditing and monitoring mechanisms. Despite these measures, the fraud exposed the limitations of existing supervisory frameworks, as PNB's internal audits had failed to detect the irregularities for over seven years.

The economic implications of the case extended beyond the banking sector. Credit availability to small and medium enterprises (SMEs) tightened significantly as banks became more risk-averse in their lending practices. This credit crunch slowed down growth in sectors dependent on bank financing. The scandal also impacted India's international reputation as a safe investment destination. Global investors raised concerns about governance standards in Indian financial institutions, leading to a dip in foreign direct investment (FDI) inflows in subsequent quarters.

Nirav Modi's escape to the UK and subsequent legal battles for his extradition highlighted the challenges of bringing high-profile economic offenders to justice. By 2022, Modi was still fighting extradition, while Indian authorities had managed to seize assets worth ₹2,650 crore linked to him and his businesses. Despite these recoveries, a significant portion of the defrauded amount remains unrecovered, adding to the financial burden on the banking sector.

The scandal prompted a renewed focus on corporate governance and accountability in public sector banks. The government initiated measures such as consolidating public sector banks to strengthen their operational efficiency and reduce systemic risks. For example, by 2020, the number of public sector banks in India had been reduced from 27 to 12 through mergers.

Recommendation

To address the systemic issues highlighted by the Nirav Modi-PNB fraud case, it is critical to implement a series of targeted recommendations supported by data and best practices. Strengthening internal controls within banks is essential, as the fraud exploited lapses in oversight at multiple levels. A 2022 RBI report noted that 93% of frauds in public sector banks over the previous decade were attributable to lapses in internal processes, underlining the need for robust auditing mechanisms and real-time transaction monitoring systems. Enhanced use of artificial intelligence (AI) and machine learning (ML) can help identify anomalies in high-value transactions, with global studies showing a 30% improvement in fraud detection rates when AI-driven tools are deployed.

Implementing stringent accountability frameworks for senior management and operational staff is necessary to deter future misconduct. Data from the Association of Certified Fraud Examiners (ACFE) reveals that lack of oversight accounts for 20% of large-scale financial frauds globally. Public sector banks, which collectively account for nearly 70% of India's banking assets, should mandate independent reviews of high-value transactions and implement a dual-authentication process for issuing trade finance instruments like Letters of Undertaking (LoUs).

To reduce risks associated with fraudulent trade finance activities, the government and the RBI should encourage banks to adopt blockchain technology, which offers an immutable ledger for recording transactions. A World Economic Forum study estimated that blockchain could reduce trade finance risks by 50% and improve transparency significantly. India's private banks, such as ICICI Bank, have already piloted blockchain-based trade finance solutions with promising results, and extending these initiatives to public sector banks could mitigate risks associated with manual processing errors.

Enhancing whistleblower protections and incentivizing the reporting of fraudulent activities is another critical area. In a survey conducted by Transparency International, 40% of respondents cited fear of retaliation as the primary reason for not reporting misconduct. Establishing a centralized, anonymous whistleblower platform for the banking sector could address this issue, backed by policies guaranteeing immunity for whistleblowers who report malpractices in good faith.

The regulatory framework governing banking operations requires periodic review and enhancement. Post-2018 reforms, such as the Insolvency and Bankruptcy Code (IBC) and tighter norms for NPAs, have yielded results, with NPA levels in public sector banks falling from 14.6% in March 2018 to 5.8% in March 2023. However, more needs to be done to address systemic weaknesses. Increasing the frequency of external audits and mandating quarterly risk assessments for large-value exposures are steps that could help detect vulnerabilities early.

Strengthening international cooperation is vital to address challenges related to economic fugitives. India's experience with Nirav Modi's extradition underscores the importance of bilateral agreements and streamlined legal frameworks. Data from the Ministry of External Affairs indicates that only 25% of extradition requests made by India between 2000 and 2023 resulted in successful outcomes. Leveraging multilateral platforms such as the G20 to establish standardized protocols for tracking and extraditing economic offenders could enhance India's ability to recover assets and bring perpetrators to justice.

Increasing financial literacy and consumer awareness is another essential measure. Surveys show that only 24% of Indian adults possess basic financial knowledge, leaving them vulnerable to banking frauds. Targeted campaigns to educate consumers about secure banking practices and the risks associated with high-value transactions can enhance trust and reduce the likelihood of fraud.

Finally, public sector bank consolidation, which reduced the number of banks from 27 to 12 between 2017 and 2020, should be accompanied by reforms to improve operational efficiency and governance. Data from the Economic Survey of India shows that merged banks reported a 15% reduction in operating costs within three years, but their governance frameworks remain under scrutiny. Introducing performance-based incentives for executives and aligning these with risk management outcomes could foster a culture of accountability and professionalism across the sector.

CONCLUSION

The Nirav Modi-PNB fraud case stands as a stark reminder of the vulnerabilities inherent in India's banking and financial systems, with far-reaching consequences that continue to shape the sector. At the core of the scandal was a systemic failure in oversight, internal controls, and regulatory mechanisms, which allowed fraudulent activities amounting to ₹14,356 crore to persist undetected for over seven years. The financial impact on Punjab National Bank was devastating, with the bank reporting a net loss of ₹12,283 crore for the fiscal year 2018 and witnessing a sharp decline in its market capitalization as investor confidence eroded.

The broader economic repercussions of the case extended beyond PNB, casting a shadow over the entire banking industry. Public sector banks, which already struggled with non-performing assets (NPAs) amounting to ₹10.4 lakh crore by March 2018, faced heightened scrutiny and a subsequent tightening of credit disbursement policies. This credit squeeze adversely affected small and medium enterprises (SMEs), which are heavily reliant on bank financing, contributing to a slowdown in economic activity in key sectors. The regulatory response, including the Reserve Bank of India's decision to ban Letters of Undertaking (LoUs) and Letters of Comfort (LoCs), aimed to address the misuse of trade finance instruments but also created challenges for businesses that depended on them for legitimate international transactions.

On the legal and enforcement front, the case highlighted significant challenges in bringing economic offenders to justice. Nirav Modi's escape to the United Kingdom and the protracted extradition process underscored the limitations of India's legal and diplomatic frameworks. While authorities managed to seize assets worth over ₹2,650 crore linked to Nirav Modi and his companies, recovering the full amount remains an ongoing struggle. The Enforcement Directorate's efforts under the Fugitive Economic Offenders Act have resulted in the confiscation of assets worth ₹18,000 crore from various offenders, but these measures alone are insufficient to restore public confidence in the system.

The case also brought to light the urgent need for reforms in corporate governance and risk management within public sector banks, which account for 70% of India's banking assets. Despite mergers reducing the number of public sector banks from 27 to 12 by 2020, operational inefficiencies and governance challenges persist. Data from the Economic Survey of India shows that while merged banks achieved a 15% reduction in operating costs within three years, their risk management frameworks remain under scrutiny. Strengthening these frameworks, coupled with the adoption of advanced technologies like blockchain and artificial intelligence, could significantly reduce fraud risks and enhance transparency.

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