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BANK FRAUDS IN INDIA IN LIGHT **OF THE NIRAV MODI CASE: HOW** **HAVE THE LAWS CHANGED?**

Authored By- Aakansha Mewar

Introduction

Banks have played an extremely integral part in a man's life. Since the nationalization of banks in 1969 and the liberalization of the economy in 1991, the banking sector has grown immensely and rightly so because it is the one stop shop for all financial needs such as that of receiving deposits and making loans. They also provide financial services like wealth management, currency exchange, and safe deposit boxes. There are several different kinds of banks including retail banks, commercial or corporate banks, and investment banks. Considering the fact that banks lead such a fast pace life handling and dealing with money and despite having a well-regulated system, the structure of such an organization is a laden with faults that are used to the advantage of some leading to frauds. The Indian Contract Act, 1872 defines *fraud* as any act that an individual undertakes either by himself or through his agent, with the intent to deceive another party. In the case of a banking fraud, an individual or his company thereto, performs acts that result in fraudulent activity by obtaining money illegally from the bank either through false statements or because of the greed of an authority who works at the bank. The Reserve Bank of India defines the same as "*any behaviour by which one person intends to gain a dishonest advantage over another*". The Indian Penal Code, 1860, although does not define fraud directly, it does have provisions for providing punishments for acts that lead to fraud. For all acts that result in a bank fraud it is essential for there to be:

- a. An active involvement of the staff,
- b. Failure to follow the instructions and guidelines of the bank by the staff,

- c. Collusion between businessmen, executives, politicians to bend the rules and regulations and any other external factors.¹

Further, under S. 65(1) of The Insolvency and Bankruptcy Code, 2016 deals with provisions in relation with the penalty for fraudulent or malicious intention of proceedings by an adjudicating officer if the applicant initiates a Corporate Insolvency Resolution Process (CIRP) either fraudulently or maliciously with anything other than the resolution of insolvency.

Objectives of the Study

The following are the objectives of this study:

- To highlight the PNB Scam by describing the chain of events and their aftermath.
- To shed light on how the laws have changed since the scam.

What was the Punjab National Bank Fraud?

On February 14th, 2018, Punjab National Bank declared that at one of its Mumbai Branches, an embezzlement of around Rs. 11,400 Crores had taken place. The key accused in the case were Nirav Modi, his maternal uncle, Mehul Choksi, along with other relatives and some of the PNB employees.

Who was Nirav Modi and How did the Scam unfold?

Nirav Modi was one of the most affluent businessmen in India, having made it to the 57th spot of the Forbes Billionaires list in 2017. He was seen as a prominent luxury diamond jeweller and designer as well as the founder of the Nirav Modi chain of diamond jewellery retail stores having 16 stores national and international stores all over the world. He made his way into the business by starting its parent company which was Firestar International of which he was the Chairman which also had stores internationally.

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

¹ Vaneeta Patnaik, 'Socio-Economic Offences' (ePathshala)

<http://epgp.inflibnet.ac.in/epgpdata/uploads/epgp_content/S001608/P001741/M022095/ET/1504180707BankfraudFormat.pdf> accessed 28 October 2021

firms, Diamonds R Us, Solar Exports and Stellar Diamonds. As of 18 May 2018, the scam has ballooned to over Rs 14,000 crore.²

How did the scam take place?

The banking sector relies on what is known as a Letter of Undertaking (hereinafter referred to as LoU) which are essentially a form of guarantee that is issued by a bank in lieu of the individual/company to attain money from a foreign branch of an Indian Bank. In the Nirav Modi Case, PNB issued a total of 1212 fraudulent LoUs for over 6 years. The process of this was such that all guidelines for the issuance of such an Undertaking was completely ignored by overseas branches of Indian Banks as they failed to share any documentation or information with PNB which were made available to them by the firms at the time of availing credit from them. The scam was made possible by the accused in the form of foreign shelf companies with the intention of embezzling through them. These shelf companies were found to be present and receiving fraudulent PNB LoUs in the British Virgin Islands, and other “tax havens” as uncovered by the Enforcement Directorate.

What went wrong on the part of the Punjab National Bank?

The following were the mistakes made by PNB:

- i. Basic Procedure was not followed: When a trade financial company approaches a bank for money, the bank sets a fixed credit limit and does so by initiating a LoU which is then sent to a lending bank. In the cases of magnitude like that of Nirav Modi and Mehul Choksi, the cases are to be vetted by officials at a higher authority in the issuing bank. This was seen as a missing step on the part of PNB in the aforementioned case.
- ii. The rule requiring the vetting of such procedures by three high officials was replaced for one in the case: When LoUs are sent to foreign banks for the process of money procurement, the documents of the same are to be vetted by 3 high authority officials and are required to log into the system using their IDs and passwords. However, this was

² ‘What is PNB Scam: PNB Fraud Case: Nirav Modi Case’ (Business Standard) <<https://www.business-standard.com/about/what-is-pnb-scam>> accessed 28th October 2021

ignored in the Nirav Modi and Mehul Choksi case and PNB had admitted to the mistake on its part stating that the same was verified by an official at a lower rank and who had acted in two capacities.

