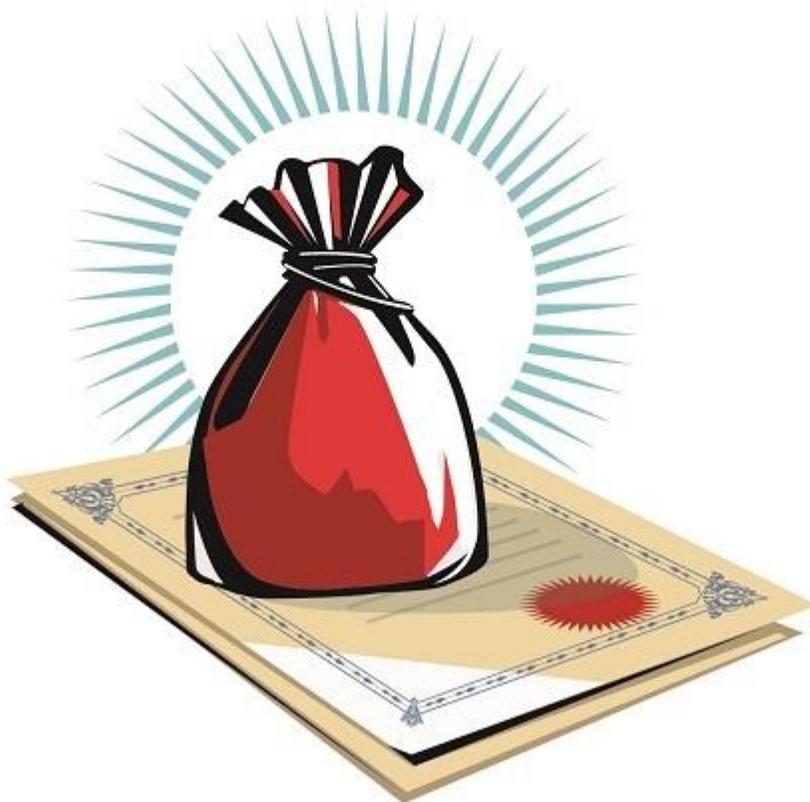


Business Standard

Scrapping of guarantees by RBI to hit foreign branches of Indian banks

Many medium size and small enterprises (SMEs) will also face the heat, say banking officials

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The Reserve Bank of India's (RBI) directive to stop issuing letters of comfort (LoCs) and letters of undertaking (LoUs) for importers will hit foreign branches of Indian banks, especially those from the public sector space. It is also likely to hasten rationalisation of such branches.

Many medium size and small enterprises (SMEs) will also face the heat, say banking officials.

Trade finance is essentially short-term credit, which includes LoUs, LoCs, letters of credit (LCs), guarantees and the like. These are a significant part of the foreign business at state-owned banks. Also, the capital requirement of public sector banks (PSBs) could go up for the trade finance exposure. It attracts risk weight, especially for clients which will have to migrate from LoUs and LoCs to bank guarantees and LCs.

LoCs and LoUs were loosely structured products; evaluation was not stringent. As against this, bank guarantees and LCs are universally accepted and standardised products; the scrutiny is also strict and comes with enhanced collateral and margin requirement. The net effect is that banks will have

to set aside more capital.

As for rationalisation of the foreign branches, the government has already questioned the need for five-six PSBs having branches at a single location, such as Hong Kong, said a senior executive with Bank of India.

Bankers say it is SMEs and not the large corporate groups which are going to face the brunt of the latest RBI move.

Shobana Kamineni, president, Confederation of Indian Industry (CII), said the buyers' credit market would be hit in the immediate term. Those doing business through the two instruments in question would have to shift to LCs and bank guarantees. So, the cost of credit is likely to rise, especially for the smaller enterprises.

CII says the RBI could have instead strengthened the regulations on LoUs and LoCs. Or announced a phasing out, rather than completely stopping a legitimate and established product. The central bank's intent in cleaning the system is appreciated, it clarifies, after the misuse of products and malfeasance on a massive scale.

Nikunj Turakhia, president of the Steel Users Federation of India, said: "The sudden withdrawal of LoUs or LoCs is highly detrimental to imports. There will be sudden funds crisis and companies which avail bank credit for 'at sight' import documents will face the music."

Big steel companies say they would not be affected by the withdrawal of LoUs. A top official at one said, "Every bank has set a borrowal limit, based on the company's standalone rating. So, the domestic branch blocks the amount and the overseas branch gives the loan. We have never used LoUs or LoCs."

An official at another steel company said it mostly used LCs. "It is the small and medium corporates which are likely to be affected. Some importers who enjoy a good reputation in the market and don't use LoUs will stand to gain," said the official.

Conversations with makers of electronics, durables and paints reveal the instrument used to settle dues of suppliers abroad are mainly LCs, not LoUs. This, they say, is a safe route, insured by international agencies in countries from where imported components or partly built units come.

Harkirat Singh, managing director of Aero Group that owns the Woods and Woodlands brand of footwear, says his company or sector would not get impacted. They mainly deal in LCs or advances.

An official representing a large automobile maker said the industry used various instruments — LCs, direct payments and credit. Planning and programmes are made for longer terms. So, the impact would be limited.

LoUs are typically, say sources, used in the gems and jewellery sector, and by traders dealing in commodities and chemicals.