

Sugar-coated political risk hits public sector banks

In India, political risk is not only impeding business, but also spilling over to financial institutions. On Monday, the Supreme Court rejected an appeal against an Allahabad high court order directing sugar mills to sell stocks to repay cane farmers.

Banks had argued they had first charge over sugar stocks and they should be used to repay the loans taken by the mills. The apex court observed, according to a news report on the *Times of India* website, that the cane growers' right to life is more important than the banks' right to carry on business. That is no doubt a humane way of looking at things, but also presents a rather chilling prospect for banks and their ability to ring-fence their collateral.

A fundamental question that arises is whether a financial institution's interests will now be secondary to public interest, even if the business in question is reliant on loans. Claims of shareholders, for instance, are secondary to creditors. But now, one more element of public interest may have been added to this equation.

Of course, this observation is specific to this case. And, this case itself has some peculiarities. It results from a public interest litigation (PIL) filed to ensure that mills pay farmers' sugar cane arrears. They were asked to pay the dues to farmers by 31 October by selling stock. The high court said that the mills were not disputing the liability, but banks were opposing the move.

Now, sugar mills operate on a long working capital cycle, being a seasonal business, and raising bank funds is common practice. Under Uttar Pradesh state law, mills are allowed to borrow money against their sugar stocks, but on condition that a percentage of these loans are used to settle dues to sugar cane farmers. The judgement mentions that up to 85% of the stocks should be earmarked for payment of the farmers' dues by the mills. However, farmer dues remained uncleared, prompting a PIL. The high court asked mills to sell the stock to repay farmers, but banks objected. Their contention was that their loans entitle them to a first claim over the stock.

But the high court clarified that if the arrears due to farmers are already tagged on to the sugar inventory, then banks cannot have a prior claim.

MARK TO MARKET

RAVI ANANTHANARAYANAN



We welcome your comments at marktomarket@livemint.com

But note that the court did not go into allegations of whether funds were diverted by the mills. Normally, they should have used these loans to repay farmers, freeing the stocks of any claims. The high court order even clarifies that once the arrears are cleared, the banks' right over the stock is restored. Banks now need to enquire why mills did not use their loans to clear arrears, and whether any action can be taken against them. If mills had cleared dues, then the stocks would have been available as valid collateral.

What are the implications of this case? In the near term, banks are sufferers as they may fall short on collateral. Sugar mills are relatively unaffected, except that large sales of sugar will keep prices down. In the medium term, banks may become wary of lending to Uttar Pradesh sugar mills. Or, they may put in a fool-proof mechanism to ensure that no arrears remain on inventory that is held as collateral.

But the mess in the Uttar Pradesh sugar industry continues. The state government succeeded in not only imposing a high state advised price, but also cleared arrears of the current season. Earlier, mills typically carried over dues into the next season. That

is going to see both the state government and farmers unlikely to back down in the current sugar season as well. Expect fireworks in the coming months.

Banks should have ensured that their loans were collateralized properly. However, they also need to become prudent about lending to sectors where government interference is high, and where public and private interests often clash. More importantly for state-owned banks, the ones affected in this case, succumbing to political pressure in lending can be hazardous for their health.

SC order presents a chilling prospect for banks and their ability to ring-fence their collateral

MARK TO MARKET

Mint-
15-10-14

