

Case Study: Nirav Modi Fraud – Anti Money Laundering Analysis

A Research Project in Investment Banking Operations

Prepared By

Ritu

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MONEY LAUNDERING FRAUD CASE

"BEHIND THE FACADE: THE RISE AND FALL OF NIRAV MODI AND THE PNB FRAUD CASE"

- RITU JOSHI

ABSTRACT

The Nirav Modi case, a high-profile financial scandal that rocked India's banking sector, involved fraudulent transactions worth billions of rupees. Nirav Modi, a prominent diamond jeweller, and his companies colluded with officials from the Punjab National Bank (PNB) to obtain fraudulent letters of undertaking (LoUs), enabling them to borrow funds from overseas branches of other Indian banks. These LoUs were used to secure credit from international banks without adequate collateral, resulting in a massive debt burden on PNB. The scam, which came to light in early 2018, exposed systemic loopholes in India's banking system and raised questions about regulatory oversight. Nirav Modi fled India before the scandal broke and took up residence in the United Kingdom, where he was arrested in March 2019. Legal proceedings for his extradition to India followed, with ongoing efforts to bring him back to face trial. The case prompted widespread public outrage and led to increased scrutiny of corporate governance practices and banking regulations in India. It also highlighted the need for stronger measures to prevent fraud and protect the interests of stakeholders in the financial system.

Keywords: Nirav Modi, Punjab National Bank (PNB), Financial scandal, Letters of undertaking (LoUs), Banking regulations, Extradition proceedings, International banking, Stakeholder protection, International extradition, Impact on India's banking system.

INTRODUCTION

Who is Nirav Modi?

Nirav Modi, an Indian-born Belgian jewelry designer and entrepreneur, captivated the world with his dazzling creations and opulent designs. His eponymous brand quickly gained international acclaim, adorning celebrities and elite clientele.



However, his legacy was tarnished by allegations of financial fraud, leading to legal battles and a global pursuit for justice. The story of Nirav Modi is a saga of artistic brilliance overshadowed by scandalous deceit. Once in the Forbes list of billionaires for 2017 with a net worth of \$1.8 billion, and the “diamond king of India” is currently a fugitive and has been charged by the Government of India and the Interpol for criminal conspiracy, fraud, money laundering, dishonesty, and embezzlement of contract since 2018.

Early Life

Nirav Modi's trajectory, from leaving Wharton to establishing himself as a prominent figure in the diamond trade, is truly noteworthy. After dropping out from the prestigious university he accompanied his father to join his uncle Mehul Choksi's business at the age of 19. Mehul Choksi was the head of the Gitanjali Group. The Group owned around 4000 retail jewellery stores across the country. Under him, Modi learned the tricks of the trade in the diamond industry and eventually went on to found 'Firestar' in 1999 a diamond sourcing and trading company. The success of the business soon saw Modi acquiring other jewellery businesses. In 2010, he launched a diamond boutique which carried his own name, and soon expanded to 16 stores across the globe in cities such as Delhi, Mumbai, New York, Hong Kong, London, and Macau. Modi gained widespread recognition after designing the "Golconda Lotus Necklace," featuring a vintage 12-carat pearshaped diamond, and the Riviere of Perfection, comprised of 36 flawless white diamonds totalling 88.88 carats, sold at a Sotheby's auction. That same year, Modi made history as the first Indian jeweller to be featured on the prestigious covers of Christie's and Sotheby's catalogues. Modi also known as the diamond king of India had aspirations to compete against Cartier, Harry Winston, and Van Cleef & Arpels. At the peak of his success, Kate Winslet adorned herself with Nirav Modi's jewels at the Oscars red carpet. All of this changed when news of his swindle emerged.

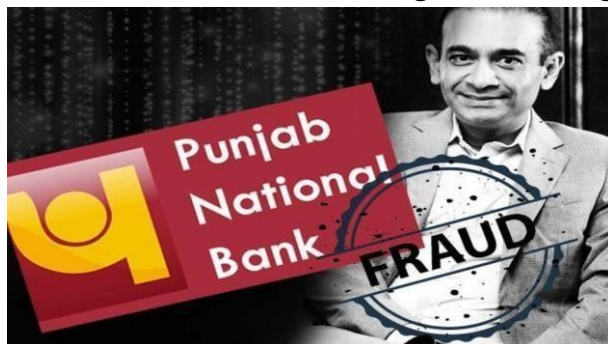
THE SCAM, AND HOW IT STANDS

Punjab national bank announced a big scam of 11000cr + in a surprise to the stock exchange. And then, apparently sent a message to various bank accusing a now retired officer for presenting fraudulent LOU (Letter of undertaking) for over 6 year. At the same time, the blame was put on people who received funds, the company owned by jeweler named Nirav modi and in other case, those owned by Mehul Choksi, such as public listed Gitanjali gems.



