

## CHAPTER IV: MINISTRY OF COMMERCE AND INDUSTRY

### Export Credit Guarantee Corporation of India Limited

#### *4.1.1 Inadequate due diligence during settlement of a claim*

#### **Madurai branch of ECGC settled an inadmissible claim for Rs.2.20 crore, ignoring the lapses committed by the bank officials.**

Export Credit Guarantee Corporation of India (ECGC) issued a Whole Turnover Packing Credit Guarantee (WTPCG) to a consortium of banks led by Canara Bank in respect of the exporter, Vijaykumar Mills Limited. WTPCG provided cover to the bank in respect of pre-shipment advances given by the bank for manufacture, purchase, processing and packing of goods to be exported out of India. WTPCG covered the risks of insolvency of the exporter and protracted default by the exporter to pay the amounts due to the bank. In the event of the bank lodging a claim, WTPCG required the bank to furnish 'Staff Accountability Certificate' stating that there was no act of omission and commission on the part of any bank official.

Canara Bank preferred a claim for Rs.2.44 crore which was admitted (March 2004) for Rs.2.20 crore subject to receiving 'Staff Accountability Certificate' from the bank before releasing the claim amount. Canara Bank submitted the said certificate in May 2005 but subsequently intimated in November 2005 that major penalty action was taken against two senior officials for their lapses in respect of the account of Vijaykumar Mills Limited.

Thus, it became clear in November 2005 that the bank had not exercised due and reasonable care in granting advances to Vijaykumar Mills Limited. Therefore, the claim of the bank was not admissible. In spite of knowing the developments, ECGC released Rs.2.20 crore later in February and March 2006, contending that the lapses pertained to the post shipment part of the account such as discounting of foreign bills without permission and hence had no bearing on the claim.

Audit observed that **the contention of ECGC was not proper as the duty of the bank doesn't end with grant of pre-shipment advances. The bank was required to exercise due and reasonable care and monitor the account till the advances were fully recovered.** Further, the bank's investigation against the officials also indicated lapses in respect of packing credit relating to pre-shipment.

Thus, inadequate due diligence by ECGC resulted in irregular settlement of claim for Rs.2.20 crore. As per clause 5 of Part II of WTPCG, payment made on inadmissible claim is to be refunded to ECGC within 30 days with interest. **The ECGC should claim a refund with interest and ensure proper due diligence in future to safeguard its financial interests.**

The matter was reported to the Ministry in July 2009; their reply was awaited (November 2009).

### **MMTC Limited**

#### **4.2.1 Loss due to delay in disposal of Zinc**

**Inordinate delay in disposal of Zinc not lifted by the buyer resulted in an avoidable cash loss of Rs.2.14 crore.**

The MMTC Limited (Company) imports non-ferrous metals against the booking made by domestic buyers and sells them to domestic buyers on High Sea Sale basis (HSS) at an agreed trade margin. The Company is required to sign a HSS agreement with the buyer for the agreed quantity of metal.

The Company offered (October and November 2006) to sell 164.413 MTs<sup>1</sup> of 'Primary Special High Grade Zinc' to M/s Shanky Services Company (buyer) and the buyer accepted to buy the entire quantity. The buyer paid Earnest Money Deposit (EMD) of Rs.28 lakh in this regard. Though the Company entered into HSS agreement with the buyer for the sale of 80.235 MT of Zinc from November 2006 shipment, it did not enter into any such agreement for the balance quantity (84.178 MTs). As per agreement:

- The buyer would have to deposit the full value of the goods (excluding EMD) within seven days from the date of intimation from the sellers or two days prior to expected time of arrival of the vessel, whichever is earlier.
- If the buyer fails to pay the full value, other charges and the interest (if any) before arrival of the vessel, the Company has the right to forfeit the EMD of the buyer and clear the goods from the Customs in its own name. In such an eventuality, the Company shall have the right to recover from the buyer all consequential damages.

#### **Audit observed (November 2008) that:**

- The Company imported 80.235 MTs of Zinc in November 2006 and 84.178 MTs of Zinc in December 2006 at the rate of US\$4,312 (Rs.1,92,100<sup>2</sup>) and US\$3,861 (Rs.1,72,008) per MT respectively valuing Rs.2.98 crore.
- The Company requested the buyer to make the full payment of Rs.3.06 crore inclusive of its trading margin. The buyer did not make the payment on due date.
- The Company, however, made the payment to the foreign supplier for imports in December 2006 and January 2007.
- The buyer lifted 19.862 MT of Zinc in January 2007 after remitting Rs.40 lakh.

