F.No.7/112/2011- BOA

Government of India

Ministry of Finance

Department of Financial Services

Jeevan Deep Building, Sansad Marg,
New Delhi, dated the 1st January, 2013

To

The Chief Executive,
Indian Bank's Association (IBA),
Mumbai.

Subject: Draft Best Practices to overcome systemic deficiencies in sanctioning and monitoring of Letter of Credit (LC) & Bank Guarantee (BG) facilities.

Dear Sir,

Kindly refer to the captioned subject. In this regard, Draft Best Practices in sanctioning and monitoring of LC & BG facilities have been evolved in consultation with IBA, Public Sector Banks (PSBs) and experts in the field (copy of Draft Best Practices is enclosed).

2. You are requested to circulate the Draft Best Practices among all the banks for consideration and adoption. You may monitor the adoption of these Best Practices in banks and intimate to this Department the status of such adoption.

Yours faithfully,

Sd/-

(Pravin Rawal)
Deputy Secretary to the Government of India
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Encl: As Above

Copy to CEOs of Public Sector Banks with a request to place these Draft Best Practices before their Board for consideration and adoption in the next Board meeting under intimation to this Department.

DRAFT BEST PRACTICES IN

SANCTIONING AND MONITORING OF LC & BG FACILITIES

1. Introduction:

The exposure to LC's & BG's has registered multi-fold increase in the past five years as both the instruments are low cost credit funding options to the business. They are also favoured by Banks as they yield good fee based income without taking direct financial exposure. It is observed that the Banking system over the period did not focus much on the Monitoring as the exposure is Non Fund based. However, the stress in the portfolio is getting exposed on account of down turn in business scenario. Further, it is also observed that some of the high value exposures in LC's & BG's are becoming NPA's. In this background, an analysis of Procedures & Systems followed in the PSBs has been carried out and the following suggestions are made as best practices to be followed by the Banking System, in order to de-risk the LC & BG portfolio.

2. Background :

The Banks have laid down procedures for Sanctioning & Monitoring the LC & BG exposures. Generally the procedures prescribe the exposure norms, cash margin, primary security, collateral security, credit rating, delegation of powers, pre-sanction compliance, post sanction compliance, etc.,

- Further, monitoring procedures are also prescribed covering periodical inspections, stock audits, etc.,
- RBI guidelines & circulars issued from time to time are also to be complied with
- In-spite of all the above, it is observed that many a time, the sanctioning norms are relaxed with higher debt equity, lower cash margin, lower security etc., with an intention to grab / grow business.
- Further, it is also observed that the required focus / importance is not given in Monitoring the exposures as the LCs & BGs are not fund based. Though, the exposure requires more focus than the fund based facilities as it is under secured or unsecured, the same is not given.
- Even, the frauds committed by fudging inventory figures, invoices, financial accounts etc., are not getting detected in time.

In this background, the following systemic improvements are suggested as best practices in Sanction & Monitoring of LCs & BGs.

3.Systemic Improvements while Sanctioning a proposal:

3.1 Debt Equity: Generally, Debt Equity of 2:1 is followed for Term Loans, in case of Working Capital Funding TOL to ANW of 4.0 is followed (Total Out-side Liabilities to Adjusted Net Worth). Further, the TOL to ANW is considered up to 10 times in case of non fund based LC & BG limits on case to case basis. Higher TOL to ANW is considered in case of trading companies, construction companies etc.,

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Further, it is also observed in some of the trading companies TOL to ANW of above 30 is also considered by some Banks. It is essential ANW is taken instead of TNW while calculating exposures in order to de-risk the exposure from high gearing in the Group companies.

It is suggested that bench mark range of TOL/ANW may be prescribed at 3:1 to 4:1 for manufacturing/practicing units and 5:1 to 6:1 for Trade/Service accounts, in case of Working Capital Funding covering LCs (both ILC & FLC), BGs, PBGs including sub-cap for fund based limits. A time limit of 6 months may be suggested for the Banks for regularising of existing exposures.

It is also suggested that the Bank should monitor closely and factor the Buyers Credit being availed by the borrowers while assessing the above limits.

