Banks advised to tighten letters of credit sanction norms

The finance ministry wants state-owned banks to follow more stringent norms while issuing bank guarantees or letters of credit to borrowers, concerned that such type of funding results in double financing, which often leads to financial indiscipline among borrowers.

A finance ministry official told ET that the government nominees on the boards of state-run banks have taken up the issue with bank officials, asking them to tighten the rules.

In June 2004, the Reserve Bank of India (RBI) had removed all limits on unsecured exposure of banks, which includes bank guarantees, and given bank boards freedom to fix their own policies on such exposures.

The finance ministry is keen that banks should restrict themselves from extending these facilities to parties who do enjoy working capital facilities with them.

"We had apprised the Indian Banking Association about these concerns earlier in the year. Banks individually are also expected to address the issue," he said, requesting anonymity.

Under the bank guarantee, a financial institution agrees to pay on behalf of its borrowers if they (borrower) fail to deliver in a contract.

A letter of credit enables buyers to take delivery of goods without upfront payment and sellers to receive immediate payment soon after goods are shipped.

The finance ministry is concerned that banks relax the sanctioning norms in order to grow business, but its adverse fallout is increase in non-performing loans."It was observed that some banks were extending bank guarantees and letter of credit outside working capital limits, which also lead to breaching of company exposure and group exposure norms," the finance ministry official said.

As per RBI guidelines, the exposure ceiling limit is 15% of capital funds in case of a single borrower and 40% of capital funds in the case of a borrower group. In case of infrastructure projects, the limit increases to 20% in single borrower and 50% to a group.

The government wants banks to follow a careful risk evaluation methodology and ensure separate margin money requirement from borrowers coupled with security cover before extending bank guarantees.

An executive director of a state bank said that these guidelines are advisory in nature and it will be for the bank boards to take a final decision. "They are concerned about rising bad loans. After some heavyweight infrastructure projects were stuck, some banks got exposed to payment obligations under performance bank guarantees (PBG)," he said.

State-run banks had gross NPAs of Rs 1.92 lakh crore or 3.99% of advances at the end of June. The top 30 such accounts in state-run banks constitute 34.83% of gross NPAs at around Rs 63,671 crore.

(Economic Times)