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NEWSALERT

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RBI DISCONTINUES ISSUANCE OF LETTERS OF UNDERSTANDING AND LETTERS OF COMFORT FOR TRADE CREDITS

1. BACKGROUND

In an attempt to promote investment activities and to liberalize the procedures relating to trade credits for imports, the Reserve Bank of India (the "**RBI**") in 2004, had granted permission to authorized dealer banks ("**ADs**") to issue letters of undertaking ("**LoUs**") or letters of comfort ("**LoCs**") in favour of overseas suppliers, banks and financial institutions, to approve trade credits, for import of all non-capital goods (except gold) and capital goods permissible under the Foreign Trade Policy, subject to prudential guidelines issued by the RBI from time to time.

However, following potential liabilities arising in the context of Punjab National Bank's credit support for Indian jeweller, Nirav Modi, on March 13, 2018, the RBI directed ADs to discontinue the issuance of LoUs or LoCs for trade credits for imports into India with immediate effect.[1]

2. CREDIT INSTRUMENTS

LoUs and LoCs are forms of facilitating trade finance, which are used by importers to fund overseas purchases. They are used as lending instruments through which an AD assures the supplier in relation to the liability of the buyer.

A LoU is broadly, an undertaking issued by the AD on behalf of a buyer to the supplier, that the buyer would fulfill the terms and conditions of the transaction.

On the other hand, a LoC is a document issued by the AD regarding statutory audits, statements, and reports that certify the financial soundness of the buyer to meet the repayment obligations under the transaction.

3. LETTERS OF CREDIT AND BANK GUARANTEES

Although the RBI notice discontinues LoUs and LoCs, the issuance of *letters of credit* and *bank guarantees* as trade credits for imports into India may continue, subject to compliance with the provisions contained in the Master Circular on Guarantees and Co-acceptances, dated July 1, 2015, as amended from time to time.[2]

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[1] A.P. (DIR Series) Circular No. 20
[2] DBOD.No.Dir.BC.17/13.03.00/2014-15

IndusLaw View:

It's an open question at the moment, whether the contingent liabilities incurred by Punjab National Bank ("PNB") in the context of loans extended to Nirav Modi's jewellery company by foreign banks or foreign branches of Indian banks, were caused by risks inherent in these instruments themselves, or otherwise, the systemic failure by PNB to record their issuance and monitor aggregate liabilities in the context of any cash collateral or other counter-indemnities deposited with the bank.

By removing these instruments from the menu card, Indian importers of goods and services will now need to rely on letters of credit or bank guarantees, essentially, increasing the transaction cost of doing business.

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