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PUNJAB NATIONAL BANK: THE MODI FRAUD-SYSTEM FAILURE OR PEOPLE FAILURE?[[1]](#endnote-1)

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On February 14, 2018, a scandal unfolded at Punjab National Bank (PNB), India’s second largest state-owned bank. At 9:13 a.m., when trading started across the local stock markets of India, PNB informed the stock exchanges that a fraud of US$1.8 billion[[2]](#endnote-2) had been detected at PNB. The news shook the financial community and the country at large.[[3]](#endnote-3)

The fraud had been engineered by Nirav Modi, a diamond tycoon in India who had been featured on *Forbes*’ 2017 list of “The World’s Billionaires.”[[4]](#endnote-4) Modi, along with his uncle Mehul Choksi, illegally extracted money from several banks from 2010 to 2017 based on letters of undertaking (LoUs) and foreign letters of credit that had been illegally issued by employees at PNB.[[5]](#endnote-5) The fraud was enacted with the help of PNB bank employees from the Brady House branch, located in the south of Mumbai, along with previous top management at PNB, including Usha Ananthasubramanian, ex-chief executive officer (CEO) and managing director of PNB, who worked at the bank until May 2017.

Gokulnath Shetty, deputy manager in the Brady House foreign exchange (forex) department of PNB before he retired in May 2017, had obtained a level-5 password for Society for Worldwide Interbank Financial Telecommunications (SWIFT), a messaging system used globally for cross-border fund transfers between banks, during his tenure at PNB. Shetty used his password to authorize the issuance of fraudulent LoUs and foreign letters of credit to Modi’s companies, including Firestar Diamond FZE and Firestar Diamond International Private Ltd. (Firestar Diamond Ltd.), and to Choksi’s companies, including Gitanjali Gems Ltd., Hyderabad Gems SEZ Ltd., Gili India Ltd., and Nakshatra Gold & Diamonds. Shetty took advantage of SWIFT’s lack of automatic connectivity with the core banking solution[[6]](#endnote-6) (CBS) at PNB by not manually uploading the information to the bank’s CBS. In addition, Shetty never asked Modi or Choksi for a deposit of margin money, a guarantee for the bank issuing the LoU, required from the firm benefiting from the LoU.[[7]](#endnote-7)

After the fraud was detected, upon the request of the Reserve Bank of India (RBI), India’s central bank, India’s top investigative agencies—the Central Bureau of Investigation (CBI) and the Enforcement Directorate (ED)—intervened. Along with Choski, Modi, and others of Modi’s family, the CBI charged several current and former employees of PNB with involvement in the fraud, including PNB’s former CEO and executive directors. According to the charge sheet filed by the CBI, Ananthasubramanian and other top management personnel had had knowledge of the fraud.[[8]](#endnote-8)

As government agencies became actively involved in the fraud investigation, several initiatives were taken to curb the situation. Modi’s passport was revoked—although he had already left the country with his family a month before the fraud was detected—and his foreign properties in the United States and the United Kingdom were attached. According to media reports, this was the first time the foreign properties of a wilful defaulter had been seized.

Sunil Mehta, who joined PNB in May 2017 as CEO and managing director, stated that the fraud was a clear indication of people issues at PNB. He argued that no system control could have saved the bank, given that senior management was involved in the fraud.[[9]](#endnote-9) PNB also criticized other Indian banks for not performing due diligence in granting loans to Modi. Nevertheless, according to the All India Bank Employees Association, merely penalizing the past managing director was not sufficient, and Mehta, on moral grounds, should stay away from PNB until the investigation was over.[[10]](#endnote-10) Academicians, on the other hand, believed it was a lack of ethical grounding at PNB that had led to the fraud.[[11]](#endnote-11)

How should Mehta deal with the fraud? Was he right in also blaming other banks? Should Mehta listen to critics and improve the ethical grounding at PNB?

**HISTORY OF PNB**

PNB commenced operations from Lahore on April 12, 1895, with an authorized capital of $2,800 and working capital of $280.[[12]](#endnote-12) PNB was the first Indian bank to be managed entirely by Indians, with Indian capital. Over the subsequent 120 years, several Indian banks, such as the Hindustan Commercial Bank and the New Bank of India, merged with PNB.