THE CONCEPT AND ITS WORKING

According to RBI, Fraud is defined as, “A deliberate act of omission or commission by any person, carried out in the course of banking transactions or in the books of accounts maintained manually or computerized system in banks, resulting in to wrongful gain to any person for a temporary period otherwise, with or without any monetary loss to the bank. An efficient and good banking system is the requirement for the proper functioning of economy. The banking industry, since it has begun to grow rapidly is also facing many challenges because of it. Recent frauds have shown that the bank is vulnerable to many risk including fraud, scam etc.,



banking fraud is a criminal act. But PNB put a clause that it will give you the loan but charge 10% interest. Nirav thought hard and said, no that is too much. Then, Nirav Modi decided to take loan from overseas bank because the interest rate of overseas bank was very low, the rate of interest was only LIBOR+2, and LIBOER was like 1.5%. PNB gave LOU (letter of undertaking) to Nirav Modi and his company without following proper procedure and without recording transaction in core banking transaction. A LOU (letter of undertaking is a guarantee by issuing bank to the receiving bank and the company that would commit to pay a certain sum of money on a specific date. PNB claimed that Nirav Modi and his company got a loan worth 1.77 billion through a false bank guarantee. In this way Nirav got a loan from the foreign branch of Indian bank.

How did Nirav Modi orchestrated the scam?

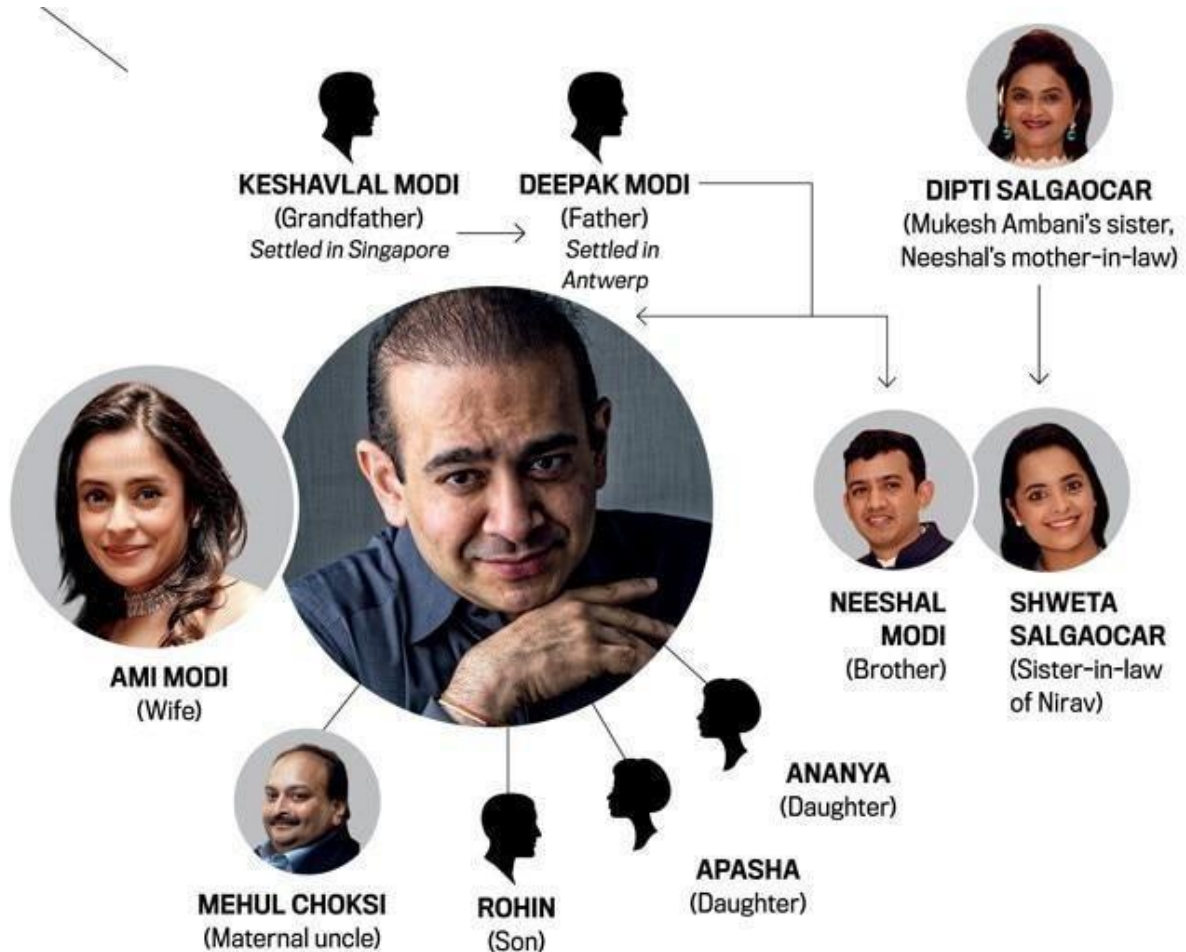
The scam which broke out in 2018 had begun way back in 2011. In order to pull off such a fraud, Nirav Modi capitalized on a banking instrument known as the



