

## General Studies-3; Topic- Indian Economy and issues relating to planning, mobilization of resources, growth, development and employment.

### Letters of Undertaking (LoU) and Letters of Credit (LoC)

#### 1) Introduction

- Issuance of LoUs was banned in March by RBI after their misuse was detected in the Punjab National Bank (PNB) scam.
- Terming the ban by RBI a 'knee jerk' reaction to the PNB fraud, the Parliamentary Standing Committee on Commerce has sought immediate restoration of issuance of LoUs and LoCs with proper safeguards.

#### 2) Highlights

- The Committee feels that the RBI got unnerved with the PNB fraud and it hastened the decision to ban LoU/LoC without much thought and consideration.
- The Committee said that RBI should have engaged in more consultations with stakeholders on the matter before resorting to discontinuation of LoUs and LoCs.
- The discontinuation of LoUs and LoCs as a response to the fraud has set an effect of conservatism in the banking sector.
- The committee stressed the need for streamlining and simplifying the processing of LoUs and LoCs issued by the banks.
- The committee said in present times when the currency is witnessing high depreciation, it is imperative that the cost of credit for imports must be minimal.
- The ban on LoU/LoC takes away the benefit of cheap source of funds availed by the importers.
- The panel suggested that SBI must ensure that small and medium enterprises (SMEs) borrowers are not left out and hoped other banks would also come up with products, which would provide similar benefits as LoU/LoC.

#### 3) Reasons for restoring LoUs and LoCs

- The discontinuation of the LoU and LoC facility had resulted in a 2-2.5% increase in the cost of credit.
- This will affect the cost competitiveness of the country's trade and industry and have a cascading effect on jobs.
- The country cannot afford the job loss.
- All the stakeholders, including banks, were of the opinion that LoUs and LoCs were accepted globally.
- They are efficient as a source of cost-effective short term credit of foreign currency for importers.
- Rating agencies, too, had sounded caution on the LoU ban.
- The Indian unit of global rating agency, Fitch, had said that banning LoUs will reduce the financial flexibility of importers, lead to liquidity pressure and result in higher funding costs for small companies.
- Indian traders are facing global restrictions (protectionist policies in developed markets/ trade wars), problems in the domestic market (demand, labour), currency imbalances across markets.
- The banning of LoUs also hit exporters hard since they use these instruments heavily to buy raw materials that are used to make export materials.

#### 4) Benefits of restoring LoU and LoC

- They will benefit number of companies engaged in cross-border trade, particularly SMEs.
- Its restoration assumes more significance because the content of imports is over 20% of India's total exports.

#### 5) What is Letter of Undertaking (LoU)?

- LoUs are used in international banking transactions.
- LoU is a bank guarantee under which a bank allows its customer to raise money from another Indian bank's foreign branch in the form of short-term credit.
- The loan is used to make payment to the customer's offshore suppliers in foreign currency.
- The overseas bank usually lends to the importer based on the LoU issued by the importer's bank.
- The messages are sent through SWIFT — an inter-bank messaging network for securely transmitting instructions for financial transactions.
- The LoU is akin to a letter of credit or a guarantee.
- An LoU involves four parties — an issuing bank, a receiving bank, an importer and a beneficiary entity overseas.

#### 6) What is a 'Letter Of Credit'?

- A letter of credit is a letter from a bank guaranteeing that a buyer's payment to a seller will be received on time and for the correct amount.
- In the event that the buyer is unable to make payment on the purchase, the bank will be required to cover the full or remaining amount of the purchase.

#### 7) Difference between LoU and LoC

- A letter of credit is more secure because it has the details of the purchase by the importer, date of issue, expiry date, the material purchase and other transaction details.
- LoU does not have these details and when it is not linked to the banking system it cannot be traced like it happened with PNB.

#### 8) What is SWIFT?

- When LoU is issued, the message of credit transfer is conveyed to overseas banks through the Society for Worldwide Interbank Financial Telecommunication (SWIFT) system.
- Such SWIFT information need to be recorded in a bank's core banking system.
- This is significant information as it gives the bank's consent and guarantee.

#### 9) What is CBS?

- Core Banking System is where all branches are inter-connected to ensure that the bank customers - regardless of their home branch - are able to operate their account and transact in any of the member branch located anywhere in the world.

#### 10) Why is it important?

- LoUs are important instruments that allow those in the import trade to transact their business.
- As an importer in India cannot simply buy dollars and send it abroad to make payments to his supplier, instruments such as LoUs and LoCs are required to carry out the transaction.
- LoUs, which are essentially a form of guarantee, have come to be a far cheaper and convenient way for importer to raise credit.
- RBI must strengthen and tighten regulations rather than discontinuing a legitimate product and tool.