PNB had overseas operations across nine countries.[[13]](#endnote-13) It had overseas branches in Hong Kong and in Dubai, United Arab Emirates; an offshore banking unit in Mumbai; representative offices in Dubai and Dhaka, Bangladesh; seven branches of a wholly owned subsidiary, PNB International Ltd., in the United Kingdom; a 51-per-cent shareholding of the seven branches of Druk PNB Bank Ltd., Bhutan; an overseas association with the SC Tengri Bank, Kazakhstan; and an overseas joint venture with Everest Bank Ltd., Nepal.[[14]](#endnote-14)

PNB had won several prestigious awards from domestic and overseas institutions. In 2017, it won the Best Public Sector Bank award in the government participation scheme category at the Dun & Bradstreet Banking Awards. PNB was also awarded the National Award in Self Help Group-Bank Linkage by India’s Ministry of Rural Development for 2016–2017 in the large bank category. PNB was the fourth-largest bank in India by assets and the second-best public sector bank in India, after the State Bank of India. *The Banker*, a financial affairs publication owned by *The Financial Times*, ranked PNB 191st in the top 1,000 world banks in 2017.[[15]](#endnote-15)

PNB was able to achieve all of this despite lower remuneration of top executives compared to other banks in India. For instance, PNB’s ex-CEO Ananthasubramanian received an annual salary of $43,000 in 2017, whereas the CEO at ICICI Bank in India received a salary of $900,000. Aditya Puri, managing director of HDFC Bank Ltd., another private sector bank, received an annual salary of $1.5 million. Similarly, Rana Kapoor of Yes Bank earned $1 million as annual salary in 2017.[[16]](#endnote-16)

Despite its successes, PNB reported a net loss of $1.66 billion for the financial year 2017–2018, compared to a profit of $180 million in 2016–2017. PNB’s net non-performing assets in 2017–2018 also increased, by 48.6 per cent, compared to 2016–2017 (see Exhibit 1). In 2017–2018, PNB had 74,897 employees.[[17]](#endnote-17)

PNB also had a history of both having a large number of wilful defaulters and issuing fraudulent LoUs. PNB had the highest number of wilful defaulters in the Indian banking sector.By March 2018, PNB had more than 1,092 wilful defaulters who had more than $35,000 outstanding.[[18]](#endnote-18) The bank had previously faced a problem with the issuance of fraudulent LoUs in some of its overseas branches in London, England, in the early 1990s.[[19]](#endnote-19) Subsequently, the London branches were merged with the State Bank of India, India’s largest public sector bank, and PNB’s chairman was fired.

In fact, the top management of several Indian banks had been alleged over the years to have been involved in various frauds. In 2017, the CBI alleged that the chairman of Canara Bank, one of the top three lenders in the Indian banking sector, was involved in a $136,000 fraud.[[20]](#endnote-20) In yet another fraud, senior management of the state-owned IDBI Bank Ltd., along with the promoter of a telecom firm, was accused by the CBI of executing a [$90-million fraud](http://www.cbi.gov.in/pressreleases/pr_2018-04-26-1.php) between 2010 and 2013.[[21]](#endnote-21) In 2011, the CBI also alleged that several executives of public sector banks such as the Bank of Maharashtra, Oriental Bank of Commerce, and IDBI Bank were involved in creating 10,000 fictitious accounts, transferring a loan of $21 million to those accounts and later withdrawing this money to increase the executives’ personal wealth. In 2014, the ex-chairman and managing director of Syndicate Bank, S.K. Jain, was accused of receiving a bribe for sanctioning a loan of $1.01 billion.[[22]](#endnote-22)

