RBI’s Move on LoUs and LoCs

Why in news?

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The Reserve Bank of India (RBI) has decided to discontinue the issue of Letters of Undertakings (LoUs) and Letters of Comforts (LoCs).

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What are LoUs and LoCs?

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- **LoUs -** These are assurance given by one bank to another to meet a liability on behalf of a customer, which is usually valid for 180 days.
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- It is used for overseas import remittances and involves four parties an issuing bank, a receiving bank, an importer and a beneficiary entity overseas.
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- LoUs are conveyed from bank to bank through “Society for Worldwide Interbank Financial Telecommunication” (SWIFT) instructions.
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- **LoCs -**A letter of comfort is a written document that provides a level of assurance that an obligation will ultimately be met.
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- In its traditional context, a letter of comfort is given to organizations or persons of interest by external auditors regarding statutory audits, statements, and reports used in a prospectus.
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- The letter of comfort will be attached to the preliminary statements as assurance that it will not be materially different from the final version.
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What are the significance of these instruments?

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- LoUs and LoCs offer exporters a source of cheap and dynamic working capital in a banking system that is clotted with high interest rates and complex procedures.
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- When mobilised legally with appropriate margin money and bank guarantees logged into the bank's formal transaction recording system LoUs have proven to be more convenient sources of funding than the conventional letters of credit (LoCs).
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What will be the shortfalls of this move?

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- RBI seems to be to have overreacted on the PNB scandal which involved the infringement of LoU protocols. Click here to Know more.
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- Depriving exporters of this instrument can have a disruptive effect on the buyers' credit market and several adverse consequences for the economy at large.
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- It would raise borrowing costs by between 0.5 percentage point and 1 percentage point.
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- Exporters will also be forced to access the dollar market for funds, exerting pressure on the rupee just as oil prices are hardening.
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- Apart from other anxieties this ban comes at a time when disruptions caused by the goods and services tax (GST) are yet to be sorted out, as many exporters have been waiting for months for offset dues from the Integrated GST to materialise.
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What needs to be done?

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- A racehorse sector such as gems and jewellery, which accounts for roughly 16 per cent of India’s exports and employs over 5 million workers, could be a particular victim of this move.
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- Although only about 5 per cent of jewellers utilise the LoU/LoC route, these are usually the bigger players that account for the bulk of exports, India being the world’s largest exporter of cut and polished diamonds.
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- RBI must consider the fact that the prime factor of the recent scam is not LoUs, its noncompliance of the state owned bank with CBS (core banking system) and SWIFT.
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- Thus this integration should be the focus of the RBI’s concerns for all banks that are involved in export finance so that disclosure is institutionalised rather than dependent on the integrity of a bank executive.
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- Besides no instrument, whether LoU or LC, can be considered 100 per cent safe so banning one in preference to another demands much more serious examination of RBI.
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Source: Business Standard

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