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PMC Bank Fiasco: The Dereliction of Corporate Governance

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ABSTRACT

Every organisation requires a good corporate governance policy to function well. Whenever there is a failure in corporate governance, the organisation fails. The same thing happened with PMC bank. There were many loopholes in the PMC bank, which led to its downfall. A Lot of financial irregularities were taking place there. There was a complete failure of the internal control and management system. They also misrepresented the financial statements. The PMC bank loopholes led to fundamental changes in law and policies. The SAF was being revised, and the Banking regulation Amendment Act 2020 came into force. Many things need to be done so that scams like PMC don't happen again.

I. INTRODUCTION

Any organisation's success is analysed by its corporate governance level. Good corporate governance can lead to its growth and development, whereas bad corporate governancecan lead to the downfall of any organisation.

Corporate governance is said to be good when the leadership and management work with transparency and accountability in the interests of shareholders instead of its vesting interest, but when it lags in transparency, it amounts to bad corporate governance.

The PMC case exemplifies how bad corporate governance can lead an organisation to meetits waterloo.

This is a case where a bank of repute ran to shame. The failure of Corporate Governance and slackwatchdogs led to the downfall of Punjab and Maharashtra Co-operative Bank (PMC bank).[2] They had Rs 11,617 in deposits in their bank, indicating trust was deposed by the public. But, the bank lent Rs 6200 crores as loans to just one client, Housing Development and Infrastructure Limited (HDIL), a real estate firm facing bankruptcy proceedings.[3] Due to this, depositors had to suffer a lot. They were restricted from withdrawing their hard-earnedmoney as RBI laid operational restrictions and imposed that only Rs 10,000 could be drawn byany

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[2] Lakshmi Mohan, "POLITICS OF ETHICS-POOR CORPORATE GOVERNANCE AT PMC BANK",Vol.12 No.12, Turkish Journal of Computer and Mathematics Education, 4305-4309,(2021)

[3] Editorial, "The biggest lesson from PMC Bank's brazen crookery," The Economic times, 6 October ,2019

customer within 6 months. After some time, the capping was raised to Rs 25,000. This project will study why the PMC BANK was brought to its doom.We will study all the loopholes and how they can be cured. The aftermath of PMC fraud and solutions will also be discussed.

II. Background

The Punjab and Maharashtra Co-operative Bank began its operations in 1984 as a cooperative bank. It operated as a single bank, but in 35 years, it had a wide network of 137 branches. In 2000, it was given the status of a scheduled commercial bank.

At the end of the financial year 2018-19, it has a very healthy balance sheet. The total deposits stood at Rs 11,617 crores, and the total loans advanced was Rs 8383 crores[4]. These numbers will not normallyseem suspicious to anyone.

However, a huge scam between Bank's top officials and Housing development and Infrastructure Limited was beneath the numbers.

RBI learned about this scam when they got a letter from a whistleblower. It restricted the bank under sec 35A of the Banking Regulations Act 1949. There was a gross violationof RBI norms of exposure.

The PMC bank manipulated the NPA figures, and after RBI's scrutiny, the percentage of Gross NPA increased from 3.76% to 77%. The bank's actual financial position was camouflaged and deceptively reflected rosy financial parameters.[5]

Massive withdrawal of funds added to RBI's suspicion as withdrawals crossed the prescribed threshold. Depositors' money was misused to fund the affluent demands of HDIL promoters. About 6 senior officials of the bank, more than 20000 dummy accounts and a decade of misreporting led to the largest scam in the history of cooperative banks.

III. The modus operandi of the scam

This is a scam worth Rs 6500 crores. It had many players involved, including senior bank management, Politicians, and Promoters of HDIL bank. The chairman of PMC bank Waryam Singh had a stake of 1.9% in HDIL till September 2017. He was the executive director of the HDILbetween 2005 and 2015. During this time, the bank was offering loans to the company. This showsthe nexus between officials of the bank and the company.

