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A STUDY ON THE FAILURE OF CORPORATE GOVERNANCE IN THE CASE OF PMC BANK SCAM

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ABSTRACT

The goal of the current research is to examine the financial hardship that Punjab and Maharashtra Cooperative Bank was experiencing in light of its steadily worsening financial situation. The purpose of the research was also to comprehend the long-term impact that financial crimes had on the industry as well as how it affected farmers' and depositors' faith. The study is also attempting to concentrate on the financial factors that led to the financial collapse of the Punjab and Maharashtra Cooperative Bank, which had been operating successfully in the cooperative sector for many years and had uplifted rural areas by establishing a remarkable working methodology. The evil at PMC Bank is a textbook example of crony capitalism, fraud, and conspiracy, as well as poor corporate governance. The case teaches crucial lessons for enhancing banking supervision in the nation and overhauling the cooperative banking industry. To operate effectively, every organization needs a strong corporate governance policy. When corporate governance fails, the organization also fails. At PMC Bank, the same thing took place. The PMC bank had several flaws, which contributed to its demise. There were several financial irregularities going on. The internal management and oversight system was totally ineffective. Also, they falsified the financial statements. Law and policy were fundamentally altered as a result of the PMC bank gaps.

Keywords: Co-operative banks, India, PMC Bank, financial statements, corporate governance.

Statement of the Problem

At the crux of the PMC Bank fraud lies the issue of higher management enabling massive loans to Housing Development and Infrastructure Ltd (HDIL) along with the creation of 'masked accounts'. The aim of this study is to understand the role of higher management and the factors

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that lead to bank failure.

Research Objectives

- To examine the role and key aspects of RBI in the PMC fraud
- To analyse the inner workings of the PMC Bank fraud
- To understand the factors of the fraud that lead to bank failure
- To study the response of the regulator and its impact on corporate governance

Research Questions

- "What are the loopholes behind financial downfall of the successful running cooperative bank?
- What were the actual reasons behind this fraud?
- Who was responsible for this fraud?
- What were the gaps that led to the planning, plotting and final execution of this fraud?
- What are the remedies that can be injected so that no more financial frauds of the sort occur that can mark the economy towards a tumultuous end?"

Research Gap

This study has gathered and incorporated the many components of several studies that have been undertaken and created in the scope of frauds in the Indian banking industry throughout the years. The biggest study gap that I can assess is the delay between discovery of fraud and reporting, the unsuitable financial sector regulation framework, and participation of employees of the bank in these frauds committed by banks. In order to organize, arrange, and carry out the scam, loopholes are exploited. Why aren't the authority's implementing security and preventative measures to ensure that some kind of fraud doesn't happen again soon?

Research Methodology

Analytical research has been conducted to bring together subtle details to create more provable assumptions. Secondary data were used and collated to analyse the PMC fraud. The study used a number of press releases, research publications, reviews and newsletters from various websites related to this. The data used for the purpose of this study is from secondary sources that comprise reports from RBI and PMC official website, newspapers and financial journals. "The research is based only on secondary data from books, journals, newspaper articles, websites, college and workplace guidelines and instructional manuals, limiting the study. No primary research was utilised, which also limits the findings of this research paper."

INTRODUCTION

Corporate governance is a measure of any organization's success. While poor corporate governance can result in an organization's demise, good corporate governance can help it grow and develop. When the leadership and management work with transparency and accountability in the interests of shareholders rather than its vesting interest, corporate governance is said to be good; however, when it lags in transparency, it amounts to bad corporate governance. The PMC case serves as an example of how poor corporate governance can lead to an organization's demise.

"The five-page confession letter written by Joy K Thomas, Managing Director and Chief Executive Officer of Punjab and Maharashtra Co-operative Bank (PMC Bank), one of the ten largest cooperative banks in India, revealed egregious financial irregularities, collusion, and fraud in banking operations of PMC Bank from 2008 onwards, shattering the confidence of depositors in the Indian banking system in September 2019." The Reserve Bank of India (RBI) acted quickly, restricting the amount of money that could be withdrawn as well as ordinary banking activity. "Depositors protested at various locations and even eleven depositors lost their lives as a result of the shock. Recovery of the whole amount was almost difficult due to the significant exposure of 73% of the total loan portfolio to a single borrower, Housing and Development Infrastructure Ltd (HDIL) & associated entities, who were also subject to bankruptcy proceedings."[2] The evil at Punjab and Maharashtra Co-operative Bank is a textbook example of capitalism, fraud, and conspiracy, as well as poor corporate governance. The case teaches crucial lessons for enhancing banking supervision in the nation and overhauling the cooperative banking industry.