**MODI’S RISE**

Modi was the first Indian to be featured on the cover of a Christie’s auction catalogue, profiled in 2010 after a diamond necklace he had designed fetched $3.56 million at an auction in Hong Kong.[[23]](#endnote-23) Born in India but raised in the Belgian city of Antwerp, considered the diamond capital of the world, Modi held both a Belgian and an Indian passport. As a third-generation diamantaire, Modi withdrew from the Wharton School’s business education program in 1989 to join Gitanjali Gems in Mumbai, which was owned by his maternal uncle, Choksi. It was at Gitanjali Gems where Modi learned the gems and jewellery business. Starting at a salary of $52 per month, Modi worked more than 75 hours a week. In 1999, when he finally had savings of $700,000, Modi started his own firm in Mumbai—Firestar Diamond Ltd.—using his savings as seed money. In 2016, Firestar Diamond Ltd. had a turnover of almost $2 billion.[[24]](#endnote-24)

Modi became famous in India and abroad as Hollywood and Bollywood celebrities bought diamond jewellery from him. Hollywood star Kate Winslet wore diamond creations by Modi’s company for her red-carpet walk at the 2016 Oscars.[[25]](#endnote-25) Actress Naomi Watts also wore Modi’s jewellery.[[26]](#endnote-26) Modi successfully competed with luxury jewellers, such as Tiffany and Co. and Cartier Limited, setting up his own boutique shops around the world. In 2013, Modi was included on *Forbes*’ list of billionaires.[[27]](#endnote-27)

**THE MODI–PNB FRAUD**

**Letters of Undertaking**

Modi first approached PNB for an LoU in 2010, when he wanted to import rough stones for his Indian firms. Because the government limited convertibility of the local currency, the Indian rupee, Modi was required to pay his suppliers abroad in U.S. dollars; therefore, he employed the use of LoUs. The LoU allowed a domestic bank branch with a forex department, such as PNB’s Brady House branch, to issue a guarantee letter in favour of a client, such as Modi.[[28]](#endnote-28)

The domestic bank issued the LoUs through SWIFT, which verified the sanctity of the letter, to an overseas branch of an Indian bank. Once the LoU was received by the foreign or overseas branch of an Indian bank, such as the United Arab Emirates or the Hong Kong branch of the Axis Bank, the branch deposited U.S. dollars as a loan into a “nostro account,” which was a foreign account an Indian bank had with other banks in its overseas branches. SWIFT acted as a formal contract between the two banks. When the dollars were deposited into the nostro account, the bank transferred the amount to the supplier based on the client’s instructions. After the supplier received the amount, the client received the goods or services. In this way, Modi received stones through LoUs issued by PNB’s Brady House branch.[[29]](#endnote-29)

However, to issue an LoU, a bank required margin money or collateral, such as assets or fixed deposits, from the client in whose favour the LoU was to be issued. This margin money could be up to 100 per cent of the guarantee.[[30]](#endnote-30) Based on their prudence, banks sometimes relaxed this limit for certain clients because of the amount of business the clients did with the bank. Although the amount could vary, margin money was necessary because the bank wanted to be sure that the client would pay the dollar equivalent and a service fee for the LoU within a specified time frame, usually a year.[[31]](#endnote-31)

**Role of PNB’s Brady House Branch**

The forex department of PNB’s Brady House branch played a major role in the fraud. Shetty, with the aid of his colleagues and subordinates, conceived fraudulent transactions amounting to $1.8 billion between 2010 and 2017. Shetty issued a series of fraudulent LoUs in favour of both Modi’s and Choksi’s firms. The first fraudulent letter was issued in 2010, for a value of $110 million in loans. Shetty had worked at the same branch for 11 years, while in most public sector banks of India, the human resources department transferred employees to a different branch every three years.[[32]](#endnote-32)

Shetty had illegally obtained a level-5 password to the SWIFT system and used the system to issue fraudulent LoUs. Shetty shared this password with other PNB employees as well as with executives of Modi’s companies, including Firestar Diamond FZE and Firestar Diamond Ltd.[[33]](#endnote-33) Generally, once these letters were issued through SWIFT, other banks immediately deposited the funds into the nostro account of the LoU-raising bank.[[34]](#endnote-34) Shetty not only illegally issued these letters without seeking a margin from Modi’s firms, as standard procedure dictated, but also failed to record the transactions on the bank’s internal CBS.[[35]](#endnote-35) Since PNB’s CBS was not linked with SWIFT, employees were required to manually log SWIFT details. If an employee failed to do so, the transactions did not show on the bank’s CBS records.