LOU (Letters of Undertakings). LoU is a bank guarantee under which a bank allows its customer to raise money from another Indian bank's foreign branch in the form of short-term credit³. These loans can be raised from Indian banks foreign branches established overseas. As Nirav Modi imported diamonds from foreign countries it preordained that he had to deal with foreign currencies. For this, he had to approach foreign branches of Indian banks for loans that were received at cheaper rates. But what collateral did he had here? This is where LOUs comes into play. Nirav Modi approached PNB for an LOU which was used as collateral for these short-term loans. These LOUs, however, are supposed to be given out only when the client has collateral in the domestic bank issuing the LOU. But PNB ignored these requirements and gave out the LOUs on Modi's guarantee. To worsen the matter, all these transactions were never added to the PNB's Core Banking System (CBS) which is used for record-keeping purposes. Also in some cases, a lower amount was quoted while making a corresponding entry. All these unauthorised LoU related transactions were done by the corrupt officials using the SWIFT system, which is an extensive messaging network used by the banks and financial institutions globally to accurately, quickly, and safely send and receive financial information. The SWIFT system had no



linkage with the bank's record keeping core system, i.e., CBS and this gave Nirav Modi and his accomplices the shadow area to operate with unauthorised LOUs. In other words, the SWIFT bypassed the CBS of the bank. As these loans were for the short term on their due date Modi was asked to pay back the loan by the foreign branches. But this is where Modi extended the scam. He simply took another LOU from Punjab National Bank of a higher amount. This was used to pay back the old loan and the additional amount was reinvested. Talk about a Ponzi scheme mechanism. By 2018 Nirav Modi had received 1,212 more such LOUs. His plan, however, was working! Modi had grown his business in a span of 5 years what would otherwise have taken 20 years. But how was he going to pay back all the debt? Modi had planned to eventually list his "successful" company, with securities being sold at a premium. These funds would then be used to pay off the billions in debt. But unfortunately, in 2018 when the employees of his companies approached PNB once again for LOUs the bank employees demanded 100 per cent cash margins. Nirav Modi's firms contested this requirement. They claimed that they had availed LOUs without collateral before. This led the PNB officials to finally take a closer look at their accounts after which they first found irregularities of Rs. 280.7 crores and immediately lodged an FIR with the CBI for fraudulent LOUs issued. As the officials dug deeper, by May 18, 2018, the scam had ballooned to over Rs 14,000 crore.



When and how did the P.N.B. scam come to light?

The scam was going on in collusion with corrupt officials of the bank for years. After a corrupt official retired, a new official replaced him and demanded collateral from Nirav Modi and his firms for issuing LoUs as per the regulations.

