



## Nirav Modi fraud highlight risk control lapses at Indian banks

by [Dexter Tan](#)

After a series of credit negative reports on the Indian banking sector in [May](#) and [November](#) last year, the attention has once again shifted to the public sector undertaking banks after details of the largest loan fraud in the country's history surfaced at the second largest state bank. Punjab National Bank (PNB) said that the bank is involved in fraudulent transactions that could result in [at least INR 126bn](#) of contingent liabilities which may lower its bottom line over the next four quarters. PNB's credit profile, tracked by the RMI-CRI 1-year Probability of Default (PD), deteriorated significantly to exceed 910bps following the bank's announcement in February.

It was found that PNB employees provided unapproved and fake bank guarantees so that firms in the Nirav Modi and Gitanjali Gems groups may receive cash advances for trade finance. The transactions date back to 2010 meaning supervisors failed for years to detect the fraud. Critics worry if the case could lead to other problems and opened a can of worms in the banking system. Although lending frauds and write-offs are not uncommon in the banking sector, the uncovering of the Gitanjali-Modi fraud served as a catalyst for decisive regulatory reform.

On Mar 1, lawmakers approved new rules to strengthen the governance of auditors and accounting standards in India. The National Financial Reporting Authority (NFRA), a new body to oversee the quality of the audit and accounting profession was established to investigate professional misconduct and impose penalties to deter errant behavior. The jurisdiction of the NFRA extends to listed firms and large private companies while the Institute of Chartered Accountants of India, a self-regulatory organization will continue to regulate smaller companies.

PNB may report losses as more clarity will be provided over the actual loan write-off over the following four reporting periods. The bank is expected to make higher future provisions as the value of the fraudulent transaction exceeds total provision expenses in FY 17 and accounts for more than 50% of the company's market capitalization on Mar 5. The central bank's [recent](#) revised stressed asset framework to ensure early recognition of non-performing assets (NPA) also requires lenders to make accelerating provisioning. PNB's provision expense in the recent December quarter nearly doubled the previous quarter.

On Mar 16, PNB will receive INR 54.7bn from a share sale that would increase the government's stake to 62.25% under the terms of the recapitalization plan announced last year. However, [Moody's](#) says the bank needs additional capital to boost the firm's common equity Tier-1 ratio (CET1) after writing off the bad loans in the recent discovered fraud. This is because PNB's CET1 ratio of 8.05% at the end of Dec 2017, barely meets the recommended Basel III March 2019 guideline of 8%.

At least 20% of PNB's total balance sheet is held in government securities and rising yields in long term sovereign notes expose the bank to interest rate risks. The prospect of higher inflation, near record government borrowing and higher interest rates may add to the PNB's Treasury losses in the coming quarters.

The RMI-CRI 1-year PD for PNB have increased since April last year and its systemic importance posted a net decline. As shown in Figure 1, the CRI Systemically Important Financial Institution (CriSIFI) global ranking for the bank dropped to 552 in Feb 2018 from 221 in Apr 2017 while, PNB's CriSIFI ranking among Indian financial institutions fell to 22 from 10. The CriSIFI analyzes the network of listed banks and insurers and quantifies the systemic importance of worldwide financial institutions with time. Local community rankings however, are rescaled from their global rankings. For example, the two riskiest Indian banks ranked 55 and 275 worldwide may be ranked 1<sup>st</sup> and 2<sup>nd</sup> within the Indian FI community. At INR 126bn, the loan markdown would be nearly 2.7% of PNB's loan portfolio and might not pose any systemic risk concern to the banking system. Interbank rates also showed movements measuring less than 20bps during the announcement period.