Between 2010 and 2017, Shetty issued several fraudulent LoUs. When Modi failed to repay the first $110-million loan raised in 2010, instead of calling a default, Shetty issued more LoUs on behalf of the bank. Based on this, the overseas branches of other banks, such as Allahabad Bank and Axis Bank, kept issuing fresh credit to Modi’s companies.[[36]](#endnote-36) Modi used some of the new LoUs to retire or pay back previous LoUs and kept the difference to increase his personal wealth.[[37]](#endnote-37)

Although Shetty admitted to the ED that he had issued LoUs illegally, he claimed that he did not derive any material benefit from the transactions. He accused Modi and Choksi of blackmailing him after he issued the first LoU without any collateral or security at the order of Rajesh Jindal, head of the Brady House branch from 2009 to 2011. According to Shetty, Modi had threatened to reveal Shetty’s misconduct in issuing the first LoU if he refused to issue further LoUs. It was this fear that motivated Shetty to continue the fraud.[[38]](#endnote-38)

According to media reports, PNB missed an alarm signal when there was an exponential rise in the branch’s business with Modi’s and Choksi’s companies after 2010, when Shetty joined the forex department of the branch. Between March 2010 and June 2011, fixed deposits with the Brady House branch increased more than twice, from $147 million to $308 million, primarily on account of the margin money extended by Modi and Choksi for the issuance of LoUs. By September 2012, the total amount held under fixed deposits in the Brady House branch of PNB had declined to $102 million. This indicated the margin money was no longer being replenished, although LoUs were still being issued.[[39]](#endnote-39)

**Fraudulent Transactions Involving LoUs**

To defraud PNB, Modi had used “rapid-fire sales,” a complex web of transactions between 35 shell companies directly or indirectly owned by Modi or his relatives, and he used “round-tripping” of diamonds across three nations—the United States, the United Arab Emirates, and Hong Kong. Round-tripping referred to the process of trading a good repeatedly across shell companies, with each trade given the appearance of a distinct transaction by altering the price of the good being traded.[[40]](#endnote-40)

In 2011, a three-carat yellow diamond with an actual price of $183,000 was shipped at least four times over a five-week period between shell companies owned by Modi or his relatives. The diamond was first sold at a price of $1.1 million by Firestar Diamond Inc., a company based in the United States and indirectly owned by Modi, to Fancy Creations Company Ltd., a shell company owned by Modi in Hong Kong. Two weeks later, Solar Exports, an Indian company indirectly owned by Modi, shipped the diamond back to Firestar Diamond Inc. at the actual price of $183,000. A week later, Firestar Diamond Inc. sold the diamond again to Fancy Creations for $1.16 million. Next, the diamond was sold at about its actual price to U.S.-based firm A.JAFFE, which was also owned by Modi. A.JAFFE then sold the diamond to World Diamond Distribution, a United Arab Emirates-based shell company owned by Modi, for $1.2 million. This trading, happening within a few weeks between different shell companies, was an example of both rapid-fire sales and round-tripping.[[41]](#endnote-41)

According to the ED, another strategy used by Modi and his Indian firms was indulging in fraudulent transactions, along with round-tripping, for importing diamonds. For example, Modi’s Indian firms would export precious jewellery to firms in Hong Kong, which were either shell companies owned by Modi or firms indirectly owned by Modi. Once the jewellery reached the firms abroad, the precious stones were dismounted from the jewellery and exported at a higher price back to Modi’s Indian firms. Before receiving the precious stones from Hong Kong, Modi’s Indian firms approached PNB to obtain an LoU to pay the Hong Kong shell company. Thus, the same set of stones and jewellery were circulated.[[42]](#endnote-42)

Between 2011 and 2017, according to the ED, Modi and his firms had borrowed approximately $3.7 billion from PNB through 1,206 LoUs. Of this, Modi and his firms repaid approximately $2.7 billion.[[43]](#endnote-43) Part of the $1 billion not repaid covered the actual shipping expenses and the remainder was used under the fraudulent cover of importing precious diamonds, but it was actually used by Modi to increase his personal wealth and to purchase premium properties in New York, London, and other cities.[[44]](#endnote-44) Choksi used a similar method of operation.[[45]](#endnote-45)