However, it was brought to his knowledge that Nirav Modi's entities had been accustomed to obtaining LoUs without collateral for years. Meanwhile, foreign banks that had extended loans to Nirav Modi based on PNB's LoUs began demanding repayment. Internal investigations commenced, but no records of these unauthorized LoUs were found in the bank's Core Banking System due to the previous official's failure to maintain relevant records. Thus, on 14th February 2018, the Punjab National Bank, the second-largest Public sector Bank helplessly reported to the stock exchanges, the Central Bureau of Investigation (CBI), Reserve Bank of India (RBI) and the public regarding fraudulent transactions of a staggering value of 1.8 billion dollars (approximately) and the



Nirav Modi scam hit the headlines

Impact and aftermath of the Nirav Modi scam

- **Impact of the Nirav Modi scam on the stock market**

Investors lose confidence in the financial sector when scams of this magnitude come to the surface and the PNB Scam was no exception. NIFTY and SENSEX suffered terrible blows in the aftermath of the Nirav Modi Scam. A more detailed effect of the scam on the stock market is enumerated below:

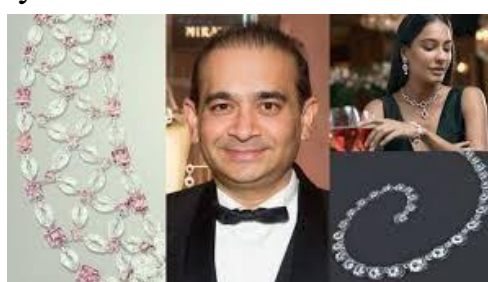


- **Impact of the Nirav Modi scam on bank stocks**

Bank stocks play a major role in the stock market and there are thirty-four nationalised banks in India. In the month of February, 2018, when the Nirav Modi scam became public, the banking stocks tanked immensely and the market cap of these thirty-four banks decreased by more than thirty-six thousand crores of rupees. PNB stocks alone lost investors wealth amounting to eight thousand crores of rupees. Without delving deep into the statistics and numerically, it can be said the exposed banks (UCO Bank, Allahabad Bank, Axis Bank.

- **Impact of the Nirav Modi scam on jewellery stocks**

Nirav Modi's jewellery companies like Firestar Diamond International Company were not listed on the stock market exchanges. But Nirav Modi's uncle, Mehul Choksi's Gitanjali Gems stocks started a skydive after the scam went public. Nirav Modi and Mehul Choksi controlled a considerable portion of the jewellery sector in India and the banks became extremely unwilling and sceptical about giving credits to the other jewellery companies. This led to more volatility in the jewellery sector and investors lost more and more wealth.



• Impact of the Nirav Modi scam on LIC



Life Insurance Corporation (LIC), another State-owned Company was badly hit by the Nirav Modi scam indirectly. It is common knowledge that LIC invests money into the stock market and LIC was the single largest institutional investor in the exposed banks viz Punjab National Bank, Allahabad Bank, Union Bank of India and Mehul Choksi's Gitanjali Gems. So, when the stocks of these companies plummeted because of the Nirav Modi scam, LIC lost thousands of crores of rupees.

• Impact of the Nirav Modi scam on the export-import industry



Letter of Undertakings (LoUs) were crucial for any businessman of the exportimport industry for they provided short term credit at low interest rates. Now one rotten apple Nirav Modi led to the complete ban of LoUs for the entire industry thereby severely jeopardising the entire export-import sector. Even though other forms of credits are still available, the higher interest rates are burning deep holes in their pockets and making other businessmen pay for Nirav Modi's greed. Specially the small-time traders have been the worst sufferers. Loss of arbitrage for businessmen, depreciation of the Indian rupee etc were all a result of the billion-dollar Nirav Modi scam.

Reforms introduced after the Nirav Modi P.N.B. scam

The following reforms were introduced post India's biggest banking fraud:

- On March 13, 2018, after about a month from the scam hitting headlines, the Reserve Bank of India (RBI) issued a notice banning banks from issuing guarantees in the form of Letters of Undertaking (LoU) to prevent any further misuse of this facility with immediate effect.⁹ Thus, the process of issuance of LoUs for trade-related credits for imports in India got discontinued by commercial banks with immediate effect as per the order of RBI. This banning of LoUs outright was later criticised by experts as RBI's knee-jerk reaction in panic.



- RBI also ordered the integration of the SWIFT system with the banks' recordkeeping system i.e. the Core Banking System (CBS) within stipulated

deadlines. The integration of SWIFT with CBS will prevent future scams along similar lines.

