

# NIRAV MODI SCAM IN PNB (PART I)

---

RAMKI

PKF S&S LLP

MAR 18

# ABOUT THIS COMPILATION

---

- This compilation is made from various Newspaper, magazine and TV reports and states the source of the news items.
- This is done with the purpose of educating the staff on the fraud, its impact and its root causes.
- Information which comes out later may change some of the conclusions presented here.
- None of this represents the views of the author or the firm.

# ABOUT NIRAV MODI

---

- Nirav Modi is a Wharton drop out and is a high flying diamond merchant
- in 1999 he founded Firestone (now called Firestar)
- He set up Nirav Modi brand in 2010
- His showrooms are in London, Beijing and Hongkong. (NDTV 16 Feb 18)
- Modi is on the board of five companies—Jewelry Solutions International Pvt. Ltd (which is now amalgamated), Radashir Jewelry Co. Pvt. Ltd, Firestar International Ltd, Firestar Diamond Pvt. Ltd and Firestar International Pvt. Ltd.
- He is also on the board of four limited liability partnership (LLP) firms including Neeshal Enterprises, Paragon Jewellery, Paragon Merchandising and Panchjanya Diamonds.
- None of these have assets that match the quantum of fraud perpetrated. (Live Mint 26 Feb 18)

# WHAT HAPPENED?

---

- Mehul Choksi owner of Gitanjali Gems and Nirav Modi founder of Firestar International P Ltd exploited loopholes in banking system by seeking LOU (letters of undertaking) from PNB and raising credit from various foreign banks/Foreign branches of Indian banks.
- On 16 Jan 18 when Modi's men asked for an LOU, the bank asked for 100% margin as they ought to. Modi's men contested this and claimed they were enjoying this facility for many years without cash margin. This led to the discovery of the fraud!
- On 5 Feb 18 PNB informed Stock exchanges of a Rs 280 cr fraud. (tip of the iceberg!)
- Later the bank said the money involved was \$1771.69M (Rs 11400 cr) (Live Mint 19 Feb 18)

# HOW IT HAPPENED?

---

Swift (Society for worldwide Interbank Financial telecommunications) messages have 3 persons involved in a bank - a maker, a checker and a verifier and a fourth not from the bank, who is the person who receives the message and sends a confirmation.

The confirmation comes to a secure room and no one has access to this room. (Looks like in PNB there was no reconciliation of these confirmations with Core banking or other record)

Either Mr. Gokulnath Shetty a (now retired) DGM at PNB by passed all these controls or he had many more executives helping him for a period of 7 years!-Live Mint 19 Feb 18

The foreign banks issued Buyer credit loans purely based on PNB's LOU's.

# HOW IT HAPPENED? CONTD.

---

- This is what possibly happened thereafter.
  - The foreign bank should have credited the funds to PNB's Nostro account and PNB should have paid the exporter who was the supplier to Modi. (how were the funds not traced by the Core banking software? Why did this not come out in Nostro reconciliation?)
  - Modi possibly never paid back PNB fully but asked them to open another LOU and so on - perpetuating a kite flying operation.
  - The LOU's were never entered into the core banking system and hence there was no record.
    - Live Mint 19 Feb 18
  - The Ponzi schemes run well till there is continuous flow of funds. When the tap is closed all the muck is thrown out.

# ABOUT LOU

---

- LoU is a direct exposure of the importer's bank to the overseas banks which are extending the buyer's credit.
- Buyer's credit is a short-term credit available to a buyer (importer) from overseas lenders such as banks and other financial institutions for goods being imported.
- The overseas banks usually lend the importer on the basis of an LoU issued by the importer's bank.
- The bank which gives the LoU earns a fee, typically 0.2-0.25% of the amount. (Live Mint 19 Feb 18)
- Thus PNB has exposed itself to massive amounts for a paltry fee!
- Normal maturity of an LOU is 90 days
- But to avoid the scam coming to light, the PNB official issued it for nearly a year just before he retired!

# HOW BIG IS THE HOLE?

---

- Rs 12723 crore as of 27 Feb 18 (NDTV 27 Feb 18) – Rs 1323 was added later to the original Rs 11400 cr estimate
  - This Rs 1323 crores were added after overseas branches checked and found them in their portfolio
- If corporate guarantees are included the amount could balloon to Rs 20000 Crores. (India Today 27 Feb 18)



# THE INVESTIGATION

---

- BDO will be handling the investigation of the Nirav Modi companies
- For : 7 Financial years from 2011
- Companies: five Nirav Modi group entities--Firestar Diamond, Firestar International, Solar Exports, Stellar Diamonds and Diamond R US

# TERMS OF REFERENCE OF INVESTIGATION

---

- 1. How LOU mechanism was misused by Modi
- 2. Gathering evidence on money trail and end use of funds
- 3. investigation into sales transactions, specifically sale on Sale on return (SOR ) basis reversed in subsequent years
- 4. Looking at 'concentrating transactions' where large volume of sales were made to same customer or large volume of purchases were made from same supplier.
- 5. Examine stocks, inventory and purchase transactions mainly with related parties
- 6. Quantifying losses the bank has suffered
  - BDO was the second lowest bidder and other bidders were KPMG, EY, PWC ; Originally press reports said PWC will do investigation.
    - (Economic times 28 Feb 18)

# GITANJALI INVESTIGATION

---

- Forensic audit of Gitanjali gems also being conducted by T.R Chadha &co
  - (Economic times 27 feb 18)
- Gintanjali's 66 bank bank accounts with funds of Rs 80cr were freezed by IT department; previously they had seized Rs 20 cr from 144 accounts. IT dept has also seized huge numbers of paintings and art work whose value is being assessed. (India Today 27 Feb 18)

# THE AUDITORS AND ICAI

---

Gitanjali Gems auditors are Ford Rhodes and Park

Firestar International P Ltd (FIPL) auditors are Deloitte

Deloitte has asked FIPL for details regarding the scam.