**ROLE OF PNB’S SENIOR MANAGEMENT**

Jindal was head of the Brady House PNB branch in 2010 when Shetty first issued the fraudulent LoUs. As the practice of giving the LoUs without sanctioned limits continued, Jindal became the general manager of credit at PNB’s head office in New Delhi, the second-largest branch of PNB.[[46]](#endnote-46) Becchu Tiwari, the chief manager of the forex department at PNB’s Brady House branch, was expected to monitor Shetty’s transactions. Tiwari admitted to not having done so between 2015 and 2017.[[47]](#endnote-47) Tiwari claimed to have formally issued a circular on February 19, 2016, and February 7 and March 14, 2017, directing employees to monitor the LoUs issued through the SWIFT code of PNB’s Brady House branch. However, according to media reports, these circulars were only a formality; Tiwari never followed up to see why his instructions were not followed by Shetty and other associated employees.[[48]](#endnote-48)

Ananthasubramanian was the CEO of PNB between 2015 and 2017, after which time she joined Allahabad Bank. When the RBI raised the alarm about the leaks in the SWIFT system during Ananthasubramanian’s reign, PNB management did not respond to the warning. The RBI circulated guidelines about how to prevent such fraud, but these were not implemented by PNB’s top management.[[49]](#endnote-49) When the RBI specifically sent a query to PNB about its LoU issuing process, Nehal Ahad, PNB’s general manager in charge of international banking operations, told the RBI, after consultation with Ananthasubramanian and two other senior executives, that everything was in order at PNB. The top management of PNB never initiated the integration of SWIFT with PNB’s CBS, despite clear guidelines to do so from the RBI.[[50]](#endnote-50)

In its charge sheet, the CBI stated that Ananthasubramanian and some senior executives, including K.V. Brahmaji Rao, Sanjiv Sharan, and Nehal Ahad, were responsible for a criminal breach of trust and were guilty of exploiting the system by manipulating SWIFT.[[51]](#endnote-51) The CBI stated that “the fraud was allegedly perpetrated despite the knowledge of senior officials of Punjab National Bank, who did not implement the circulars and caution notices issued by the Reserve Bank of India regarding safeguarding SWIFT operations and instead, misrepresented the factual situation to RBI.”[[52]](#endnote-52) The CBI also alleged that Ananthasubramanian had met regularly with senior executives from Modi’s firms, including the firms’ chief financial officers.[[53]](#endnote-53)

Because the fraud covered 2010–2017, senior executives prior to Ananthasubramanian were also suspected of involvement in the fraud—specifically, of fraudulently reporting appropriate banking practices to the RBI. Even the audit department of PNB was alleged to have failed to check SWIFT activities because there was a clear discrepancy between LoUs dispatched through SWIFT and loans that showed on PNB’s CBS.[[54]](#endnote-54) Mehta defended the audit department of PNB, stating, “I don’t blame them. They come only for a short period of time and they go and basically see data only on the CBS.”[[55]](#endnote-55)

**ROLE OF OTHER BANKS**

PNB accused other Indian banks, such as Allahabad Bank and Axis Bank, of not performing due diligence in disbursing loans, which PNB claimed the banks should have done since some LoUs were opened for a period of an entire year, although the permissible limit according to the RBI was just 90 days. PNB stated, “This stipulation was overlooked by overseas branches of Indian banks, who are required to follow RBI guidelines.”[[56]](#endnote-56)

C.H. Venkatachalam, general secretary of the All India Bank Employees Association, responded to PNB’s accusation of other banks failing to perform due diligence by saying, “The PNB management is blaming other banks for not sharing details of their due diligence done on Modi’s business. The $1.8 billion fraud is done on non-fund-based transaction. The PNB management has to clarify what kind of due diligence it had done.”[[57]](#endnote-57) He further stated, “There must be involvement of top officials of PNB to facilitate Modi’s fund needs. A high-profile person like Modi would not directly deal with a low-level official at [the] branch level.” Venkatachalam also found it difficult to believe that only a few employees at the branch issuing LoUs were involved in the fraud and that the entire bank had been unaware of the fraud for eight years.[[58]](#endnote-58)