A reputable bank fallen in a pit. Lack of corporate governance, laid-back watchdogs, and a banker-politician nexus were the causes of Punjab and Maharashtra Co-operative Bank's demise. Deposits totaled Rs. 11,617 crores as of March 31, 2019, which wasn't a joke and only served to highlight the public's confidence in the bank. The bank loaned Rs. 6200 crores as loans to just one client, a real estate company called Housing Development and Infrastructure

[2] Gupta, A. (2021). The devil's laugh at corporate governance: The case of Punjab and Maharashtra Co-operative Bank (PMC Bank) India. Indian Journal of Corporate Governance, 14(2), 248-267

Limited (HDIL), which ironically was already going through bankruptcy.[3] This situation can unfortunately be described as a multi-crore loot. Depositors endured great hardship as a result. Because the RBI placed operational restrictions and mandated that only Rs 10,000 could be drawn by any customer within 6 months, they were unable to withdraw their hard-earned money. The cap was eventually raised to Rs 25,000. This project will investigate the factors that led to the PMC Bank's demise. We will research every flaw and how to close it. There will also be discussion of the effects and solutions to the PMC scam.

REVIEW OF LITERATURE

Financial scams and their effects on the economy and other stakeholders are the subject of many writings that are both constructive and contentious. To comprehend the problem of frauds in the banking industry, a massive amount of thorough reconnaissance has to be done. There has been a review of pertinent literature explained.

According to research by *Swain and Pani (2016)*[4] titled "Frauds in Indian Banking: Aspects, Causes, Trend Analysis, and Suggestive Remedies," there has been an upsurge in fraud in Indian banking in recent years. He claims that the failure of responsible officials, a lack of sincerity, reckless behavior, and ignorance on the part of bank workers, as well as a rise in staff workload and non-compliance with RBI-mandated KYC criteria, are some of the key causes of bank frauds.

An investigation on the root causes and mitigation of fraud in the banking sector was carried out by *Vigneshwaran and Yokesh (2018)*[5]. This research reveals that although the banking industry is fundamentally highly regulated and overseen, it does have its fair share of ethical issues.

Khanna and Arora (2009)[6] looked at the causes of bank frauds and the deployment of preventive security measures in the Indian banking sector since there is no employee understanding of these issues. The personnel is overworked, there is a training gap, and there is employee rivalry.

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[3] “Gupta, A. (2020). Infrastructure financing at crossroads: The case of Infrastructure Leasing and Financial Services Ltd (India). International Journal of Business and Globalisation.

[4] Frauds in Indian Banking: Aspects, Reasons, Trend-Analysis and Suggestive Measures Dr. Sukhamaya Swain, Dr. Lalata K Pani,(2016), International Journal of Business and Management Invention.

[5]Vigneshwaran, T.S. &Yokesh, M.(2018). A Study on Causes and Prevention of Fraud in Banking Industry. International Journal of Pure and Applied Mathematics, 120(5), 311-321.”

[6] “Khanna, A., & Arora, B. (2009). A study to investigate the reasons for bank frauds and the implementation of preventive security controls in the Indian banking industry. International Journal of Business Science & Applied Management (IJBSAM), 4(3), 1-21.

According to *Singh & Nayak (2015)*[7], the Indian banking industry has made significant strides since the Indian economy was liberalised in 1991. Their article is titled Frauds in Banking: Corporate Governance Problems. Swindles in the financial sector have reached unprecedented heights as a result of the rise in cross-border financial transactions. Banks and other financial organisations need to be closely examined to see if corporate governance is correctly implemented and whether checks and balances are there.

OPM was discussed by *Swarak Swain (2020)*[8] in his book "The Great Indian Frauds that Shook the Economy" (other people money), The con artists mistakenly assume that when a bank approves a loan for them, the money they get becomes an asset rather than the hard-earned cash of the average person. The financial stability of democracies like India is severely weakened by such fraudulent actions. The book details a broad spectrum of significant frauds, their methods, and their profound effects on financial institutions.

