Fault lines in the Indian banking industry

Two things occur with metronomic regularity in the Indian banking sector: scams and committee reports. One, perhaps, follows from the other.

The Indian banking story, whether pre- or post-nationalization, has been an unfortunate hostage to a long catalogue of scams and frauds. The discovery of each scam is usually followed up with a flurry of committees and reports, rule reversals and a systems overhaul. A few years lapse in all this frenetic activity, a sharp light is focused on the scam area and just about when everybody starts getting complacent, another scam hits the industry. The entire round-robin league is replayed all over again.

The modus vivendi is common: exploit the system’s weakest link. There is another common thread in all the scams: diversion of funds. Both the Punjab National Bank (PNB) and Bank of Baroda (BoB) scams—the Nirav Modi and Rotomac cases, respectively—underline how fund diversions were overlooked; what’s distressing is how no alarm bells were sounded, nor red flags raised, despite an obvious piling up of operational, human and market risks that have debilitated two of India’s stronger public sector banks. Unfortunately, this seems to have become the default template for Indian banking scams, underscoring wide gaps in the regulatory framework. A cursory glance at scams since 1990 show how each episode methodically leveraged regulatory and supervision gaps.

The Harshad Mehta scam coincided with the dawn of India’s economic reforms. Mehta exploited the manual and antiquated settlement systems in trading of government securities. Taking advantage of a few pliant bank officers, Mehta conducted gilts trade between different banks using forged documents and diverted proceeds to prop up untenable equities positions. The scam-tainted large public sector banks (State Bank of India), foreign banks (Standard Chartered), small private banks (Bank of Karad, now extinct), corporate behemoths and sundry securities markets intermediaries.

A decade later, Ketan Parekh—ironically Harshad Mehta’s protégé—replicated almost the same methods: divert funds from the banking system through fraudulent methods to sustain equity market positions. KP would obtain pay-orders from Ahmedabad-based Madhavpura Mercantile Cooperative Bank without providing sufficient collateral. He would discount these pay-orders with Bank of India in Mumbai and use the proceeds to ramp up shares. The house of cards eventually collapsed when bear traders hammered KP’s favourite stocks and Madhavpura’s outstanding pay-orders exceeded its ability to repay Bank of India.

Here’s another familiar story: Sanjay Agarwal, former CEO of Lloyds Brokerage, created portal Home Trade in 2000 but was forced to go on the run a year later. Agarwal had inserted himself into the world of cooperative banks, promising to invest in gilts on their behalf and delivering lucrative trading returns. Instead, he diverted the money without delivering the securities or providing the promised returns. The charade continued till one of the cooperative banks complained about not receiving the promised securities.

In recent times, Winsome Diamonds and Jewellery Ltd allegedly used standby letters of credit to divert Rs7,000 crore. Winsome Group promoter Jatin Mehta shares another common strain with Nirav Modi: both have ostensibly become citizens of Saint Kitts and Nevis islands in the Caribbean, which does not have an extradition treaty with India.

Many more similar banking scams have occurred and gone undetected for long periods till the final moment of denouement. One trend is unmistakeable: money is diverted out of the banking system with the active connivance of either the bank’s senior management or a couple of rogue officers. This is what makes both the PNB and BoB cases incredulous: with Reserve Bank of India (RBI) putting so much emphasis on anti-money laundering mechanisms, and with an increasing number of prosecutions against either money laundering or diversion of bank funds, it is indeed curious how both the banks persisted with lax risk mitigation and supervision frameworks.

This also then begs the question: how is it that so many similar scams occur with such frequency, especially when RBI is such a hands-on regulator and supervisor? Every small action needs RBI approval, be it a CEO’s annual bonus, bank management’s decision to nominate a senior executive to the board or to open a branch in a city. Yet, copycat scams continue with ineluctable monotony.

Each time a scam occurs, committees are set up and numerous studies take place. Even now, post the PNB scandal, RBI has set up a committee under chartered accountant Yezdi H. Malegam to examine the increasing number of frauds in the banking system, the measures that will be needed to prevent them (including technological solutions), the role and efficacy of various audits currently conducted in banks to mitigate such frauds and the growing divergence between RBI and bank assessments on asset quality.

Many similar committees were set up earlier and voluminous reports submitted; yet, sadly, they are never enough to prevent future scams.

Next episode: what could be the probable reasons for the recurrence of such scams.

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