FRAUD & PREJUDICE

Industry expert PRANAY NARVEKAR analyses the impact of the Nirav Modi and Mehul Choksi scandal on the industry, and explains why banks are likely to become extra cautious of the sector for a long time to come.
Much ink has been spilt, eyeballs have been grabbed and eardrums have been busted in the media over the recent Nirav Modi and Mehul Choksi LoU episode. These headlines have grabbed the collective attention and wrath of the entire country, and at a retail level, there are reports of them having affected customer sentiments as well.

The author is sure that by now everyone in the industry is closely following these events and their aftermath, and he has no intention to go into another autopsy of the case nor get into investigative reporting. What is probably more interesting to discuss is what will be the long-term impact of these cases on the industry.

**Calling a fraud a fraud**

To set the stage for any discussion, it is important to clearly call this out as a fraud. This sometimes gets lost out in all the high-decibel diatribe in the media channels. In fact, the fraud itself had absolutely nothing to do with the gems and jewellery industry. Any enterprising fraudster could have used the very same method for any other underlying product, be it scrap metal, engineering goods, oil and gas or any product with a high import content and low value addition. No one in our industry condones a fraud.

It is important to distinguish between a business bankruptcy, which is a business failure, and a fraud. While the former is a possibility in business, what differentiates it from a fraud is the intention of the business to pay back the loans. In India, we tend to view every bankruptcy as a fraud, especially after the banks were nationalised, as bank losses are essentially a loss to the government, and by extension, the citizens. Therefore, it is natural that there are questions being raised about the privatisation of nationalised banks.

The other reason why bankruptcies are treated with suspicion is because the policies and processes of the nationalised banks make it difficult to establish whether the bankruptcy was due to inefficiency (of the underlying business), incompetence (of the bank) or the inappropriate intent (of the employees). This makes it difficult to pin down the responsibilities and to establish who was complicit.

It’s seen in many large bankruptcies (not just in the industry), that the inherent business weakness morphs into a fraud as businesses try to keep themselves going, in the hope of a better future, and eventually promoters plan to exit the business by removing their capital, at the expense of the banking system. The exact nature of the involvement of bank personnel along this process is usually not clear and difficult to prove.

In this instance, however, there was a clear involvement of the bank employees in the fraud.

**Lazy banking?**

The gems and jewellery industry is known to provide long-term credit to their customers and have numerous trade interactions internally amongst each other as well. All these credits are clean credit on receivables, without any collateral. However, in this instance, as in the past, there was little impact felt in the market as most dealers did not extend credit to the affected companies. This was also the case in the previous two episodes in 2010 and 2013, when public sector banks lost monies to bankruptcies in the sector.

The 2010 bankruptcy was the first major bankruptcy in the industry, and it was a shock to the banking industry. The author was part of the efforts of the Gem & Jewellery Export Promotion Council (GJEPC) to provide banks with best practices in risk management for the industry. However, with the boom in 2011, this advice seems to have been forgotten. A policy of transfers in these banks, too, means that expertise developed about the industry is lost to the bank, while also diffusing the responsibility for the loan.

In 2013, the Winsome episode again triggered concerns from banks. In a seminar held with banks later that year, the author moderated a session, where it was suggested that the GJEPC request banks, on a monthly basis, to provide their
Banks and employees would be facing increased scrutiny and regulatory inspections will be increased. In such a scenario, for both banks and for the employees, it’s simply better to avoid giving credit. Errors of omission (i.e. not giving credit) often go unnoticed, while errors of commission (i.e. giving credit and explaining why the credit was given) are easily scrutinised!

There are already reports of this occurring, with the RBI, from their side, stopping the LoU route completely. This does not affect the gems and jewellery industry significantly, as it was not a common financing mechanism used by the industry in any case.

From an industry perspective, banks have already started reviewing the sanctioned limits and the hard collateral they hold against them. There are reports of banks asking companies to increase the hard collateral provided.

Facing prejudice
In the immediate term, the banks’ reaction to any such event is to become more conservative. Banks and employees would be facing increased scrutiny and regulatory inspections will be increased. In such a scenario, for both banks and for the employees, it’s simply better to avoid giving credit. Errors of omission (i.e. not giving credit) often go unnoticed, while errors of commission (i.e. giving credit and explaining why the credit was given) are easily scrutinised!

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From an industry perspective, banks have already started reviewing the sanctioned limits and the hard collateral they hold against them. There are reports of banks asking companies to increase the hard collateral provided. In reality, working capital loans are, by definition, only provided against current assets, namely stock or receivables.
Hence, the additional hard collateral means that technically the banks have 30-40% more assets than the loan they provide. This move is a reflection of either the inability to value or the lack of confidence of the banks in the current assets on whose basis the loans are provided.

All companies in the industry would essentially be presumed guilty, unless they prove their innocence. Typically, it’s the smaller companies who face the brunt of these actions as banks try to either ask for more collateral or start to reduce their exposure to the companies, in order to meet the collateral norms. Credit to the industry would slowly start to be squeezed.