3.2 MPBF (Maximum Permissible Bank Finance): It is observed that some of the Banks are extending LCs & BGs outside Working Capital limits. Even the cash margins against LCs & BGs are taken as part of current assets while assessing MPBF. In fact, such type of funding is resulting in double financing, which is resulting in financial indiscipline among borrowers.

It is suggested that LC & FBG limits in connection with Working Capital requirements should not be given outside Working Capital Limits worked out as per MPBF. Further, margin against LCs & FBGs should not be funded through Fund based Working Capital Limits. In case of Bid-bond, Performance Guarantees a careful risk evaluation methodology should be followed and separate margin money requirement coupled with security cover should be ensured. Even such facilities should not be extended to the parties who are not enjoying Working Capital facilities. In case of IDBI Bank, new entrant a special dispensation may be given for certain period.

3.3 Consortium Lending: It is observed that Banks are extending LC, BG facilities on Multiple Banking basis out side Working Capital Consortium, which is leading to indiscipline in the borrowers

It is suggested that LC, BG & PBGs should not be extended outside Working Capital Consortium and proportionate sharing to fund based limits should be ensured.

3.4 Drawing Power (DP) Computation: It is observed that some times the Banks are not excluding the value of Stocks procured & Debtors created out of such Stocks sold while calculating Drawing Power for Cash Credit purpose.

It is suggested that the value of Stocks procured and Debtors created out of such Stocks, and outstanding creditors on such stocks should be excluded while calculating Drawing Power for Cash Credit purpose

<u>3.5 Only Extending Non Fund Based Limit</u>: It is observed that Banks are extending stand alone Non Fund Based Limits without participating Fund Based Working Capital Limits, which is resulting Non Monitoring of Working Capital Operations and also Non Capturing of Cash Flows.

It is suggested that the Banks should not extend stand alone Non Fund Based Limits without participating in Fund Based Working Capital Limits. In case of IDBI Bank, new entrant a special dispensation may be given for certain period.

<u>3.6 Exposure Limits</u>: It is observed that the Banks are frequently exceeding both Company exposure and Group exposure norms fixed by the Boards, while extending LCs & BGs, by taking approvals at Board Level Committees.

Frequent violations to self set norms are against the Principles of Good Governance. Hence, it is suggested such practice of frequently exceeding norms preferably be avoided.

<u>3.7 Peer Review</u>: It is observed that many a time Peer Review of competitor's financials covering Capacity Utilisation %, EBIDT %, PAT %, Working Capital Turnover Ratio, Current Ratio, Debt Equity, TOL to ANW etc., are not compared in the Loan Appraisal process, which is leading to sanctioning excess limits compared to other units in the same business.

It is suggested that Peer Review should be necessarily carried out in the Loan Appraisal process. The pre-review should cover performance ratios, working capital facilities, TOL/ANW, enjoyed vis-à-vis turnover, EBIDT % etc in addition to other ratios.

<u>3.8 Pre-Sanction Inspection:</u> It is observed that there is no structured process for Pre-Sanction Inspection Process. Some of the Pre-Sanction Inspection Reports are covering only the visit details to Administrative Office. Inadequate coverage of physical inspection is leading to non verification of critical items while sanctioning fresh proposals / renewal of facilities, leading to non detection of fudged figures.

It is suggested that a structured Pre Sanction Inspection procedure should be introduced to cover issues of Organizational Structure, Board Governance, Internal Control & Internal Audit Systems, Stocks & Debtors verification, Internal Performance Monitoring & Management Information Systems, Budgetary Control System etc., Further, proper Treasury and Forex Hedging Systems should be ensured in case of sanctioning FLCs. The

Hedging of all Forex exposures should be made mandatory up-front, unless there is a natural Hedging

<u>3.9 Monitoring System of LCs & BGs:</u> It is observed that there is no separate Monitoring System for LCs (both ILCs & FLCs) in vogue in the Banking System. The whole cycle of opening LCs, getting goods / stocks / services under LC and payment against the LCs, completing transaction cycle ending with out go of funds from Current / OCC Account is not monitored, in the absence of which unscrupulous borrowers are getting Scot- free.