The bank has issued a loan to HDIL and its 44 associated companies. The bank keeps lending

[4] PMC Scam, available at: http://economyria.com (last visited at 7 September 2021)
[5] Editorial," Why scam-struck PMC Bank passed to new owner Centrum and if depositors will get their money back", First post, 21June ,2021

them money even after they fail to repay the loan. The total amount borrowed wasINR 6500 crores, which was 73% of its assets and 4 times more than theregulatory cap imposed on the bank. This led to a 73 % increase in their Non-Performing Assets. To conceal 44 loan accounts of HDIL and associated companies, more than 21000 dummyaccounts were opened.[6] The RBI and other regulators could not catch this as they tend to check only some accounts. Also, these accounts were reported as standard accountsand irregularities were not brought to RBI's notice.

It did not come to the knowledge of the regulatory authorities. RBI could not spot it as dummy accounts matched the outstanding balances in the balance sheet.

Bank software was also tampered with to conceal these loss accounts. Most employees were oblivious to this as they had limited access to the CORE Banking solution's centralised system.[7]

In this way, they committed the greatest fraud in the history of cooperative banks.

IV. Reasons for the failure of PMC Bank

In PMC BANK CASE, there was a complete failure of corporate governance, which eventually led to its downfall. The top management resorted to ill practices and were partners in crime with promoters of HDIL Company. They did many things to hide their fraud. But truth can never be hidden. It eventually came out, and with it, PMC BANK Collapsed.

The factors which led to its downfall are mentioned below:

1. Financial irregularity:

The main reason for the PMC bank's downfall was its financial irregularities. Therewere frantic withdrawals from the bank.

- They lent 29% amount of their total deposits. The amount was 73% of total assets which is 4 times more than the regulatory cap imposed on cooperative banks.[8]
- The bank transferred 70% of credit facilities to HDIL Company.
- This led to an exponential increase in NPA.
- The loans which were sanctioned to HDIL were given without collateral.
- This led to high liquidity risk.
- Moreover, there was a misappropriation of funds.

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[6] Lessons from the PMC Bank fiasco, available at: https://www.ideasforindia.in/topics/money-finance/lessons-from-the-pmc-bank-fiasco.html (last visited at 06 September 2021)
[7] PMC bank issue, available at: https://lexlife.in/2019/10/31/analysis-pmc-bank-issue/amp/(last visited at 7 September 2021)
[8] Editorial, "What is PMC Bank fraud and how it started", National Herald,1 october,2019

- The hard-earned money of depositors was being misused.
- PMC kept on granting loans to it despite knowing that HDIL was under the preview of bankruptcy. It even misrepresented the association in its statements and with the regulatory bodies.
- This affected PMC bank in a very disastrous manner.[9]

2. Failure of internal control and management system:

Such scandals cannot be executed without the help of management or top-level authority.In this case, 5-6 senior bank officials were also involved in the fraud.

The HDIL kept defaulting on loans, but they were given regular loans. The bank didn'tclassify it as NPA despite the non-payment.

There was nexus between the promoters of HDIL Company and PMC bank. Moreover, creating dummy accounts would not have been possible without the support of the respective chains of command.

They even interfered with the CBS of the bank. Most employees have limited access to the CBS, so they remain unaware of what is happening in their bank. False reports were made to hide their scam from regulatory bodies.[10]

It took 9 years for this scam to become public, a matter of deep concern.

3. Misrepresentationion of its financial statements:

To protect themselves from regulatory authorities' radar, they resorted to misrepresenting the financial statements.

The association of PMC and HDIL started way back in the year 2011, and they have been defaulting the transaction since then. The profit figures and non-performing assets behaved oddly along withthe performance of the industry or category.

The bank had reported its NPA to be 3.76 % in the year 2019, but after Investigation, it turned out to be 77%.

Similarly, The Return on Assets was also misrepresented. It was shown to be 0.89 % but dropped to 0.75% within a year.

