

**MARCH 16, 2018**  
**ISSUE NO: 77, FY18****LOC BECOMES LOD / LETTER OF DISCOMFORT**

In light of the recent events getting unearthed in the banking sector, it has been decided by RBI to discontinue the practice of issuance of LoUs/ LoCs for Trade Credits for imports into India by AD Category –I banks with immediate effect.

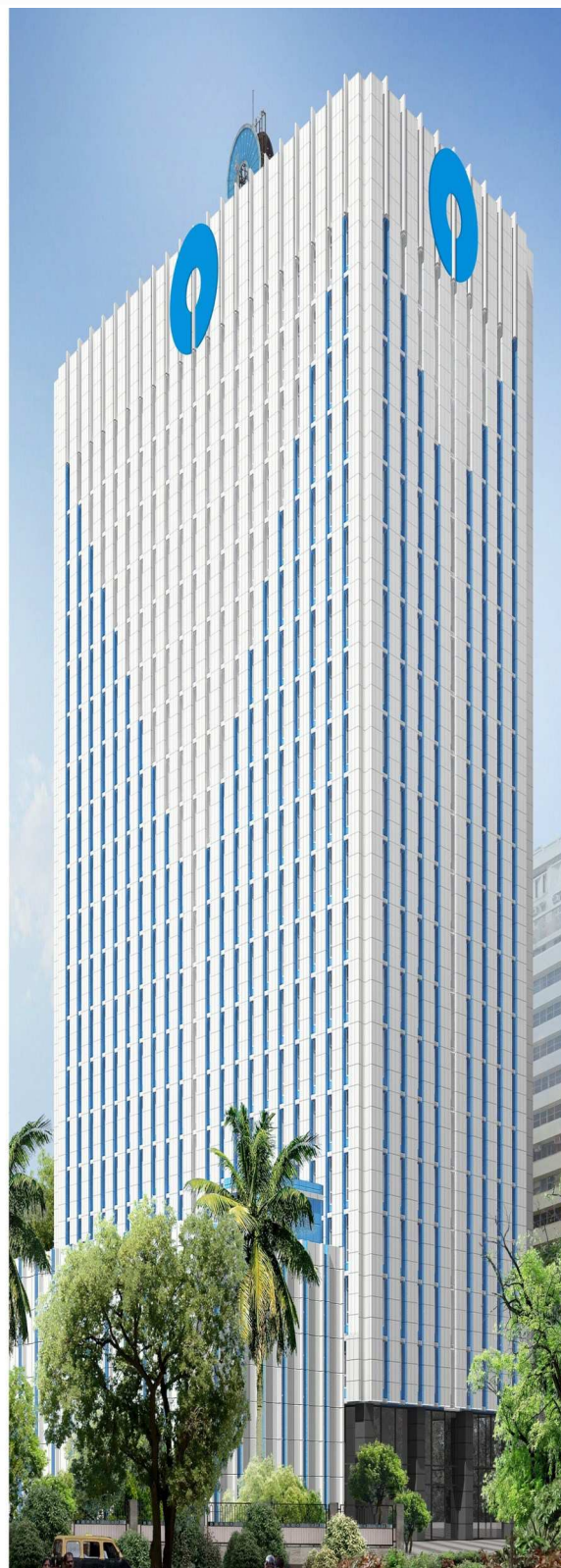
Banning LoUs/LoCs might lead to shifting to other off balance sheet products i.e. LCs, Bank Guarantees, other fund based facilities etc. or on to balance sheet. We, however, believe such shift to other off balance sheet products, if it occurs will be administratively time consuming.

In terms of numbers, as per latest available RBI data, under Contingent Liabilities (Guarantees Given on behalf of Constituents Outside India) stood at Rs 1.95 lakh crore as on 31st Mar 2017. When we look at ASCB credit the figure stands at Rs 81 lakh crores. Guarantees outside India, if looked at as % of total ASCB Advances are 2.4% and this share has in fact reduced over the years.

While it may be hazardous to guess the impact of abolition, nevertheless we have treaded on this path to put a number to it. Taking scenarios of 10% and 20% of the above off balance sheet exposure in LoUs/LoCs amounts to around Rs 20000-40000 crore. This amount which has been in the system through credit by overseas banks/branches on the back of LoU/LoCs as hitherto, will possibly now be financed through alternate arrangements/products.

The other impact could be foreign branches of Indian banks witnessing some decline in business and an increase in borrowing costs.

However the impact on capital charge is not clear and may vary for different products leading to changes in capital requirements in either direction depending on the product used and associated risk. For example, in LOUs/LOCs which are direct credit substitute Credit Conversion Factor (CCF) is 100%. The same is 20% under Short-term self-liquidating trade-related contingencies (such as documentary credits collateralized by the underlying shipments).