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<sup>1</sup> Metric tonne

<sup>2</sup> Adopting rate per US\$ as Rs.44.55

- The buyer neither paid the balance amount due to the Company nor took delivery of the balance quantity of Zinc viz. 144.551 MTs (164.413 MT – 19.862 MT).

As the buyer did not lift the balance quantity, the Company placed (April 2007) the material in Custom bonded warehouse. The total expenditure incurred by the Company on these imports aggregated to Rs.4.06 crore<sup>1</sup>.

Despite the buyer's failure to comply with the provisions of the agreement terms, the Company did not take any timely action to dispose of the unlifted quantity and recover all consequential losses from the buyer. The Company disposed of the balance quantity in February 2009 for Rs.1.24 crore and suffered a loss of Rs.2.14 crore<sup>2</sup> on this import.

**The Management stated (September 2009) that:**

- It did not dispose of Zinc immediately after the buyer defaulted in payment as the market reports suggested that Zinc prices might reach upto US\$4,600 (Rs.2,04,930) per MT due to deficit in supply and that before selling the unlifted quantity to alternate customers, it was necessary to give proper notice to the original customer.
- It had initiated legal action to recover its losses from the defaulting customer.

**The Ministry endorsed (October 2009) the above reply of the management.**

**The replies are not convincing as:**

- The Zinc prices which declined to around US\$3,000 (Rs.1,33,650) per MT in the first quarter of 2007, improved in the second quarter of 2007 and were ruling between US\$4,150 (Rs.1,84,883) per MT (April 2007) and US\$3,800 (Rs.1,69,290) per MT (July 2007). Thereafter, it steadily declined and was around US\$1,150 (Rs.51,233) per MT in February 2009 when the Company eventually disposed of the balance quantity. **The objective of the Company in this case should have been to recover its money quickly rather than speculate on the future price movements.**
- The Company's contention about giving proper notice to the original customer is also not acceptable as he never responded to the pleas of the Company to lift the balance quantity and all the communications addressed to him were returned undelivered.
- Further, the Company would not be in a position to recover any amount from the buyer as the detective agency engaged by the Company reported (August 2008) that the whereabouts of the buyer were not known and that no such Company existed.

Thus, inordinate delay in disposal of zinc resulted in an avoidable loss of Rs.2.14 crore.

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<sup>1</sup>*Cost Insurance and Freight (CIF)( value -Rs.2.98 crore, custom duty- Rs.0.57 crore, handling, detention charges etc.- Rs.0.46 crore and godown rent- Rs.0.05 crore.*

<sup>2</sup>*Rs.4.06 crore – Rs.28 lakh (EMD) – Rs.40 lakh (amount paid by the buyer) – Rs.1.24 crore (sales realisation).*

**STCL Limited****4.3.1 Failure to devise internal controls in entering and executing contracts with Business Associates**

**The Company entered into new line of business activity of third country exports of metal scrap in 2004-05 without finalising operational guidelines and without protecting its financial interests against defaults by overseas buyers. System deficiencies in entering into contracts with the Business Associates and failure to devise internal controls led to loss of Rs.1167.48 crore.**

Spices Trading Corporation Limited, a wholly owned subsidiary of State Trading Corporation of India Limited, whose core business was trading in whole range of spices, amended (July 2004) the objects clause in the Memorandum of Association to include trading in iron ore and other metal scrap including third country exports<sup>1</sup> and renamed as STCL Limited (Company). The metal scrap trade increased from Rs.4.10 crore (0.94 *per cent*) of the turnover of the Company in 2004-05 to Rs.1414.86<sup>2</sup> crore (65.19 *per cent*) in 2008-09.

Third country export of metal scrap by the Company is done through an arrangement for purchase and sale of metal scrap on back to back contract with overseas sellers and buyers identified by the Company's Business Associates (BA)<sup>3</sup> from 2005-06. The Company establishes Letters of credits (LCs) in favour of overseas seller for a period ranging from 90 to 120 days and upon receipt of remittances from overseas buyers, the original shipping documents are released to BA by endorsing the same to overseas buyers for taking delivery of goods. The Company acted as a facilitator for third country exports.