ANALYSIS OF BANK FAILURE AND CORPORATE GOVERNANCE IN PMC SCAM

Background and Modus Operandi of PMC Bank Scam

As a cooperative bank, The Punjab and Maharashtra Co-operative Bank started operating in 1984. Despite having 137 branches over 35 years, it functioned as a single bank. It received the designation of scheduled commercial bank in 2000.[9] By the conclusion of the fiscal year 2018–19, its balance sheet is in excellent shape. There were a total of 11,617 crores in deposits, while 8383 crores in loans were granted. Most people won't find these statistics strange. Below the figures, however, was a significant fraud involving the Bank's senior executives and Housing Development and Infrastructure Ltd. RBI received a letter from a whistle blower informing them of this fraud. According to section 35A of the Banking Regulations Act of 1949, it limited the bank. The exposure standards of the RBI were flagrantly violated.[10]

Once the RBI looked into the PMC bank's manipulation of the NPA data, the proportion of Gross NPA rose from 3.76% to 77%. The bank's true financial situation was concealed and ostensibly represented by optimistic financial metrics. Once withdrawals exceeded the allowed

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[7] Singh, T., & Nayak, S.(2015). Frauds in Banking. CCS Project Report, IIM Bangalore

[8] Swarak Swain "The Great Indian Fraud-Serious Frauds which shook the Economy

[9] "Jadhav, R., & Anand, N. (2019, October 1). India's PMC Bank created over 21,000 fake accounts to hide loans: Complaint. Reuters. https://www.reuters.com/article/ us-india-banking-pmc/indias-pmc-bank-created-over-21000-fake-accounts-to-hideloans-complaint-idUSK"

[10] Kelkar, N. (2019, December 5). After PMC Bank crisis, RBI to strengthen regulations for urban cooperative banks. The Week. https://www.theweek.in/news/ biz-tech/2019/12/05/after-pmc-bank-crisis-rbi-to-strengthen-regulations-for-urbancooperative-banks.html

level, there were significant increases, which raised RBI's suspicion. Money from depositors was taken advantage of to pay for the wealthy demands of HDIL promoters.

Senior bank executives, politicians, and HDIL bank promoters were among the many participants. Waryam Singh, the CEO of PMC Bank, has a 1.9% interest in HDIL as of September 2017. From 2005 to 2015, he served as the HDIL's executive director. The bank was giving the business loans at the time. This demonstrates the connection between bank and corporate authorities. The 44 affiliated firms of HDIL have received a loan from the bank. Even when they don't pay back the loan, the bank continues to give them money. The entire amount borrowed, INR 6500 crores, was 4 times the regulatory maximum imposed on the bank and represented 73% of its assets.[11]

Their Non-Performing Assets increased by 73% as a result of this. More than 21,000 fictitious accounts were formed in order to hide 44 loan accounts of HDIL and related firms. As they usually just verify a select few accounts, the RBI and other authorities were unable to notice this. Moreover, these accounts were reported as conventional accounts, and RBI was not made aware of any anomalies. The regulatory bodies were not made aware of it. Since fake accounts matched the amounts on the balance sheet, the RBI was unable to detect it. Furthermore altered bank software was used to hide these lost accounts. Due to their restricted access to the centralized network of the CORE Banking solution, the majority of staff were unaware of this.

The biggest fraud in the existence of cooperative banks included six senior bank employees, more than 20,000 fictitious accounts, and ten years of false reporting.

Effect of PMC Bank Fraud on the Economy and Society

The faith and active participation of a country's depositors, which PMC Bank ruthlessly betrayed, are essential to the banking sector's prosperity. If the loss of depositors' faith has a domino effect or extends to the account holders of many other banks, the whole financial system might be destroyed. There was a great deal of controversy and public uproar when the PMC Bank issue broke out and limitations were imposed on depositors' ability to withdraw their own money. Depositors thereafter raced from pillar to post. They set up their demonstrations practically anywhere they could. All the depositors, were waving signs and yelling during their rallies. The passing of eleven PMC Bank account holders due to different medical conditions, mostly cardiac arrest, caused profound shock, anguish, and mounting rage.

[11]Shivappa, K. (2019). Development of Urban Co-Operative Banks in India after Independence. Asian Journal of Managerial Science, 8(2), 114–118".