- iii. Discrepancy in the process: the PNB Officials are usually to follow the core banking system which records all transactions of a high amount, this particular case however, the managerial official of the bank responsible for forging LoUs, had delinked the Core Banking System thereby having no record of these transactions.
- iv. PNBs ignorance: The IT Department plays an integral role in the process as they are responsible for checking that the Controlled Banking System-SWIFT functions smoothly and properly. What it failed to notice were the absent LoUs in the present case for over 6 years. Further, this was not detected by the Vigilance Department, external auditors or the PNB fraud management committee.
- v. The foreign bank that provides the loan against these LoUs by the issuing bank, writes to the controlling office of the issuing bank to confirm the LoU which the Punjab National Bank claimed to never have received.

How did the fraud come to light?

The LoUs for the Nirav Modi firms were handled by 2 junior employees of the Punjab National Bank who had been sending out unauthorised Letters of Undertakings for over 6 years. Upon the retirement of an employee, a new employee had been hired in his place, and was made responsible for the LoUs in relation to Nirav Modi. When a fresh guarantee was asked for the same, the new PNB employee as per protocol asked about the collateral in place of the Firm which ultimately resulted in an investigation after he was informed that a collateral had never been asked for in the past from the Nirav Modi Firms.

RBI's Reforms for Banks post the Nirav Modi Fraud Case

Post the Nirav Modi Case, the RBI with immediate effect on March 13th, 2018, barred the issuance of Letters of Undertakings as well as Letters of Controls to prevent any further misuse of the facility. All Commercial Banks' LoUs having trade related credits for imports in India, under this

directive were asked to discontinue the same.

Further, the RBI also directed the banks to connect their Core Banking Systems to the SWIFT (Society for Worldwide Interbank Financial Telecommunications) System by April 30th 2019. Nirav Modi having charges of criminal conspiracy, cheating, dishonesty, fraud, breach of trust and breach of contract has been arrested in London after an arrest warrant was released against him. As per economic times report, shares of Punjab National Bank jumped 4 per cent after scam accused Nirav Modi was arrested in London.³

RBI's Reforms in the Aftermath of Recurring Bank Frauds

In the last three years, India has seen 22,864 bank fraud cases with an embezzled amount of Rs. 3.95 trillion. The startling number of bank frauds brought to the forefront that the guidelines as set had not been quite effective. The RBI published its annual report for 2020-21 which disclosed not only the astonishing number of bank frauds but also brought to the limelight the repercussions of poor Corporate Governance. It highlighted that not only had low officials in the banks been a part of a fraud but also officials having high posts in the banks. Due to these reasons, the RBI looked into bettering the Corporate Governance in the Banking Sector.

On June 11th, 2020, the RBI published a discussion paper on governance of commercial banks which depend on the recommendations made by the Basel Committee on Banking Supervision, the guidelines from the RBI Circular of March 1992 on Do's and Don'ts for Directors, the provisions of the Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015 (Listing Regulations) and the Companies Act, 2013, and other RBI circulars. On 26 April 2021, RBI issued a circular on 'Corporate Governance in Banks – Appointment of Directors and Constitution of Committees of the Board' (Circular) which aims to bolster the governance regime of the banking sector in India.⁴

The Circular pushes revision of provisions related to appointment of a bank's chairperson, tenure

³ Amrith Dogra and Manu Dogra, 'Sustainability and Ethical Banking: A Case Study of Punjab National Bank' [2019] 4(1) Amity Journal of Corporate Governance <<https://amity.edu/UserFiles/admaa/6561aPaper%202.pdf>> accessed on 29 October 2021

⁴ Souvik Ganguly, Saumya Sharma and Altamash Qureshi, 'RBI pushes for Massive Governance Reforms of Banks in the Aftermath of Recurring Bank Frauds' (Mondaq, 17 August 2021) <<https://www.mondaq.com/india/corporate-governance/1093700/rbi-pushes-for-massive-governance-reforms-of-banks-in-the-aftermath-of-recurring-bank-frauds>> accessed on 30 October 2021

of directors, and constitution of committees in relation to private sector banks, small finance banks and wholly owned subsidiaries of foreign banks. These however do not apply to the foreign subsidiaries of the bank. The Circular would only apply to nationalized banks to the extent it is not inconsistent with provisions of the specific laws applicable to the nationalized bank. Under the State Bank of India Act, 1955, (SBI Act), the directors of State Bank of India (other than managing director) can hold office for up to three years with an option of reappointment and a cap of six years on holding the office without a break. In this instance, the provision under the SBI Act is more protective for stakeholders than the Circular. As the provision with respect to appointment term of directors (other than managing director) under the Circular and the SBI Act are inconsistent, the provision of the SBI Act will continue to apply to the State Bank of India.⁵

CONCLUSION

The Punjab National Bank in relation to the Nirav Modi Case is the biggest bank fraud that India has ever seen with an estimate of Rs. 14,000 crores in stolen funds. This case was a turning point in the eyes of banking law and revealed the loopholes that the laws contained which allowed such frauds to take place. The alarming amount of money embezzled opened the eyes of the respective law makers to come up with a more airtight statutes that will result in fewer bank frauds. In light of the Nirav Modi Case, India saw a vast realization upon which there have been several amendments in laws and a more conscious effort to prevent the same on the part of the banks. The PNB scam exposed several banks to credit risk which need to be examined with regards to how the process got diluted and how the employees collusion with the client leading to such a massive fraud could go unnoticed for so long. These resulted in the changes of the appointment, tenure and constitution changes in bank employees in the managerial sector.

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