It also impacted the loan portfolio of the Bank. It changed drastically in 4 years, from 2015 to

[9] Editorial , "PMC case shows why dual regulation doesn't work",livemint ,04 December 2019
[10] PMC Scam, available at: www.outlookindia.com(last visited on September 8,2021)

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2019.

V. LOOPHOLES IN THE SYSTEM

In the ‘90s collapsing of the banks was not so shocking as there were many bank failures. But the collapse of a bank in the 21st century, i.e., PMC bank, one of the biggest co-operative banks, will surely bring the depositors to their knees because the co-operative banks were less likelyto collapse in 21 st century. The NPA of the bank showed a domino effect and was raised from 4% to 73%.

However, what was more shocking was that the sudden boost in the NPA ratio belonged to only one borrower, i.e. HDIL.

How they managed to pull out this scam under the nose of RBI is discussed below-

1. Dual Regulatory System:

The supervision and management system of cooperative banking in India differs from commercial and scheduled banks. 2 authorities control cooperative banks one is RBI, and the other is the state government.[11] The RBI only has the power to financially supervise these banks, and the rest power lies with the state. RBI has the power to lay down capital inadequacy, income recognition, asset classification and provision of norms but cannot supervise the management of the Bank.

Because of this limit on the power of the RBI, they were able to create dummy accounts and divide the loan book in the interest of HDIL, as RBI can only rely on information provided by PMC bank.They could not notice how much capital was loaned to one borrower. This fraud continued for more than 8 years. It came to the notice of RBI through a letter written by a whistleblower.

2. Biased Audits:

Such a big scam cannot take place without the support of the auditors of the company. The auditors did not report the scam of creating thousands of dummy accounts as they were themselves involvedin the fraud.[12]

Before 2009, RBI used to appoint auditors for banks. But in 2010, the audit regulations were changed, and banks were allowed to appoint auditors independently from the list of auditors approvedby the RBI and compiled by ICAI.

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[11] *Supra* note 8

[12] Editorial, "RBI flagged irregularities at PMC bank ",The Economic Times,18 December 2019

Given this loophole, the last defence in RBI's armoury to prevent such scams is also compromised, which is exactly what happened in the present case.

Though we have strict punishment for auditors if they are found guilty of professional misconduct,they are rarely implemented. This gives the auditors more courage to commit such frauds.

3. No instrument to detect such scams:

There is a need to protect frauds before they happen. The use of technology and data analytics canbe a probable solution.

It is very difficult to predict fraud when the management is involved. But we need to have some technology which can predict frauds like this.

VI. In the Aftermath of the PMC Scam

As RBI learned about the scam, it imposed restrictions on the bank under section 35A[13] ofthe Banking Regulations act 1949 to conduct normal business, and a withdrawal limit of Rs 1000 was set up for the depositors. The withdrawal limit was later increased to 25000 Rs. FIR was filed against PMC Bank officials, HDIL entities and promoters.The deposit limit was set up to be Rs 50000 only.

People with salaried accounts faced difficulties in withdrawing money. Businesses with PMC checkingaccounts ran out of operating cash.

7 customers died after knowing that they had lost their money.

VII. The Developments Concerning Laws and Policies

1. Revision of SAF:

After the PMC scam, The Reserve Bank of India revised the Supervisory Action Framework for the urban cooperative banks to ensure expeditious resolution of financial stress. As per revised norms, an urban cooperative bank may be placed under SAF when net NPAs exceed6% of net advances when it incurs losses for 2 consecutive financial years or has accumulated losses in the balance sheet.

The RBI may even ask them to curtail their lending powers.

2. Banking Regulation Amendment act, 2020(Act 39 of 2020):

To avoid a PMC bank-like crisis, the government passed an Amendment to the Banking regulations

[13] Banking Regulation Amendment Act,2020(Act 39 of 2020), s. 35A

acts to protect investors' interests.[14]

Direct supervision of RBI-The amendment enforces banking regulation guidelines of RBI on cooperative banks while administering issues will still be guided by the Registrar of Cooperative. These changes will help strengthen financial stability.