In addition, many of the companies were unable to operate their enterprises, pay their workers' salaries and energy bills, etc. On the other hand, elderly retirees and individuals with disabilities who relied on the interest from their bank accounts for subsistence were most severely impacted by the PMC bank failure. Several of the children's educations were also disrupted since they didn't pay their school tuition, while others struggled to pay for their medical expenditures. As it was required of them to store their money solely in cooperative banks up until 2013, several co-operative housing societies in Maharashtra had deposited their money in PMC Bank.[12] Moreover, the income collected from these deposits was tax-free. Co-operative societies were now permitted to deposit funds in nationalized or regional banks thanks to revisions to the Maharashtra Co-operative Societies (MCS) Act of 1960; nevertheless, interest on bank deposits was taxed. Since the tax-free interest was a more attractive choice for them than nationalized or regional banks, or else because they were unaware of the Act's change, many cooperative societies did not transfer their savings from cooperative banks to such institutions. These cooperative organisations experienced a severe financial crisis and unwelcome pressure to pay for ordinary maintenance costs like cleaning staff wages.

The stock markets were not unscathed either. The HDIL stock reached the lower circuit limit on the Bombay Stock Exchange (BSE) in response to news of the PMC Bank crisis caused by the substantial exposure of the bank portfolio to HDIL, and eventually fell to an exceptionally low level on October 31, 2019.[13] On April 1, 2019, the identical share was selling at a premium of 18 times. Due to complaints from depositors and widespread public uproar, the RBI extended the limit on withdrawal of public deposits. It was said that up to 78% of PMC Bank depositors might withdraw their whole balances from the bank with the withdrawal cap of US$1,000.

By directing public deposits towards the profitable endeavours of companies, a nation's banking system serves as the main mechanism for capital creation. “The reputation and credibility of banks, particularly cooperative banks, were severely damaged by PMC Bank. As a result, depositors may no longer have faith in and interest in the country's banking system, which will lower the rate of capital formation and reduce the amount of money available for the country's economic growth.”

Reasons for PMC Bank Failure

[12] Kundu, S., & Rao, N. (2014). Reasons of Banking Fraud – A Case of Indian Public Sector Banks. International Journal of Information Systems, 4(1), 11-24.

[13] “Gupta, A. (2020). Infrastructure financing at crossroads: The case of Infrastructure Leasing and Financial Services Ltd (India). International Journal of Business and Globalisation

Corporate governance was wholly ineffective in the PMC Bank Case, which ultimately contributed to the bank's collapse. The top management engaged in unethical conduct and collaborated with HDIL Corporation promoters to commit crimes. They took various steps to cover up their scam. When it ultimately surfaced, PMC Bank eventually failed. The following are some of the causes of its collapse.

Financial violations: The PMC bank's financial flaws were the primary factor in its demise. There were a lot of hasty bank withdrawals. Of their entire deposits, they loaned 29% of it.[14] 73% of total assets was the amount, which is four times the statutory maximum set on cooperative banks. The bank shifted 70% of the loan facilities to HDIL Corporation, which caused the NPA to skyrocket. HDIL received loans that had no security attached to them. High liquidity risk resulted from this, in addition, money was misappropriated. Depositors' hard-earned money was being wasted. Despite being aware that HDIL was on the verge of bankruptcy, PMC continued to provide loans to it. This had a highly catastrophic impact on PMC Bank, even misrepresenting the affiliation in its statements and with the regulatory organisations.[15]

Internal control and management system failure: Such scandals are impossible to carry out without the assistance of management or a senior executive. In this instance, the scam also implicated 5–6 senior bank employees. Despite repeatedly missing payments on loans, the HDIL received standard financing. Despite the non-payment, the bank didn't categorize it as an NPA. The promoters of the HDIL Corporation and the PMC bank were connected. Dummy account creation would not have been feasible without the cooperation of the relevant chains of command, as well. They even meddled with the bank's CBS. As the majority of workers only have restricted access to the CBS, they are often oblivious of events inside their bank. In order to conceal their swindle from regulatory organizations, false reports were prepared. This swindle was kept a secret for nine years, which is quite concerning.