Dinesh Dubey, a former government nominee director of Allahabad Bank, presented documents to the media in February 2018 that showed he had been trying for years to call attention to the illegalities committed by banking officials in dealings with Modi and Choksi. Dubey stated, “I had told the board [of Allahabad Bank] that Choksi and his firm will turn into a big scam one day. Even if they had listened to me, this scam could have been avoided. I remember the present managing director of PNB [Mehta] was then serving as the general manager with Allahabad Bank and he was aware of what was happening inside the shadowy walls of the board meeting.”[[59]](#endnote-59) He further stated that solely blaming Shetty, a junior employee at a bank branch, would not resolve the Modi fraud because it could not have unfolded without the involvement of PNB’s top management.[[60]](#endnote-60)

**DETECTION OF THE FRAUD**

In January 2018, Modi’s companies sought a fresh LoU with PNB, but Shetty and other employees involved in the fraud had retired by that time. In accordance with standard practice, PNB’s new employees asked for a 100-per-cent cash margin as collateral to issue the LoU. Modi’s companies insisted they had previously used the facility without any security, which alerted the new employees, who reported to PNB management about a possible fraud that had been happening over the years. However, according to media reports, the fraud was exposed when an employee of a company owned by Modi in Hong Kong informed a foreign branch of PNB about bribes being sought by PNB employees in their domestic branch for the issuance of LoUs. The foreign branch of PNB immediately informed the RBI of this, which subsequently started an inquiry into the scandal. According to yet other reports, the RBI had asked banks to make some changes in the way short-term loans, LoUs, etc. were reported, which also would have exposed Modi’s fraud even if the bank did not proactively inform the stock exchange.[[61]](#endnote-61)

After further internal investigation, on January 29, 2018, PNB filed an initial criminal complaint with the CBI. PNB charged Modi and others with defrauding the bank and causing the loss of more than $43 million. On further investigation, it was found that the actual loss borne by PNB due to fraudulent LoUs amounted to $1.8 billion. PNB’s investigation revealed the active involvement in the fraud of 50 PNB employees, including 10 branch heads, seven circle heads, treasury and forex departments, an international banking division, and auditors, in addition to other senior management officials including PNB’s ex-CEO and managing director. The ED’s 14,000-page sheet against Modi charged him as the main culprit in the fraud. The report stated, “He was the mastermind behind the scam, designing the entire scheme of fraud and the movement of the monies under the garb of export/import of diamonds and other jewelleries.”[[62]](#endnote-62)

**POST-FRAUD FOLLOW UP**

On February 14, 2018, one day before PNB made its announcement to the media about the fraud committed by Modi and Choksi, Modi wrote a letter to PNB offering to repay all his dues within three to six months. He proposed to do this by selling Firestar Diamond Inc., which was valued at $880 million.[[63]](#endnote-63) However, PNB declined the offer. Modi made the same offer through another letter, on February 17, 2018. According to veteran bankers, it was standard practice by defaulters to make comforting statements. One banker, on condition of anonymity, stated, “This is a tactic of buying time we see in all fraud cases.”[[64]](#endnote-64)

After his offer was twice rejected by PNB, Modi accused the bank of “overzealousness,” saying, “In the anxiety to recover your dues immediately, despite my offer [on February 13 and 17], your actions have destroyed my brand and the business and have now restricted your ability to recover all the dues, leaving a trail of unpaid debts.”[[65]](#endnote-65) He continued, “The erroneously cited liability resulted in a media frenzy, which led to immediate search and seizure of operations, and which in turn resulted in Firestar International and Firestar Diamond International effectively ceasing to be going concerns. This jeopardized our ability to discharge the dues of the group to the banks.”[[66]](#endnote-66)

Anticipating the fraud would definitely be exposed, Modi, along with his family and Choksi, left the country in the first week of January. As PNB tried to recover the loan amount, the CBI issued Modi with a summons, which he rejected on the grounds that he was very busy managing his other businesses abroad. The ED claimed that in March 2018, it attached properties belonging to Modi and Choksi that were worth $815 million.[[67]](#endnote-67)