Moreover, the qualifications for appointing the CEO of a cooperative bank will be set up, and RBI permission will be sought before the appointment.

The audit will also be according to RBI guidelines and can supersede the board if any cooperative bank is distressed.

VIII. POSSIBLE SOLUTIONS

1. Better regulatory system:

The regulatory system needs to be improved to prevent fraud like this. When PMC fraud happened, the cooperative banks were under dual regulations. The government has taken a positivestep inthat by theBanking regulations Amendment act 2020, cooperative banks have been brought undera single regulatory mechanism.

2. Unbiased audits:

Earlier, the auditors for cooperative banks were appointed by RBI, but after 2010, the government allowed the banks to appoint auditors on their own from the list of approved auditors of RBI.

The Banking Regulations amendment act 2020 has ensured that auditing should be done accordingto the RBI norms. Had the audits been unbiased, the PMC scam would have come to the knowledge of regulatory authorities at an earlier stage.

Moreover, strict actions must be taken against auditors if they indulge in misreporting.

We have various penalties for misreporting facts, but they need to be given more teeth.

3. Reforms required in DICGC:

When a bank is liquidated, depositors are entitled to receive an insurance amount of up to Rs 1 lakhfrom the Deposit Insurance and Credit Guarantee Corporation of India. It includes principal and interest dues across your savings, current bank, fixed deposits and recurring deposit account.

This limit is very less as compared to other counties. This limit needs to be increased.

[14] Banking Regulation Amendment Act,2020(Act 39 of 2020)

[15]Currently,THE DICGC AMENDMENT BILL, 2021, has been passed by both houses, and the limit has been raised to 5 lakh Rs, but, presently, it has not taken the shape of law.

Moreover, the time delays in settling the claims need to be reduced.

4. Upgradation of technology:

We need to develop such technology which finds out such scams before they happen. We are in the 21st century, which is the age of technology. Any technical advancement can be handy while handling such scams

5. Greater financial literacy among people:

Financial literacy should be improved to understand the system of cooperative banks. People mustalso be aware of what should be done to their hands if fraud like this happens.

6. Independent directors:

The board should consist of independent directors with requisite technical knowledge, including a deep understanding of financial statements and the economy.

7. Capacity building and training of Cooperative banks and RBI officials:

For the effective regulation of cooperative banks, the Officials should be given special training to become more vigilant regarding such ill activities.

IX. Conclusion

PMC Bank followed the ranks of failed cooperative banks due to misgovernance. Waryam Singh was a board member of HDIL while serving his term as Chairman with PMC Bank, a sheer misuseof corporate governance. The nexus of politicians, property owners and bankers formed aconspiracy that paralysed the cooperative bank.[16] There was a total deviation from business ethics. 1.6 million Depositors were made to suffer. Some of them even committed suicide. The sad state of affairs was that the watchdogs like auditors, the government and RBI were unconscious.

The internal management of the Bank was involved in this fraud with HDIL promoters. Making 21000 dummy accounts was not a joke. Better boardroom counselling on risk and surveillance through data analytics will be essential to protect the long-term interest of stakeholders of the financial system. A Lax administration, an ill-equipped regulatory system and a delayed justice delivery process make things easier for corporate crooks to make a killing. Our overall system

[15] Editorial, "Parliament passes DICGC amendment bill", The Hindu, August 9,2021
[16] *Supra* note 1

in India is conducive and attractive for them to flourish rather than making their lives difficult for them to continue their trial of crimes.

It is high time that we understand that good corporate governance and stringent regulatory bodiesare indispensable in any organisation. Good corporate governance is necessary to prevent any organisation from fraud and ensure it's smooth running.

We have plenty of laws to prevent fraud and punish offenders, but the need is too stringent implementation and the creation of an efficient framework for the rapid dispensation of justice.

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