The audit report of FIPL for the year ended March 2016 had some qualifications on the company's liabilities.  
(BS 20 feb 18)

## **ICAI:**

- ICAI has sent show cause notices to the auditors of PNB, Gitanjali Gems.
- It has also constituted a high powered committee to study the issues and suggest remedial measures.  
(economic times 25 feb 18)

# THE RATING AGENCIES

---

- CARE Ratings issued a red flag in February 2016 that FIPL was suffering from very high leverage, large off-balance-sheet exposure and limited customer and geographical spread.
- In February 2016, Care further said FIPL was operating on stretched operating cycle till March 2015 which led to full utilisation of working capital bank facilities at a time when its operational performance was on a decline. CARE then downgraded the company's debt instruments worth Rs 24.6 billion. CARE also warned about its subsidiary in Hong Kong and Firestar Diamond International Pvt Ltd, saying the companies might not be able to repay their loans, unless the parent company stepped in as a guarantor.
- While CARE issued warnings, another rating firm, Fitch-owned Indian Ratings, gave good ratings to the company until the scam came to light and put its rating under watch. (BS 20 Feb 18)

# THE FALL OUT-I

---

- PNB has lost 40% of its market value by 28 Feb 18 (NDTV 28 feb 18)
- US companies of Nirav Modi have filed for bankruptcy (NDTV 28 feb 18)
- The Fugitive Economic Offenders Bill 2017 now proposed by Govt. will ensure:
  - 1. confiscating property and assets of offenders
  - 2. setting up special court to declare a person 'fugitive economic offender'
  - 3. offender will be disentitled from bringing forward or defending any civil claim.
  - 4. prevent offender from reclaiming property if he returns to India.

# THE FALL OUT-2

---

Govt moves to set up NAFRA (National financial reporting authority) on the lines of PCAOB in USA and The Financial reporting council in UK. This will take away the review and self-disciplinary functions of ICAI. (news item 28 Feb 18)

Six LR (Letter Rogatory) being issued to 6 countries to obtain information on financial holdings, bank accounts, assets, partnerships, showrooms, trusts and other assets of Nirav Modi and Choksi and their companies abroad.(Hong Kong, US, UK, UAE, South Africa, Singapore) (NDV 27 feb 18)

Rs 6393 Crores of assets seized so far. (NDTV 27 feb 18)

# THE FALL OUT -3

---

- Modi has filed for bankruptcy proceedings under US laws for Firestar Diamond Inc. and affiliate companies. (BL 27 feb 18)
- RBI has asked all PSB's to check all NPA's above Rs 50cr for fraud. (Qunit 27 Feb 18)
- Obviously the auditors of PNB as well as other PSB's and the Nirav Modi /Choksi companies will face a lot of heat in the months to come
- Govt has asked RBI whether there were regulatory lapses especially since annual audit is conducted by the regulator of banks. (FE 27 feb 18)
- Cyril Amarchand Mangaldas (lawyers) office was raided by CBI (ALB 27 Feb 18)



# THE FALL OUT-4

---

- 114 companies being probed by the Serious Fraud Investigation Office (SFIO) for possible fund diversion and fraud in connection with Modi and his uncle Mehul Choksi's case.
- MCA has approached the National Company Law Tribunal to attach the properties connected to these 114 firms to prevent them from disposing of assets. (Live Mint 26 Feb 18)
- RBI has formed a committee headed by 84 year old reputed CA ,YH Malegam to ascertain fraud risks and NPA's in banks. (Economic times 26 Feb 18)
- Lenders want Govt to take over the companies belonging to Modi and his uncle (Economic times 26 feb 18)
- Banks are rushing to increase their insurance cover for employee fraud. (Economic times 25 Feb 18)

# CONTROLS REQUIRED IN BANKS

---

- Linking of all systems in the banks to core banking solution—no stand alone systems; The private banks like Axis, Yes, HDFC, ICICI have linked LOU and Core banking
- Reconciliation of Nostro accounts with books of accounts
- Reconciliation of confirmations for LOU with books of accounts
- Credit and Credit risk assessment to be segregated
- Bank person sanctioning loan to borrower not to talk to borrower
  - Quartz 15 feb 18 and Live Mint 19 Feb 18
- The way non-fund based limits are treated has to change and they should be on same footing as fund based limits
- Keeping a tab on sensitive sectors like Jewellery (RBI has issued circulars stating how banks have to guard themselves against money laundering)
- More robust concurrent audits and inspections

# CONTROLS REQUIRED AT GOVT LEVEL TO PREVENT SCAMS

---

- Agencies like CEIB (Central economic intelligence bureau) are woefully inadequately staffed and have no latest technology to mine data and information. Also various govt agencies like CBI, Narcotics control bureau, DRI, ED, SFIO, NIA, CBDT , National crime records bureau etc do not work together and cooperate. (Economic times 25 feb 18)
- By linking direct, indirect tax, bank and stock exchange information a lot of frauds can be unearthed early.
- Companies like Palantir in USA work closely with US Govt agencies and provide commendable support in terms of data analytics.