Audit noticed that there were system deficiencies and major irregularities in third country export activity as discussed hereunder:

**System Deficiencies:**

- While the Company established LC on the foreign sellers for the purchase of metal scrap, it accepted the offer of getting sales proceeds through '**swift payment**' from the overseas buyers without insisting for back-to-back LC. Reasons/compulsions for accepting such payment terms which were not in the financial interests of the Company were not on record. The Company's action of exposing itself for Rs.2525 crore (2008-09) for a meager margin of 1.26 *per cent* (Rs.32.13 crore) without insisting for LC from buyers was fraught with the risk of default, which finally resulted in devolvement of 134 LCs during the period September 2008 to January 2009 valuing Rs.1320 crore<sup>4</sup> due to non remittances by overseas buyers.
- Clause C- 9 of contracts of sale provided for pre-shipment inspection by SGS (inspecting agency) or any certification agency approved by Directorate General of Foreign Trade (DGFT) of India, who will conduct the pre-shipment inspection

<sup>1</sup> In third country exports goods are shipped from one foreign country to another without entering India  
<sup>2</sup> excluding devolved LCs of Rs.1208.48 crore

<sup>3</sup> Future Metals Private Limited, Bangalore and Future Exim (India) Private Limited, Bangalore

<sup>4</sup> including interest of Rs.152.84 crore up to November 2009

about weight and quality at load port at seller's expense and at discharge port at the expense of the buyer. As the inspection agencies were appointed by the overseas sellers, there was no control on the inspection agencies by the Company. The sellers loaded iron scrap as against nickel/copper scrap mentioned in the contracts and in 146 pre-inspection certificates did not indicate the contents clearly. Failure of the Company in insisting on the clear indication of the contents amounted to deliberately ignoring the most important control on the quality/nature of the material transacted. As a result, the sellers succeeded in getting the payment of Rs.1208 crore.

### Other major irregularities:

#### 1. Entering into the new business without due diligence

- The Company neither conducted any market survey/SWOT<sup>1</sup> analysis before getting into new line of business nor framed guidelines/procedures for selection of BA and for trading in metal scrap (domestic/third country).
- Based on the proposal (28 March 2005) of Future Metals Private Limited (FMPL) to be BA, the contract for sale with BA was entered into by the Company<sup>2</sup> on the same day without even waiting for the approval of Managing Director (MD). Further, the approval was given (May 2005) without verification of the credentials of FMPL, which was incorporated only in July 2004. Similar was the inclusion (April 2007) of Future Exim (India) Private Limited (FEIPL), a group company of FMPL, as another BA.
- The contract with overseas seller<sup>3</sup> was entered on 25 March 2005 even before its incorporation (April 2005) and even before the receipt of business proposal from the FMPL on 28 March 2005.

#### 2. Disregard to the Board's directions

- Even though the Company amended (July 2004) the 'Object' clause in the Memorandum of Association for trading in iron ore and other metal scrap, the modalities of operation in respect of iron ore only was deliberated in the Board while approving the Revised Market Plan for the year 2004-05. Board's direction (July 2004), while approving the Company's proposal, to seek guidance from the holding company i.e., The State Trading Corporation of India Limited (STC) on the issue was also ignored. Board discussed the modalities of operation for third country export of other metal scrap only during July 2007.
- Board while approving (July 2007) Business Plan for 2007-08 directed to conduct periodical risk analysis of buyers and sellers on continuous basis by utilizing the services of risk analysts viz., M/s. Dun & Bradstreet (D&B). The Company obtained (July 2008 to August 2009) D&B reports on overseas buyers/sellers and

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<sup>1</sup> Strength, Weakness, Opportunities and Threat

<sup>2</sup> Signed by the Chief Marketing Manager of the Company

<sup>3</sup> M/s Al-Mustaqbal FZC., UAE

FMPL only after the commencement of the metal scrap trade which indicated inter-alia that the line of business of some of the overseas buyers/sellers was undetermined and that the overseas sellers/buyers were associates of BA.

### 3. Violation of Delegation of Powers

- The MD of the Company did not have any delegated power when the proposals (March 2005) from the BA for metal scrap trading was received and every transaction was required to be approved by the Chairman or the Board.
- By virtue of its increased turnover (major share from scrap trade activities) the Company was elevated from Grade “D” to Grade “C” in June 2005 but still the MD did not have the delegated power on business transactions. It was only in January 2006, the Board approved the delegation of power (DOP) according to which for non-fund based back-to-back contracts, the Managing Committee comprising of MD can enter into contracts upto Rs.20 crore only beyond which the proposals were to be approved by one Director/Chairman/Board. DOP was silent about the maximum extent to which the MD can commit the Company by entering into such contracts within his delegated powers. It was observed that each of the contracts entered into with the BA was kept under Rs.20 crore limit of the MD. The value of contract entered in a single day varied from Rs.30.71 crore to Rs.279.29 crore, which indicated misuse of delegation of powers. In 115 cases, LCs valued Rs.927.07 crore were opened without prior approval of MD. However, MD ratified these subsequently.
- As per the DOP of Chairman, STC, the total amount of financial assistance at any time to BA should not exceed Rs.75 crore. The actual credit availed on this count was Rs.1770.13 crore (out of Rs.1785 crore approved by Board) in respect of the present BA transactions. The fixation of maximum exposure on BA was overlooked while framing the DOP in January 2006.