- Better Risk Management Framework was put into place with an efficient system of checks and balances to optimise the risk management system.
- RBI had also set up an expert committee¹⁰ headed by YH Malegam, a former member of the Central Board of Directors of RBI, to investigate the reasons for high divergence observed in asset classification, various incidents of fraud, breach of trust and necessary interventions to prevent such frauds in future.
- RBI also issued Prompt Corrective Action (PCA) framework to the banks like UCO Bank, Dena Bank, IDBI Bank, Oriental Bank of Commerce, Indian Overseas Bank, Central Bank of India, Corporation Bank, Bank of India, Bank of Maharashtra, Allahabad Bank and United Bank of India to encourage them to abstain from riskier bank practices and stress on conserving capital.
- The RBI also ordered the banks to tighten the use of the SWIFT framework; a limit on foreign currency payment instructions where beneficiaries were individuals; and an additional layer of security on transactions above a certain threshold was told to be put in place.
- To curb the menace of offenders escaping to foreign countries and avoiding prosecution, the Indian Government enacted the Fugitive Economic Offenders Act (2018) w.e.f. 21st April, 2018. Any person who has committed offences like counterfeiting government stamps or currency, cheque dishonour, money laundering, transactions defrauding creditors and other offences under this Act amounting to Rs. 100 crores or more and has left India to avoid prosecution and refuses to return can be declared as a fugitive economic offender. Moreover, all his properties (including benami properties) can be confiscated by the central government and all such rights and titles of the properties shall vest with the Indian government without any encumbrances

An Analysis of Nirav Modi's ongoing Court-case

The 53-year-old Modi, who is facing charges of fraud and money laundering, amounting to an estimated \$2 billion (Rs 13,758 crore) in the Punjab National Bank (PNB) loan scam case, is currently lodged at Wandsworth prison in southwest London.

The INTERPOL has issued a red notice against him for involvement in money laundering. Over the subsequent months of 2018 and 2019, significant developments occurred in his extradition case. By February 2021, the court had granted extradition approval, and in April of the same year, the UK government also consented to the extradition. Nonetheless, his legal representatives lodged an appeal in the London High Court citing concerns about his mental well-being, contending that his mental health had worsened.



The verdict given by the Westminster Magistrate's court in the case of *The Government of India v. Nirav Deepak Modi*¹⁴ is by far the most important and crucial judgement in this case, that has again given rise to expectations regarding Nirav Modi's extradition to India.

What's the status of the case in India?

A special PMLA (Prevention of Money Laundering Act) court recently declared that the Central Government is entitled to proceeds from the sale of a London property belonging to fugitive diamond trader Nirav Modi and directed that the amount be deposited with the central government.



Nirav Modi was declared a fugitive economic offender in 2019, after he failed to surrender to the Indian prosecuting agencies investigating the ₹13,850 crore fraud at Punjab National Bank (PNB). Soon after, the court granted the Enforcement Directorate's (ED) request to confiscate 68 properties worth ₹329.66 crores associated with Modi, including a flat 103 in Marathon House, 200 Marylebone Road, London.

Conclusion



The PNB scam has left more than a conspicuous dent on India's banking sector. The resolution of the Nirav Modi case serves as a poignant reminder of the urgent need for comprehensive reforms and rigorous oversight in the financial sector. This landmark case has brought to light glaring deficiencies within banking systems and underscored the critical importance of bolstering transparency and accountability measures. The magnitude of the fraud perpetrated by Nirav Modi underscores the far-reaching consequences of unchecked corruption and inadequate regulatory frameworks. Moving forward, although the Fugitive Economic Offenders Act represents a positive step forward, it should not stand as the sole legislation enacted to address this issue.

Looking ahead, it's essential for regulators and policymakers to enact comprehensive reforms aimed at bolstering the resilience of the financial system. This includes strengthening governance mechanisms, enhancing risk management practices, and fostering a culture of compliance and ethical conduct within financial institutions. Moreover, there's a pressing need for greater transparency and accountability, not only from banks but also from regulators themselves. Furthermore, addressing the root causes of financial misconduct requires a comprehensive approach that encompasses both regulatory reforms and cultural shifts within the industry. This may involve tighter scrutiny of high-risk transactions, improving the effectiveness of antimoney laundering measures, and encouraging greater collaboration between financial institutions and law enforcement agencies. Moreover, rebuilding trust in the financial system necessitates proactive engagement with stakeholders, including investors, customers, and the wider public. Transparent communication about the steps being taken to prevent future incidents and hold wrongdoers accountable is essential in restoring confidence. Ultimately, the Nirav Modi case serves as a wake-up call for all stakeholders to prioritize integrity, accountability, and ethical conduct in their operations. By learning from past mistakes and implementing robust reforms, we can strive towards a more resilient and trustworthy financial ecosystem for the benefit of all.

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