It is suggested that a duly certified quarterly report on ILCs, FLCs & BGs should be obtained from the borrowers and should be verified with the transactions in the concerned borrowers Current / OCC Account. Further, the Banks should endeavour to develop suitable Software for integrating Reports received from borrowers with that of Current Account transactions. Once, such Software is developed by the Banks, they can obtain the Reports also in Soft copy and the Monitoring of ILCs, FLCs & BGs can be made Software driven. A Model Quarterly Report Form is enclosed. Further frequent devolvement of LCs should be closely monitored and be communicated among the constituent banks.

<u>3.10 Periodical Physical Inspection:</u> It is observed that the Periodical Physical Inspections done by the officials are not covering the verification of Stocks & Debtors relating to the Goods / Services procured against the LCs, similarly, the due diligence of LC transactions at least on test check basis is not carried out, which is leaving out the whole LC facilities un-monitored

It is suggested that the Periodical Physical Inspections should be carried out on a structured basis, inter-alia covering Physical Inspection of Stocks & Debtors relating to the Goods / Services procured against the LCs issued by the Banks. Further, due diligence of transactions, covering movement of goods, their quality and the parties should be carried out. At the time of

Inspection, latest financial statements should be obtained and Physical Stocks & Debtors should be cross verified.

<u>3.11 Stock Audits:</u> It is observed that that the LC facilities are not covered under Stock Audits.

It is suggested that the LC facilities should be brought under the regular Stock Audit process of the Banks.

<u>3.12 PBGs (Performance Bank Guarantees):</u> It is observed that the Banks are extending Performance Bank Guarantees in large numbers, consequent to spurt in infrastructure projects on account of recent increase in their activity. Further, there is no Structured Monitoring System for the PBGs issued by the Banks. In the absence of periodical reporting and monitoring of projects under the PBGs, the Banks are getting suddenly exposed to payment obligations under PBGs.

It is suggested that the Banks should implement the following system for strengthening the PBGs Sanction and Monitoring Process:

<u>3.12A Precautions at the time of Appraisal/ sanction:</u>

The following additional precautions should be adopted while considering proposals under PBG assistance:

a. **The capacity and ability of the borrower to execute the job within the prescribed time limit should be critically examined**

b. **Milestones should be stipulated for completion of the project and consequently in case of Events of Default (EOD), the flexibility of increasing the margin and commission rate of changing the terms and conditions should also be stipulated.**

c. **An EOD trigger should be introduced in the system.**

d. **A separate limit/ sub-limit should be sanctioned for issuance of PBGs.**

e. **In case foreign exchange element is envisaged in the PBG, a condition may be stipulated regarding the forex risk to be borne by the borrower.**

f. **A condition with regard to submission of periodical review of the status of the project for which PBG is issued should be stipulated.**

3.12B Suggested Monitoring Mechanism:

Further, keeping in view the risk associated with PBG assistance, it is suggested to strengthen the monitoring mechanism through the following additional measures, which would be applicable to PBG of over Rs.5 Crores and with tenor of over 1 year

a. **The projects under PBGs should be monitored with respect to the envisaged milestones and reviewed by the respective Dealing Groups on quarterly basis. For the purpose, the company should be advised to submit project specific progress reports at quarterly intervals.**

b. **The Dealing Groups should visit periodically the project site to verify the physical progress achieved.**

c. **The Dealing Groups should have discussions with the beneficiary regarding milestones achieved, quality of the work done, etc.,**

d. **In case of non achievement of milestones in physical progress, the actions under EOD should be triggered for corrective measures.**

e. **Inter - changeability of normal BGs to PBGs should be permitted only on selective bases.**

f. **While submitting the Annual Loan Review note to the concerned authority a special mention may be made in respect of status of the projects with regard to mile stones covered under PBG, including project wise Risk Analysis.**

4. The above suggested systems should be considered as supplemental to the existing systems being followed by the Banks.

The Banks should endeavour to dovetail the above systemic corrections in their existing systems at the earliest.

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