By the time the PNB fraud had been detected, almost 30 banks had fallen victim to the illegal LoUs issued by PNB, resulting in the provision of credit in favour of overseas suppliers on behalf of Modi and his companies. Four large public sector banks—the State Bank of India, Union Bank of India, UCO Bank, and Allahabad Bank—were also exposed in the fraud, resulting in losses of $212 million–$412 million.[[68]](#endnote-68) Since the loans were credited to PNB’s nostro accounts, PNB was responsible for repaying the amount to all 30 banks involved.

PNB initially declined to honour the loans issued by different banks on the basis of PNB’s LoU because they had been issued illegally. PNB further stated that other banks had violated RBI norms by granting loans for longer than 90 days. It stated, “Letters of undertaking were opened in favour of overseas branches of Indian banks for [the] import of pearls for [a] one-year period as against the RBI guidelines that stipulate only [a] 90-day timeline from the date of shipment. This 90-day timeline stipulated has been overlooked by overseas branches of Indian banks.”[[69]](#endnote-69) However, India’s Ministry of Finance and the RBI directed PNB to pay back all bona fide commitments, otherwise PNB could be included in the list of defaulters.

By March 31, 2018, PNB had paid $900 million to seven banks, to cover the LoUs that were maturing in March, and committed to paying the remaining $900 million to the banks.[[70]](#endnote-70) Since LoUs had been issued to Modi and Choksi for a prolonged period without any margin money requirement, PNB had no assets of Modi’s from which to recover the money.[[71]](#endnote-71)

**future ACTIONS**

According to Mehta, the fraud was not a failure of the system, but a failure of certain people. RBI corroborated, stating that the PNB fraud had taken place because of the delinquent behaviour of bank employees. Mehta further believed the fraud was an isolated incident across PNB’s 7,000 branches in India and overseas. He stated that since the banking industry was a service industry, a people risk would always be present.[[72]](#endnote-72)

Commenting on the lack of linkage between a bank’s CBS and SWIFT, Mehta explained that banking in India was in the process of evolution. The integration of SWIFT with CBS did not exist in several other banks; this was not unique to PNB.[[73]](#endnote-73) Because the fraud had been enabled by the lack of this link, Mehta promised in March 2018 that PNB would integrate its CBS with SWIFT, as was mandated by RBI for all Indian banks by the end of April 30, 2018.[[74]](#endnote-74)

Commenting on how PNB would avoid such fraud in the future, Mehta stated that if the top management started conniving, anything could go wrong. To control such failures, PNB was segregating its front-line and back-office functions. Further, all foreign exchange transactions were to be processed in the back office of the New Delhi headquarters to minimize the risk of people failure. The bank also segregated functions for credit. Thus, the employees responsible for processing a loan would not be the same employees who monitored or recovered the loan.[[75]](#endnote-75)

Mehta decided to upgrade PNB to the best technology available and to further strengthen in-house inspection and audit systems. He stated that the physical system of conducting inspections was of no use and required supplementation with an offsite monitoring system.[[76]](#endnote-76) For this purpose, PNB created a data analytical cell, from which a team of employees would examine transaction analytics and point out any exceptional transactions. Mehta also decided to centralize certain tasks, and further withdrew branches’ powers to approve credit. Further, he withdrew the authority of a branch’s junior employees to operate SWIFT, so that only senior managers were allowed to use the system.[[77]](#endnote-77)

**THE ROAD AHEAD**

Mehta took pride in transparently reporting everything once the fraud unfolded. He stated, “We are known for clean banking. The fraud started in 2010. We . . . brought it under the notice of regulatory and law enforcement agencies as soon as we came to know about it. We will not spare anyone involved in the fraudulent practice.”[[78]](#endnote-78) Investors, however, were not convinced by this claim of transparency. Consequently, after the incident, credit rating agency Moody’s Investors Service, Inc. downgraded the bank to “junk,” indicating the bank was not worth investing in. Within two months of the fraud report, PNB’s stocks lost 50 per cent of their value on the Bombay Stock Exchange, the largest securities market in India.[[79]](#endnote-79)

For the fourth quarter of fiscal year 2017–2018 (January–March), PNB reported a net loss of $1.98 billion. This was the highest quarterly loss reported by any Indian bank since 1947, when India became independent. [[80]](#endnote-80)PNB’s gross non-performing assets also rose to $13.33 billion at the end of the fourth quarter, or 18.38 per cent of its total advances. PNB’s stock prices decreased further (see Exhibit 2).