This time it’s different

Such actions by the banks have been seen in past incidents; however, for the most part they have lasted for 6-12 months. As the memory of the incident dulls, old employees are transferred and banks show an eagerness to increase their loan book; it’s back to business as usual. However, the initial signs are that the industry might not find the path as straightforward.

There are multiple signs which point to financing becoming tougher for the gems and jewellery industry in India going forward.

Firstly, it’s not an isolated incident. There have already been reports of 3-4 other such bankruptcies or frauds (though some of them should have been recognised long ago by the banks) and more might follow. While a single incident can be forgotten, multiple instances reaffirm the “high risk” nature of the industry in the minds of the banks and regulators.

Secondly, the scale of the losses has the potential to threaten the stability of the banking system. This has made the government sit up and take notice. There seems to be a greater will on the part of the government to take more concrete steps to reduce the risks in the sector.

Thirdly, the RBI, which has been one of the most prudent banking regulators globally, has been tasked with keeping inflation in check. RBI has gone about drying up the excess liquidity, and coupled with global interest rates going up, this would lead to higher borrowing costs in the near future for the sector as a whole. Also, the RBI oversight has been questioned, and the author is sure that they will step it up, which should add to the burden of borrowers.

Lastly, with all the scrutiny and the multiple episodes, banks are likely to become extra cautious of the sector for a long time to come.

Understanding the impact

While it is too early to try and quantify the impact of the crisis, we need to understand the various areas in which this will affect the industry.

On the demand side, it will have a limited impact on the diamond industry. India accounts for less than 7% of global demand and though there are reports of customers being a little shy of buying diamonds, especially as there were reports that some of the errant companies sold simulants as diamonds, it is likely that this would quickly rebound. This is historically a slow period for jewellery, and the upcoming Akshaya Tritiya period will help us quantify the impact on retail consumers.

The big impact will be on the funding and liquidity side of the business as banks tighten their norms and strengthen the oversight of the loans. This will affect the stocking capacity of the industry. On the diamond side, the impact of the tightening might be less severe, but the jewellery sector, both the export and domestic, will feel the full weight of the tightening. Companies, who have higher leverage, carry higher stock and depend on long credit terms for sales, could feel the pinch.

The biggest change will be on the way the government views compliance within the sector. Over the last few years, the governments were targeting reduction in the cash component of the business, especially on the retail side (i.e. PAN card requirement for sales above ₹2 lakh). With this event, the focus is likely to be widened to include the possibility of trade-based money laundering and on
B2B transactions. This will bring with it additional regulatory oversight and scrutiny. The GST system is gradually becoming a repository of all transactions, which will make scrutiny easier. Businesses will be forced to adapt as both the banks and government start addressing the fundamental concern about the industry, which is the perceived lack of transparency (both in stock and receivable valuation) in understanding the underlying viability of the business, and this is where the trade can begin to make vital contributions in rebuilding the confidence.

Self-regulating the industry
The industry has to come forward and take greater responsibility in self-regulating itself in order to avoid the possibility of regulatory and banking overreach. Self-regulation implies that the industry would set and monitor adherence to the standards which businesses would need to follow. Quite simply, unless the industry becomes pro-active and accepts changes, more un-palatable requirements would be forced upon the industry.

It is important, at this point, to distinguish between self-regulation and self-governance. Another fallout of the crisis was that the government took away some of the regulatory and oversight powers of the Institute of Chartered Accountants of India (ICAI) over their members. The National Financial Reporting Authority (NFRA) was established by the government to regulate audits of large companies and it has the power to impose fines and debar chartered accountants. The ICAI lost some of its powers of self-governance, while the self-regulatory role continues.

For our industry, the self-regulation will need to clearly cover the following aspects:

- **Code of ethics** – This is really the starting point and states the principles and standards to which the companies within the industry will adhere to.
- **Identify the trade participants** – Identify genuine industry participants given the nature of the industry, this should be easily identifiable with the help of industry bodies, both within the country and outside the country. It would give banks greater confidence to fund invoices which are made out to such companies.
- **Enhance compliance** – In India, there are already enough laws which exist, however, the compliance to these laws needs to be monitored, including the Prevention of Money Laundering Act (PMLA), which is also targeted to reduce trade-based money laundering.
- **Sharing information** – In the age of big data, establishing a simple credit information system, at least in India, should be quite straightforward. Examples exist in other countries where this has been done decades ago, however, our industry needs to be willing to share information. The key to this will be to establish an entity which can collect and compile the transaction history received from both banks and industry participants. With the government’s consent, information can also be fed in from the GST system, if feasible.

In the diamond industry, India is the primary global polishing centre, and Indian banks account for more than 50-60% of the total credit to the industry. The industry and banks working together can simultaneously de-risk the industry while also improving overall profitability.

In the long run, the only way to reduce the risk profile of the industry is for banks and the industry to work together. While this has not happened in the past due to the reluctance of the industry to share information, it is critical for the future of an industry which provides employment to 3-4 million people in India. We have a one- to two-year window, and we need to change ourselves and the industry for the better.

In the words of Winston Churchill, “Never waste a good crisis.”

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