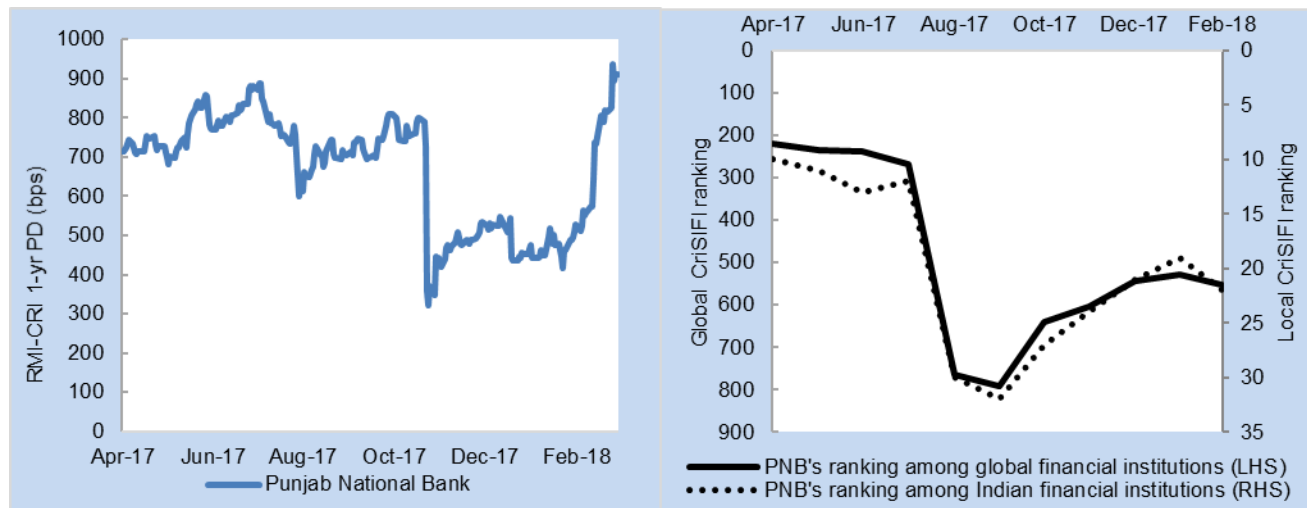


Figure 1: RMI-CRI 1-year PD for PNB and CrISIFI rankings. Source: RMI-CRI

The Gitanjali-Modi fraud may have damaged PNB’s brand and reputation as well as decreased depositor’s confidence with the bank and limited the bank’s access to funding from private investors. Investors may want to see stricter risk management processes in place before committing further capital into the lender. The trade finance network could also witness more regulation and trade counterparties may ask for higher risk premiums before doing business. Overall, lenders may adopt a cautious approach to financing trade transactions in the wake of the largest financial fraud in Indian banking history.

<p><b>Credit News</b></p>
<p><b>PSBs write off NPAs worth INR 5.16bn in first-half of FY18</b></p> <p><b>Mar 5.</b> According to the finance ministry of India, INR 5.16bn loans owed by willful defaulters have been written off by public sector banks in the first half of the current fiscal year. The write-offs erode operating profit and puts pressure on the balances sheet, especially since the possibility of recovery for these amounts is very remote. According to the data collected by the finance ministry, State Bank of India, the largest lender in India, has INR 251bn loans owed by willful defaulters as of Mar 31, 2017. Punjab National Bank, which is the second largest lender, has INR 122.78bn bad loans on balance sheet. Total outstanding loans due to public sector amounted to INR 923.8bn and the two banks above account for 40% of the total outstanding loans. (<a href="#">Economic Times</a>)</p>
<p><b>China hedge funds suffer in debt crackdown</b></p> <p><b>Mar 4.</b> China’s crackdown on debt has slammed the hedge fund industry, as the bear bond market prompts banks to withdraw funds they had parked with external bond managers, cutting a key source of funds. Barely existed in China five years ago, the industry boomed during the stock bubble of 2015, with the number of hedge funds increasing to more than 15,000 at the end of 2015 from less than 4,000 a year earlier. The bursting of the stock bubble in 2015 hit equity hedge funds, but a subsequent run-up in the bond market sustained the industry through 2016. The bond market, however, suffered in 2017 from the rising interest rates and a “regulatory windstorm” that discouraged banks from using leverage to boost returns. Total employment in the “private fund” industry fell by nearly 40,000 people in the 12 months to the end of January 2018, equal to 14% of workforce. (<a href="#">FT</a>)</p>

