Standing Committee Report Summary

Impact of Banking Misappropriation on Trade and Industry

- The Standing Committee on Commerce (Chair: Mr. Naresh Gujral) submitted its report on 'Impact of Banking Misappropriation on Trade and Industry' on August 6, 2018. Typically, industries have been using different borrowing instruments to finance trade, including Letter of Credit (LC), revolving LCs, Letter of Undertaking (LoU), Letter of Comfort (LoC), among others. The Committee noted that the banking sector has recently faced misappropriation through frauds of high magnitude. Consequently, the Reserve Bank of India (RBI) has taken various measures regarding trade financing to curb fraud, which have had deep ramifications on trade and industry. Key observations and recommendations of the Committee include:
- **Discontinuation of LoUs and LoCs:** RBI had discontinued issuance of LoUs and LoCs by banks effective from March 2018. The Committee observed that LoUs and LoCs had been an effective instrument of raising cheaper, short-term credit in foreign currency. Further, industrial organisations and federations do not consider LoUs or LoCs to be flawed instruments. It noted that the discontinuation by RBI was a knee-jerk reaction to the frauds. It recommended restoration of LoUs and LoCs at the earliest with proper safeguards.
- **Impact on MSMEs:** The Committee noted that frauds and misappropriation have eroded the capital base of banks, and increased their non-performing assets. As a result, the RBI has adopted a more cautionary approach towards lending. This has proved to be a burden for trade and industry, chiefly for micro, small, and medium enterprises (MSMEs).
- The Committee noted that banks extend financing to firms with high credit ratings at concessional rates. Rating agencies assess every firm on the same scale without taking into account their nature and size. This system has deprived multiple MSMEs of easy access to bank finance. The Committee recommended that: (i) local uncertainties specific to each industry be taken into consideration by credit rating agencies while rating firms, (ii) the Securities and Exchange Board of India be engaged to take necessary action in issuing credit ratings, and (iii) banks strengthen their credit appraisal frameworks and undertake in-house credit risk appraisals.
- **Effect of the Prompt Corrective Action (PCA) framework on MSME lending:** The Committee observed that a set of rules have been put in place by the RBI under the PCA framework to assess, monitor and take corrective action on weak and troubled banks. These rules place several restrictions on banks, such as lending to riskier customers, opening newer branches, inter-bank borrowing, among others. The RBI has put 11 public sector banks under PCA. MSMEs largely get their credit from public sector banks. Due to the imposition of PCA on their creditors, MSMEs are struggling to meet their financial needs. The Committee recommended that RBI consider exempting bank credit to MSMEs from the purview of PCA restrictions.
- **Collateral requirements for issuing LCs:** The Committee noted that banks are insisting on higher collaterals of 35% to 50% of credit value (compared to earlier levels of 15% to 25%) for issuance of LCs and bank guarantees. Higher collateral requirements may lead to diversion of funds to build collateral, and thereby impact the competitiveness of industry. It recommended that the RBI clearly specify collateral requirements for issuance of LCs and bank guarantees, especially for MSMEs.
- **Business with embargo countries:** The Committee noted that many banks are not handling transactions related to countries such as Syria, Sudan, etc., as they have been put under sanctions by the United States of America or the United Nations. However, it observed that these sanctions do not apply to exports of pharmaceuticals and food products to such countries. It recommended that banks be given clear guidelines to enable smooth handling of business with such countries in these sectors.
- **Export credit cover by Export Credit Guarantee Corporation (ECGC):** The ECGC provides export credit insurance for risk of non-payment by the buyer to Indian exporters. The Committee noted that there are delays in payment of claims of exporters by the ECGC, with 94 claims worth Rs 219 crore pending with it. It recommended that the ECGC: (i) settle claims expeditiously, and (ii) frame timelines for settlement of claims. Further, the Committee noted that ECGC no longer extends the Whole Turnover Policy (WTP), which provides protection to banks against non-repayment of loans by exporters, to the gems and jewellery industry. As a result, exporters in the industry have to take individual policies at a higher premium. The Committee recommended that ECGC reinstate the WTP for this sector, as it is one of the largest foreign exchange earners in the country.

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