### 4. Meek acceptance of terms prescribed by the BA

- As the consignments never touched the Indian shores in the third country contracts, constant and close monitoring was necessary. However, in the absence of any internal procedure in place, the Company relied on the BA. The exposure gradually increased from a mere Rs.4.10 crore in the first year (2004-05) of their association to a whopping Rs.2525 crore (approximately) in the fourth year (2008-09). The failures of the Company to read the nexus between the BA and sellers/buyers were fully exploited by the BA. It was evident from various contracts entered into with the BA, that the said sellers<sup>1</sup> and buyers<sup>2</sup> were the associates of the BA.

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<sup>1</sup> Asia Metal & Commodities Pte Ltd. Singapore, Al-Mustaqbal Metal FZC, Dubai, American Metal Management Inc., New Jersey, USA

<sup>2</sup> SinoAsia Pacific (H.K) Ltd., Hong Kong, Haoweilai Jinsu Limited, Hong Kong, Haoweilai Jinsu (H.K.) Limited

- Even though the BA had proposed for mutually agreed service charges to the Company, **no record of discussions as to the basis/adequacy of the margin of 1.75 per cent of the carriage and freight value of the contract accepted by the Company was available.**
- Back-to-back contracts with the BA stipulated an amount equivalent to 10 per cent (which was later amended to 5 per cent during 2007-08) as security deposit (SD)/margin money (MM) to be provided in the form of DD/cheques before opening of the LC. **On review of contracts, it was observed in 56 cases, the SD was mentioned as 10 percent but the Company actually collected only 5 percent and in 12 cases the percentage of SD to be collected was not indicated in the contract. Justification for reduction in percentage of MM /SD was not on record.** Considering the fact that an amount of Rs.70.73 crore were adjusted against the principal and dues by banks, the collection of 10 per cent MM would have reduced the Company's financial burden by Rs.70.73 crore.
- The Company reduced its margin of profit from 1.50 per cent to 1.266 per cent in November 2006 at the request of BA on the grounds of increase in volume of business transacted. **However, such reduction was not specifically brought to the notice of the Board nor was any justification for reduction duly recorded.** This has resulted in reduction in profit by Rs.7.77 crore during 2006-07 to 2008-09.
- In 10 cases, the goods were sold on forward sale basis based on the letter from BA to the Overseas Buyers without entering into formal agreement.

## 5. Pre-shipment inspection

- Clause C-7 (K) of agreement with Overseas Seller provided certificate to be issued by BA at load port for having inspected the goods for quality and quantity, which were stuffed in containers as certified by inspection agency. It was observed that the date of Bill of Lading (57 cases) and invoices (12 cases) which were referred by BA in inspection certificates were after the date of inspection certificate of BA.
- After devolvement of LCs, when the Company sought to take possession of the consignments in Busan (South Korea)/Vietnam, it was found (March 2009) **on opening the five containers that the contents were iron scrap and not nickel or copper scrap.** Subsequently, under court directions 583 containers were opened (June /November 2009) and contents of all were also found to be scrap iron. The value of all the consignments (885 containers) was estimated to fetch approximately US\$4.58 million (Rs.22 crore) as against US\$249.57 million (Rs.1208 crore) paid by the Company. As per the Busan court direction, all the 588 containers were auctioned and the realisation towards this was adjusted towards the pending port dues and storage costs. The details of disposal of balance 297 containers were not known.
- The contracts provided for deputing Company's team (as a buyer) for inspection while loading the commodity. The Company officials visited abroad during

September/October 2008 after the Company noticed the first default of payment by overseas buyer.

- In 108 cases, the pre-inspection certificates were prior to the date of entering into contract with BA and overseas sellers and in 54 cases, the bills of lading were prior to the date of entering into contract, indicating that the contracts were a mere formality.

#### **6. Failure to encash in time cheques given as guarantee**

- Clause 5.1.2 of back-to-back contract provided for furnishing corporate/personal guarantee together with post dated cheques (dated two days prior to the due dates of LC) for the contract value, to safeguard against breach of contractual obligations by the BA. **The reasons for accepting cheques as security without verifying the financial credentials of the BA were not on record. The Company collected undated cheques in all 134 cases from BA.** The first default started by 17 September 2008 and by end of September 2008, it was Rs.175 crore. **The Company not only failed to encash the cheques furnished by BA but also opened 24 more LCs for Rs.152.95 crore between 18 September and 3 October 2008.** The Company presented all the cheques (valuing Rs.1056.28 crore) only in January 2009 which were dishonoured as the BA had issued 'stop payment' instruction to bankers.