Falsification of its financial statements***:*** They turned to distorting the financial statements as a means of avoiding regulatory authorities' notice. The relationship between PMC and HDIL began back in 2011, and ever since then, they have been defaulting on the deal. Together with the success of the sector or category, the profit figures and non-performing assets exhibited strange behaviour. In 2019, the bank declared that their NPA was 3.76%; however, an investigation revealed that it was really 77%. The Return on Assets was also distorted in a

[14] Editorial, "What is PMC Bank fraud and how it started", National Herald, October 2019"
[15]Editorial , "PMC case shows why dual regulation doesn't work", Livemint ,04 December 2019

similar manner. It was first reported to be 0.89% but fell to 0.75% after a year. It also had an effect on the Bank's lending portfolio. Between 2015 and 2019, it saw a significant alteration.

Developments in Law and Policies after PMC Bank Scam

1. Revision in Supervisory Action Framework (SAF):

The Reserve Bank of India updated the urban cooperative banks' supervisory action framework after the PMC scandal to guarantee quick relief from financial strain. According to the updated standards, an urban cooperative bank may be subject to SAF if its net nonperforming assets (NPAs) are more than 6% of its net loans, it experiences losses for two straight fiscal years, or it has accumulated losses on its balance sheet. They could even be asked by the RBI to limit their lending authority.

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

The government enacted an amendment to the Banking Regulation Act to safeguard investors' interests and prevent a crisis similar to the one that hit PMC Bank. direct control over RBI- The change applies the RBI's banking regulatory rules to cooperative banks, while the Registrar of Cooperatives will continue to provide administrative guidance. These modifications will improve monetary stability. Also, the requirements for hiring the CEO of a cooperative bank will be established, and the RBI's approval will be requested before the appointment. If any cooperative bank is in trouble, the audit will also be conducted in accordance with RBI norms and may take precedence over the board.

CONCLUSION

Due to poor governance, PMC Bank joined the ranks of bankrupt cooperative banks. There is a clear violation of corporate governance when Waryam Singh served as a board member of HDIL while also holding the position of chairman of PMC Bank. A conspiracy between politicians, property owners, and bankers paralysed the cooperative bank. 16 The whole breach of corporate ethics occurred.

This scam was carried out by HDIL founders and Bank internal management. Creating 21,000 fake accounts wasn't only for laughs. To safeguard the long-term interests of financial system stakeholders, better boardroom risk counselling and data analytics monitoring will be necessary. Corporate thieves may profit more easily due to inadequate government oversight, an inadequate regulatory structure, and a slow punishment delivery system. Instead of making their life tough so they may prolong their criminal trials, India's whole system is enticing and suitable for them to prosper. It is past time for us to realise the need of strict regulatory bodies and effective corporate governance in any organisation. Each organisation must have good corporate governance to guard against fraud and maintain seamless operations. There are many laws in place to deter fraud and punish perpetrators, but their strict application and the development of a structure that is effective for the prompt administration of justice are still required.

SUGGESTIONS

The PMC bank fraud is a clear example of poor corporate governance in banks. To improve corporate governance in banks, here are some suggestions that PMC Bank should undertake:

1. Improve board oversight: The board of directors of a bank plays a critical role in overseeing the bank's operations and ensuring that it is being run in a transparent and ethical manner. To improve corporate governance in banks, boards must be made up of independent directors who have the necessary expertise and are not influenced by the bank's management or shareholders.
2. Strengthen internal controls: Banks must have robust internal controls in place to prevent fraud and other financial irregularities. This includes implementing strong risk management policies, establishing adequate checks and balances, and ensuring that all employees are trained on proper ethical and compliance standards.
3. Enhance transparency and disclosure: Banks must be transparent in their operations and disclosures. This includes publishing regular financial reports and disclosing any conflicts of interest that may arise. Investors and other stakeholders should be able to access information about the bank's performance and governance practices.
4. Strengthen regulatory oversight: Regulators must have the necessary powers and resources to oversee banks and enforce regulatory compliance. Banks must be held accountable for their actions, and regulatory bodies must be empowered to take action against banks that violate regulations.
5. Promote whistle-blower protection: Employees who report fraud or other unethical behaviour must be protected from retaliation. Whistle-blower policies must be established and enforced to encourage employees to come forward with any concerns they may have.

6. Enhance customer protection: Banks must protect their customers' interests and ensure that their financial transactions are secure. This includes establishing adequate cybersecurity measures, protecting customers' personal data, and providing clear and transparent information on fees and charges.

By implementing these measures, banks can improve their corporate governance practices and prevent incidents of fraud and financial irregularities.

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