**UK credit card debt rises 10% in January**

**Mar 1.** According to Bank of England (BoE), the UK credit card debt reached its second-highest rise in January 2018 since 2005. The December credit card debt annual growth was 8.9% and grew by 0.7% to 9.6% in January. Growth in credit card lending has slowed slightly in recent months due to regulators' concern on consumer debt levels. It led to a steadier all consumer borrowing, which increased by 9.3% in January YoY, compared with 9.5% growth in December. However, the household debt levels remain high and credit card debt is having its fastest growth. BoE also showed that the number of mortgage approvals for housing purchases has reached its highest since last July. There were 67,478 mortgages approved in January 2018 while only 61,692 mortgages were approved in the previous month. ([FT](#))

**IMF expects Mozambique to default on foreign debt until 2023**

**Feb 28.** According to International Monetary Fund (IMF), Mozambique authority plans to hold off on making payments on about USD 2bn foreign loan until 2023, which will be when Mozambique starts producing gas from large offshore deposits. Mozambique has amassed USD 710mn of arrears on the debt. The authority intends to use loans to buy tuna-fishing boats and an associated coastal security system. However, an audit published in 2017 found USD 500mn of the spending remains unexplained, suggesting the state-owned companies involved paid too much for equipment. IMF said Mozambique's debt is currently in distress, and total public debt is on an unsustainable path. The publication of IMF report will be essential in debt restructuring discussions Mozambique plans to hold with its commercial creditors as the creditors need to consider the risk of prolonged delays to the gas projects. ([Bloomberg](#))

**Red ink continues to flow at Serrano as company undergoes debt restructuring**

**Feb 28.** Serrano, an interior design contractor, announced that its schemes of arrangements have been approved by the court. The company experienced a loss of SGD 8.93mn in fiscal 2017, smaller than the SGD 111.63mn in 2016 as the group continued to suffer contract terminations and the inability to secure new contracts. Revenue for the 12 months ended December 2017 fell by 96% compared to the year-ago period, while total liability rose by 5% to SGD 122.5mn during the same period. Serrano said it is working to revive its business, including plans to expand its product range and develop complementary business to leverage the group's interior fit-out track record. ([Business Times](#))

**China keeps growth target at 6.5%, stays focused on financial risks** ([Reuters](#))

**Interserve plans further job cuts as it fights bankruptcy fears** ([FT](#))

**Noble Group reports USD 4.9bn annual loss, focus on debt restructuring** ([Reuters](#))

**Regulatory Updates****Bank of Japan will think about stimulus exit around 2019: Kuroda**

**Mar 2.** On March 2, 2018, Governor Haruhiko Kuroda stated that Bank of Japan (BOJ) will start thinking about how to exit its monetary stimulus program, which will start in April 2019. Correspondingly, Yen surged 0.5% to 105.71 per dollar and yields on Japanese sovereign debt climbed across the curve. Citing from Governor Kuroda statement, BOJ expects that the inflation will reach 2% in around fiscal 2019, thus encouraging an exit strategy around then. Under an increasing pressure from Federal Reserve already raising rates and the European Central Bank debating normalization, Kuroda acknowledged that there is a significant need to provide details on when the BOJ may follow suit. His testimony will resume on March 6, following his claim on the impossible stable 2% inflation without having wage growth more than 3%. The next BOJ board meeting is on March 8-9, with no stimulus change expected. ([Bloomberg](#))

**Bitcoin faces regulatory crackdown, Bank of England warns**

**Mar 2.** The Bank of England has warned that the “inherently risky” cryptocurrencies are failing to fulfil their most basic currency function and bitcoin faces a regulatory crackdown. Mark Carney, the Bank’s governor, pointed out the time had come to regulate crypto-asset ecosystem to combat illicit activities. Authorities are rightly concerned as cryptocurrencies can be used for money laundering, financing terrorism and drug dealing given the anonymity. Anarchy may reign on the dark web and shield illicit activities, while backers of bitcoin said the underlying technology has potential to revolutionize the financial system and fasten daily payments. Although the digital currencies do not pose material risks to financial stability at present, things could change with wider use in future. The European Union has warned that it will regulate cryptocurrencies if they increase in risk, while China has already closed some bitcoin exchanges and clamped down on initial coin offerings. ([Guardian](#))

**China aims to resolve debt at local government level** ([Reuters](#))

**Key US lawmaker urges steel tariff exemptions for NAFTA allies** ([Reuters](#))

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