Commenting on the future of PNB, Mehta stated that its business had increased; both domestic credit and domestic deposits had grown. For instance, in the fiscal year ending March 31, 2018, domestic credit for PNB grew by 10 per cent, and PNB’s performance on some parameters, such as its retail segment or priority sector growth, was actually better than the industry average[[81]](#endnote-81). In early April 2018, Mehta explained PNB’s financial performance: “So, we have grown in line with [the] industry and even during difficult days it was business as usual. With all this negativity which was created in the environment, the customers’ confidence was not lost and the credit goes to 70,000 employees who stood with me in [a] difficult time. They have gone the extra mile, they have done extra hard work to see that every customer is attended to properly.”[[82]](#endnote-82)Mehta disclosed that even after the announcement of fraud in February 2018, there were no incidences in which customers showed a lack of trust by demanding their money back or closing their accounts with PNB.

However, for future transactions, RBI banned the use of LoUs, which had an adverse impact on the $85-billion buyers’ credit market of India and raised the cost of import for the buyers. However, RBI did permit PNB to spread the losses over four quarters. Commenting on PNB’s position on debt payment, Mehta stated, “We have the capacity and the capability to bear the loss.” PNB was expected to be on track within six months, without its capability to lend being adversely affected.[[83]](#endnote-83)

What should Mehta do to overcome the fraud? Should he focus only on the future, or also on the possible means to recover the loan from Modi? Further, to avoid such a fraud in the future, should Mehta focus on ethical grounding at PNB? If so, how could he further improve PNB’s ethical culture?

**EXHIBIT 1: PNB FINANCIALS, 2015–2018 (US$ BILLION)**

|  |  |  |  |
| --- | --- | --- | --- |
| **Financials** | **2015**–**2016** | **2016**–**2017** | **2017**–**2018\*** |
| Total Revenue | 7.33 | 7.59 | 7.68 |
| Domestic Revenue | 7.14 | 7.38 | 7.41 |
| International Revenue | 0.19 | 0.21 | 0.27 |
| Net Profit | −0.54 | 0.18 | −1.66 |
| Operating Expenses | 1.35 | 1.27 | 1.82 |
| Interest Earned | 6.40 | 6.38 | 6.48 |
| Net Non-Performing Assets | 4.78 | 4.42 | 6.57 |

Note: \*In India the financial year was from April to March.

Source: “Financial Results March 2018,” Punjab National Bank, accessed October 31, 2018, [www.pnbindia.in/downloadprocess.aspx?fid=qTvsjnzvILodoPNEqn9wCQ](https://www.pnbindia.in/downloadprocess.aspx?fid=qTvsjnzvILodoPNEqn9wCQ)==; “Financial Results March 2017,” Punjab National Bank, accessed October 31, 2018, [www.pnbindia.in/downloadprocess.aspx?fid=Qitugu6uQJEMjzHZbLFNRg](https://www.pnbindia.in/downloadprocess.aspx?fid=Qitugu6uQJEMjzHZbLFNRg)==; “Financial Results March 2016,” Punjab National Bank, accessed October 31, 2018, [www.pnbindia.in/document/financials-current/finencial\_result\_march\_2016.pdf](https://www.pnbindia.in/document/financials-current/finencial_result_march_2016.pdf).

**EXHIBIT 2: PNB STOCK PRICES, November 14, 2017 to October 15, 2018 (US$)**

Source: “Punjab National Bank: Historical Data,” Yahoo Finance, accessed October 31, 2018, <https://uk.finance.yahoo.com/quote/PNB.BO/history?p=PNB.BO>.

ENDNOTES

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