Lecture

INSTITUTE OF ACTUARIAL & QUANTITATIVE STUDIES

Class: TY BSc

Subject : Risk Management & Investment Management -1

Subject Code: PUSASQF5.

Chapter: Unit 3 Chp 1

Chapter Name: Case Studies – Financial Disasters

Topics to be covered

1. Financial Disasters

2. Operational Risk
    1. Chase Manhattan & Drysdale Securities
    2. Kidder Peabody
    3. Barings
    4. Harshad Mehta Case
    5. Ketan Parekh Case
    6. PNB Bank
    7. PMC Bank
    8. NSEL Case

2.6 PNB Bank

What Happened?

- Nirav Modi, Indian diamantaire, along with his uncle Mehul Choksi and other family members and employees of Punjab National Bank(PNB) and his firm, Gitanjali Group, fraudulently obtained Letters of Undertaking(LoU) from the bank under the pretext of paying overseas suppliers. It resulted in the biggest banking scam of Independent Indian history.

What was the cause?

- At PNB's branch office at Brady House in Fort, Mumbai, two of its employees, Gokulnath Shetty, retired Deputy Manager of PNB and another bank official, issued fraudulent LoUs to Hong Kong based creditors on behalf of three firms associated with Nirav Modi and the Gitanjali Group.
- The LoU serves the purpose of a bank guarantee), on the back of which foreign branches of a few Indian banks — including Axis and Allahabad Bank — gave dollar loans to PNB.
- These foreign currency loans were used to fund PNB’s Nostro accounts and from these accounts funds moved to certain overseas parties. A Nostro account is the account an Indian bank (here, PNB) has with an overseas bank.

2.6 PNB Bank

What could have been done better?

- During the course of the investigation,, it was revealed that two employees of PNB directly used SWIFT, the global financial messaging service used to move millions of dollars across borders every hour, and bypassed the core banking system (CBS) which processes daily banking transactions and posts updates.
- The internal banking system is not systematic and is prone to fraudulent activities.
- A SWIFT message is sent to the overseas branch by the three-layered process, involving the three officials – Maker, Verifier, and an Authorizer. Each one of them has different login ids and passwords. However, in PNBs the same person carried out all the functions so it was a clear cut wrong intention.

Result:

- The estimated size of the fraudulent LoUs was ₹11,356.84 crore (US$1.4 billion) when detected in 2018. As of 18 May 2018, the scam has ballooned ₹14,356.84 crore (US$2.1 billion).
- It resulted in the entire value of PNB evaporating overnight.
- Nirav Modi and his uncle, Mehul Choksi are fighting protracted legal battles with Indian authorities overseas regarding extradition and have been classified by GoI as economic offenders and fugitives.

2.7 PMC Bank

What Happened?

- HDIL promoters, The Wadhwans , colluded with the bank management to draw loans from the bank's Bhandup branch. The bank officials did not classify these loans as non-performing advances, despite non-payment.
- Reports estimate the bank’s overall exposure to the HDIL group at around Rs 6,500 crore, or over 73 per cent of all of the bank’s advances — and all of this is not being serviced.

What was the cause?

- The PMC bank allegedly favoured to the promoters of Housing Development and Infrastructure Ltd (HDIL) and allowed them to operate password protected ‘masked accounts’.
- It was found that around 21,049 bank accounts were opened by bogus names to conceal 44 loan accounts. The bank's software was also tampered to conceal these loan accounts.
- PMC didn’t check the credit rating of HDIL because the loans work were sanctioned only thanks to the political influence of HDIL.

2.7 PMC Bank

What could have been done better?

- According to the regulation, banks have one entity exposure limit of 15% of their capital account, while group companies have a limit of 20%. within the case of HDIL, exposure was at 73 percent fourfold the standard level. This should have been more strictly monitored through a rigorous risk management process.
- PMC was a multi-state co-operative bank and was thus regulated both by state laws and the RBI which did not establish a clear authority over it. That should have been avoided through more effective laws.

Result:

- As PMC routed its depositor's funds of INR 4335 Cr to HDIL but they ran out of funds.
- There was a situation of a run on the bank as the withdrawal limit was initially capped at 5000 Rs followed by lifting it upto 50,000 Rs currently. The bank is currently being merged with Centrum Finance to form a Small Finance Bank.
- Subsequent to the scam, RBI was assigned more powers with regards to regulatory authority over Multi-State Co-Operative Banks.

2.8 NSEL Case

What Happened?

- NSEL case relates to a payment default at the National Spot Exchange Limited that occurred in 2013 involving Financial Technologies India Ltd, when a payment default took place after a commodities market regulator, the Forward Markets Commission (FMC), directed NSEL to stop launching contracts. This led to the closure of the Exchange in July 2013.

What was the cause?

- The brokers mis-sold NSEL products to their clients by assuring them fixed returns. The defaulters hypothecated stocks and produced fake warehouse receipts and siphoned the entire default money.
- The exchange is blamed to take as long as 25 to 35 days to settle some contracts. The permitted time period to do so was up to 11 days.
- Against the regulations, short-selling, too, was allowed in many cases. The then regulator Forward Market Commission (FMC), then intervened and asked NSEL to wind down existing contracts. This ended in payment default.
- Jignesh Shah, the promoter of NSEL, was initially arrested but released on bail. He wasn't found guilty as no money could be traced to him but rather to 22 other defaulters.

2.8 NSEL Case

What could have been done better?

- As we have seen quite often, internal controls at the exchange were very weak.
- Mukesh P Shah, who is a maternal uncle of Jignesh Shah, had been internal as well as external auditor of NSEL from time to time. Mumbai police while opposing his anticipatory bail confirmed that he was doing insider-trading in FTIL, the holding company, shares and by virtue of possession of FTIL shares alone he should have been disqualified as an auditor.
- The FMC with it's bizarre change of rules also created confusion and mass panic in the market which lead to insufficient delivery. That should have been avoided from the regulator.

Result:

- Initially, it was projected that there were 13,000 trading clients affected by the NSEL crisis. The genuineness and entitlement of these 13,000 trading clients is questionable.
- The NSEL management have been given a schedule of repayment, according to which every Tuesday (commencing August 20, 2013) would see a payout of Rs 174.72 crore for the first 20 weeks and Rs 86.2 crore for the next 10 weeks. But as expected, the exchange has failed in the very first payout, having distributed just around Rs 92 crore against a commitment of Rs 174.72 crore. The exchange closed in July 2013.