Who’s responsible for the PNB fraud?

There’s an old saying that goes: “Fool me once, shame on you; fool me twice, shame on me.” That adage, when applied to Indian banking, would probably be: “Fool banks once—oh these things happen; fool them twice—catch a few low-level minions and jail them after a trial lasting twenty five years; fool them for the umpteenth time—allow the fraudster to escape abroad, recapitalise the banks and continue with business as usual.” Contrary to what Abraham Lincoln was supposed to have said, it seems entirely possible to fool all the people all the time.

The bank management

Consider Punjab National Bank (PNB), in the eye of the current storm. It has on its website the list of “wilful defaulters” to the bank as on 31 January 2018, the total amount being Rs14,593 crore.

“Wilful defaulters” is a euphemism for frauds. The point is that, even before the Nirav Modi scam, PNB had lost substantial amounts to bank fraud.

Pride of place in PNB’s defaulter list goes to Winsome Diamonds & Jewellery Ltd, which owes the bank Rs899.70 crore. Close behind is Forever Precious Jewellery & Diamonds Ltd, which owes it Rs747.98 crore. Zoom Developers Ltd owes it Rs410 crore.

The overall list of wilful defaulters against whom lawsuits had been filed as on 31 December 2017, on the CIBIL website, shows that among nationalized banks, PNB had the highest number of wilful defaulters as well as the largest amount outstanding from these accounts.

Indeed, it accounted for almost 30% of the amount outstanding from nationalized banks. Both the number of frauds and the amounts involved should have been a wake-up call for the bank management.

What’s more, many of the wilful defaulters in the PNB list are diamond or jewellery companies. Bankers know that lending to the sector is fraught with risk and more than usual caution and market intelligence is needed. Yet the PNB management hasn’t learnt much even after burning its fingers badly.

To be sure, the current scam seems to have been a failure of the most elementary checks and balances in operations. But regardless of whether it is operational risk or credit risk, the bigger picture is of a total failure of risk management in the bank.

The banking system

PNB may be a particularly egregious example, but risk management in the entire public sector banking system leaves much to be desired. As on 30 September 2017, data from CIBIL shows that the amount outstanding on account of wilful defaulters at nationalized banks together with the State Bank group was Rs93,359 crore. This was 83.6% of the entire outstanding on account of wilful default in the banking system, including foreign banks.

That percentage is well above the share of public sector banks in loans and advances. And it’s not just frauds that are a problem—public sector banks also account for a disproportionate share of total stressed assets.

Not all of this is due to poor risk management systems. Public sector banks have long been subject to political interference and politicians have often viewed them as gold mines for dispensing patronage. They have also been used and abused to carry out government objectives, whether they are loan waivers or lending to risky infrastructure projects. Small wonder then that public sector banks have become the weak underbelly of India's financial system. As the P.J. Nayak committee report said almost four years ago, "It is unclear that the boards of most of these banks have the required sense of purpose, in terms of their focus on business strategy and risk management, in being able to provide oversight to steer the banks through their present difficult position." That said, fraud is no respecter of bank ownership. Massive frauds, many times bigger than the current PNB fraud, occur regularly in banks abroad. The global financial crisis was not caused by state-owned banks. Frauds will always be with us—as the irrepressible K.C. Chakrabarty, former RBI deputy governor, pointed out, even Kautilya had described forty ways of embezzlement in the *Arthashastra*. But surely, given their spotty track record, banks in India need to be extra cautious about risks? They do not seem to have learnt their lessons.

Auditors

All through this latest episode of ever-larger non-performing assets being detected in banks' books, or in the numerous cases of evergreening of loans, the auditors have been conspicuous by their silence. The less said about concurrent auditors the better. Yes, RBI has of late found discrepancies between what banks have reported as NPAs and their own assessment, but did they impose any penalties for hiding these bad loans?

The Reserve Bank of India

The buck stops with the regulator. Was the Reserve Bank of India (RBI) unaware of the rising incidence of frauds in the banking system? Of course not. In its *Financial Stability Report* of June 2017, it had pointed out that one of the emerging risks to the financial sector is a rising trend of frauds in commercial banks and financial institutions. During the last five financial years, the RBI report said the volume of frauds had increased by 19.6% from 4,235 to 5,064 and the loss incurred had gone up 72% from Rs97.5 billion to Rs167.7 billion.

That's not all. In a speech delivered on 7 September 2016, former RBI deputy governor S.S. Mundra specifically said, "We have also come across instances of fraudulent messages confirming documentary credits being transmitted using SWIFT infrastructure. Although the latter incidents were mainly a result of failure of internal controls and non-adherence to 'four eyes principles', it is also on account of reliance on disparate systems whereby SWIFT transactions could be done without originating a corresponding transaction in the CBS." This is precisely the flaw in PNB's operating system that was used by the scamsters. The question is: did RBI take any follow-up action to remedy this defect?

The government

Finally, the government too must bear its share of the responsibility. The P.J. Nayak committee had this to say about the public sector banks: "If the governance of these banks continues as at present, this will impede fiscal consolidation, affect fiscal stability and eventually impinge on the government's solvency.

Consequently, the government has two options: either to privatise these banks and allow their future solvency to be subject to market competition, including through mergers; or to design a radically new governance structure for these banks which would better ensure their ability to compete successfully…." The government hasn't done either of these things, instead continuing with its usual tinkering. The upshot is that, as the Nayak committee had foreseen, there is little material improvement in the governance of these banks.

The big question

RBI deputy governor Viral Acharya urged all of us to ask an important question in a speech last year. He said, “I wish to encourage you to reflect on all this, read about the current state of Indian banking sector in newspapers and economic writing, try to make sense of it from first principles, and ask the question if we have a banking sector that our economy can bank upon.”

Manas Chakravarty looks at trends and issues in the financial markets.

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