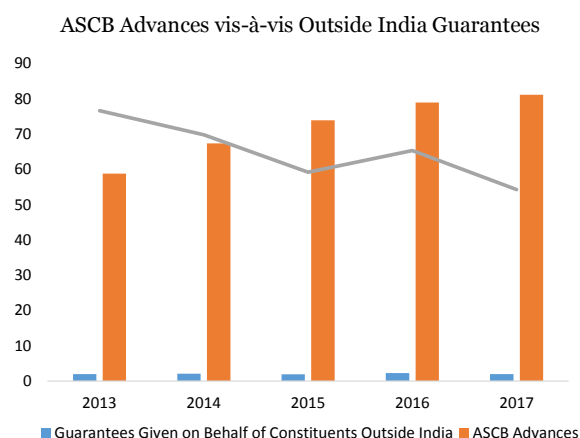


## RBI SCRAPS LOU/LOC

- ♦ AD Category I banks were permitted to issue Guarantee/ Letters of Undertaking (LoU) /Letters of Comfort (LoC) in favour of overseas supplier, bank or financial institution up to USD 20 million per import transaction (Automatic route) for a maximum period up to one year in case of import of non-capital goods (except gold, palladium, platinum, rhodium, silver, etc.). For import of capital goods, the period of guarantee/ Letters of Credit/ Letters of Undertaking by AD can be for a maximum period up to three years.
- ♦ However, in light of the recent events getting unearthed in the banking sector, it has been decided by RBI to discontinue the practice of issuance of LoUs/ LoCs for Trade Credits for imports into India by AD Category –I banks with immediate effect.
- ♦ Banning LoUs/LoCs might lead to shifting to other off balance sheet products i.e. LCs, Bank Guarantees, other fund based facilities etc. or on to balance sheet. We, however, believe the shift to other off balance sheet products if occurs, will be administratively time consuming. However capital charge may vary for different products leading to changes in capital requirements in either direction depending on the product used and associated risk. For example, in LoUs/LoCs which are direct credit substitute Credit Conversion Factor (CCF) is 100%. The same is 20% under Short-term self-liquidating trade-related contingencies (such as documentary credits collateralized by the underlying shipments). For fund based facilities the risk weight is as per the rating of the borrower on the total exposure.
- ♦ As per latest available RBI data, Guarantees given on Behalf of Constituents outside India stood at Rs 1.95 lakh crores as on 31st Mar 2017. When we look at ASCB credit the figure stands at Rs 81 lakh crores. Guarantees outside India, if looked at as % of total ASCB Advances are only 2.4% and this share has in fact been reduced over the years.

Contingent Liabilities of Scheduled Commercial Banks (Amount in Rs Crore)		
	Guarantees Given on Behalf of Constituents	
As on March 31	In India	Outside India
2012	594337	192124
2013	665737	200224
2014	718486	208919
2015	795773	194443
2016	824360	229210
2017	887770	195795

Source: Table No.6, Statistical Tables Relating to Banks in India, RBI



Amount in Rs lakh crore, Source: RBI, SBI Research

- ♦ Taking scenarios of 10% and 20% of the above off balance sheet exposure in LoU/LoC amounts to around Rs 20000-40000 crore only. This amount which has been in the system through credit by overseas banks/branches on the back of LoUs/LoCs as hitherto, will possibly now be financed through alternate arrangements/products. These may be through LC, Financial Guarantees, PC etc. We can also say domestic credit may increase to some extent as an alternative mechanism of funding, though foreign branches may see some decline in business. The costs of funds are expected to go up for customers who may avail of LC etc. (LC opening charges, negotiation / collection etc).
- ♦ Overall, we believe even though Guarantees are a miniscule portion of total ASCB advances and hence impact on credit growth may not look statistically large because of such discontinuation, there could be an increase in borrowing costs.

Arithmetic of LoCs/LoUs		
ASCB Advances as on 31st Mar 2017 (Rs Crore)	8116197	
Guarantees Given on Behalf of Constituents Outside India as on 31st Mar 2017 (Rs Crore)	195795	
Assuming LoUs/LoCs constitute % of the Guarantees Given on Behalf of Constituents Outside India	10%	20%
	19579	39159
LoUs/LoCs as % of ASCB Advances	0.2	0.5

Source: RBI, SBI Research

## ABOUT US

The Economic Research Department (ERD) in SBI Corporate Centre is the successor to the Economic and Statistical Research Department (E&SRD). The latter came into being in 1956, immediately after the State Bank of India was formed, with the objective of “tendering technical advice to the management on economic and financial problems in which the Bank has interest and which required expert analysis”.

After the first reorganization of the Bank, when specialized departments like Management Science, Management Information Systems, Planning and Market Segment Departments took over the statistical work of E&SRD, the Department was renamed as ERD.

However, with the ERD team now taking on multidimensional functionalities in the area of risk management , corporate analytics, strategy and so on, who knows, the time may have come to rename it again!

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