#### **7. Failure to learn from past back-to-back deals**

- Even as the Company aligned with present BAs (FMPL & FEPL) during 2005-06 for metal scrap trade, the Company found (March/April 2005) in the LMS (Light Melting Steel Scrap) trade, with another BA, **that the consignment supposed to be of LMS actually turned out to be sand and used tyres.** The consignment was certified by the nominated inspection agency from whom the Company finally recovered its loss.
- Similarly, in another case relating to back-to-back contract for trading in pulses with RSR best commodities (P) Limited, Chennai, the Company relied on the certificates of the associates' nominated inspecting agency on the quality and quantity of pulses who certified that the inspection done at the Central Warehousing Corporation (CWC), Chennai. The Company did not verify the stocks at CWC Chennai despite having a branch office in Chennai and made the payment of Rs.5.25 crore to the associate/seller. As the associate failed to sell the pulses under the contract, the Company decided (March 2008) to sell stock at CWC Chennai, on 'as is where is basis'. However, no publicity was given for the sale. **There was no transparency in the sale which was finally effected to a third party- FEPL for Rs.5.25 crore and the payment was received from FEPL. Later it was found that there was no stock and the CWC receipts were fabricated and in this case too the associate (RSR) and the seller were group firms only. However, there was no financial loss to the Company as FEPL agreed to settle the issue with the RSR. Thus, despite being aware of the consequences in relying on the certificates of the associate's nominated inspection agency, the Company failed to**



insist on appointing its own agency or satisfy itself about the contents of the material loaded in its dealing with the BA for the metal scrap trade.

The Management in its reply stated that:

- The Annual Marketing/ Business Plan with modus operandi against import/export transactions are put up to the Board and approved, the business is carried out in line with the Board's approval.
- No banker insisted for LC either orally or in writing from the overseas buyers for 2<sup>nd</sup> leg of operation and if BA had been in the position to provide Bank Guarantee/LC from overseas buyers, they would have not utilised the services of the Company.
- The Company's officials visited (September 2008) Dubai and were present while stuffing the copper scrap to containers; on verification, the stuffed containers were never shipped.
- Consequent to global recession and the assurance given by BA in getting remittances from overseas buyers the Company opened LCs valued at Rs.43.72 crore during 1<sup>st</sup> week of October 2008.
- All the shipping documents including inspection report are in order where as the contents of the containers were Iron and Steel Scrap instead of Nickel & Copper Scrap. The present liability is only on account of the fraud committed by BA along with overseas sellers/buyers.

Reply of the Management is not convincing as:

- The approved Annual Marketing/ Business Plan for 2004-05 and 2005-06 did not specifically mention the modalities of operation of metal scrap trade.
- The Company should have insisted for back to back LC or an unconditional bank guarantee from a well-rated scheduled bank to safeguard its financial interest. If that was not possible from BA, the Company should have resisted from doing this business.
- The Company's officials visited abroad to oversee the stuffing of material into containers only after the Company noticed the first default of payment by the overseas buyers.
- Although the Company noticed the first default of remittances from the overseas buyers on 17 September 2008 it still continued to open 24 LCs valuing Rs.152.95 crore between 18 September 2008 to 3 October 2008 which could have been avoided.
- The pre-inspection certificate issued by inspection agency indicated the description of commodity as 'Metal Scrap' instead of 'Nickel/Copper Scrap' as

per the contracts. Moreover, the Company filed case against the Inspection Agency for issuance of fabricated pre-inspection certificates.

Had financial prudence in the business of third country exports of metal scrap been followed by protecting its financial interest against non-remittance by overseas buyers/BA, the fraud could have been avoided. The State Bank of India has also issued notice on behalf of the Consortium of Bank for recovery of dues from the Company.

### **Conclusion**

The Company entered into new line of business activity in 2004-05 by entering into third country exports of metal scrap without finalising operational guidelines and without protecting its financial interest against defaults by overseas buyers. System deficiencies in entering into contracts with the Business Associates and failure to devise internal controls resulted in non-payment by overseas buyers and supply of iron scrap as against nickle/copper scrap, led to loss of Rs.1167.48 crore\*.

The matter was reported to the Ministry in November 2009; their reply was awaited (November 2009).

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\* *Rs.1208.48 crore total LC devolved Less margin Money adjusted Rs.41 crore*