Report of the

Working Group on

# Discounting of Bills by Banks

# Contents

Page No.

Contents ..................... i

**Executive Summary ..................... 1**

Preamble ..................... 1

Bill Financing – Historical Perspective ..................... 2

Bill Financing – Key Issues ..................... 3

Alternatives to Bill Financing ..................... 8

Banker's Acceptance ..................... 9

Bill Financing – Services Sector ..................... 11

Challenges of e-Commerce ..................... 13

Chapter - 1

**Introduction ..................... 15**

Constitution of the Working Group ..................... 15

Members of the Working Group ..................... 15

Members co-opted to the Main Group ..................... 16

Terms of Reference ..................... 16

Approach of the Working Group ..................... 16

Acknowledgements ..................... 18

Chapter - 2

**Bill Financing – Historical Perspective ..................... 19**

Measures to Promote Bill Market ..................... 24

Chapter - 3

**Bill Financing – Key Issues ........ 27**

Trends Abroad ........ 27

Domestic Trends ........ 28

Payment Discipline ........ 29

Changing Trade Pattern ........ 29
Operational and Procedural Constraints ........ 30
Transaction Cost ........ 31
Stamp Duty ........ 31
Dominance of Cash Credit System ........ 32

Recommendations ........ 33

Pricing ........ 33
Removal of Operational Constraints ........ 34
Stamp Duty Exemption ........ 34
Payment Discipline ........ 35
Supervisory Guidelines – Need for Review ........ 35
Product Innovation ........ 38
Credit Insurance ........ 39

Chapter - 4

**Alternatives to Bill Financing ........ 41**

Invoice Financing ........ 41

Methodology of Invoice Financing ........ 41
Special Features ........ 42

Post-Dated Cheques ........ 44

Recommendations ........ 45

Chapter - 5

**Banker's Acceptance ........ 47**

Origin & Development ........ 47

Definition and Transaction Mechanics ........ 48

Acceptance Finance - Import Trade ........ 49

Acceptance Finance - Export Trade ........ 49

Acceptance Finance - Domestic Trade ........ 50

Pricing Structure ........ 50

Bankers Acceptance - Indian Scenario ........ 51

Bank Paper - A New Instrument ........ 52

Chapter - 6

**Bill Financing – Services Sector ........ 54**

Chapter - 7

**Challenges of e-Commerce ........ 59**

Annexure - I

*Monetary Policy Department*
Memorandum for setting up of a
Working Group on Discounting of Bills by Banks ........ 65

Annexure - II

Questionnaire to Customers ........ 67

Annexure – III

Questionnaire to Banks ........ 71

Annexure - IV

Analysis of Response to Questionnaire ........ 76

A. Customer Questionnaire ........ 76

B. Bank Questionnaire ........ 82

Annexure - V

List of Persons with whom
the Working Group had discussions ........ 90

Annexure - VI

List of Institutions who made presentations
to the Working Group ........ 91

Annexure - VII
Funding Importer through
Banker's Acceptance – Non-LC Transaction ........ 92

Annexure - VIII
Funding Importer through
Banker's Acceptance – LC Backed Transaction ........ 93

Annexure - IX
Banker's Acceptance – Funding an Exporter ........ 94

Annexure - X
Peculiarity of Services Sector ........ 95

Bibliography ........ 96

# Executive Summary

## Preamble

1.0 Financing post-sale operations against bill of exchange is always considered beneficial from the bankers' point of view since bills represent the receivables stage of the operating cycle of a commercial activity, short term in tenor, self liquidating in nature, provide credit enhancement through acceptance by the drawee, a third party, and offer liquidity to the bank through re-discounting window. However, in the Indian Banking scenario, for decades now, Cash Credit/Overdraft continues to be the preponderant style of working capital funding. While Cash Credit constitutes about 70% of the total bank credit, bill finance is barely at around 10% of total bank credit. Further, bill financing is historically associated with movement of tangible goods and did not cover in its ambit the various types of activities in the services sector, though they arose out of commercial transactions. Services sector is transforming the economic profile of the country and is poised to register tremendous growth and contribute significantly to the overall economy in terms of wealth creation. It is against this backdrop that the Reserve Bank of India constituted a Working Group in December 1999 to examine the possibility of strengthening the existing bill discounting mechanism and extend its scope to services sector in view of the latter's growing importance.

1.1 The terms of reference of the Group are: -

a. **To examine the feasibility and suggest measures to strengthen the existing bill discounting mechanism as an instrument for facilitating financing, in particular trade and services sectors, including discounting of Trade bills against letters of credit opened by banks.**

b. **To examine the role and scope for introducing "Bankers' Acceptance" facility.**

c. **To examine all critical and relevant issues including the necessary safeguards to be put in place before extending Bills discounting to new areas like services and introduction of "Bankers' Acceptance" facility.**

d. **Any necessary changes in the existing legal/regulatory frame work that may be needed.**

e. **Any other issue relevant/incidental to the subject which the Group considers necessary.**

1.2 The Group had extensive interactive meetings with trade associations/ Chambers of Commerce like, Federation of Indian Chambers of Commerce and Industry, ASSOCHAM, Bombay Chamber of Commerce and Industry, Indian Merchants' Chamber, Bengal Chamber of Commerce, Federation of Karnataka Chambers of Commerce and Industry, Greater Mysore Chamber of Commerce and Industry etc., at various centres like Delhi, Mumbai, Calcutta and Bangalore and also with select corporates at Chennai. The Group, through separate structured questionnaire, elicited the views of customers and bankers on various issues pertaining to bill finance. It also had the benefit of the suggestions of banks at a meeting held under the aegis of Indian Banks' Association (IBA) and had the benefit of the views of IBA as well in this regard. Thus based on the responses received to the questionnaire, the views that emerged during interaction with the trade associations, corporates and banks and the findings of the sub-groups, the Group finalised its report.

## Bill Financing – Historical Perspective

2.0 Commercial Bill, which had its origin in Europe is an early medieval financial innovation evolved over centuries – from a personal bond executed by debtor before a Court or a public notary to its present form of a commercial financial instrument - acquiring at various stages of evolution its distinctive characteristics of easy transferability and negotiability, and thus lending itself to discounting by banks to provide liquidity to the holder. With the rapid growth in international trade, bill became the principal instrument of settlement in international trade.

2.1 In India, too, indigenous bankers and other business houses have been historically using some kind of Bill-like instruments written in vernacular languages, known as 'Hundies' in their many variants to pay and receive the value of goods exchanged in the course of trade. However, with the development of organised financial markets over the years, and the spread of commercial banking, the role of indigenous bankers in the financial system diminished in importance and Hundies too gradually started losing their status as the principal instrument of credit and were replaced by Bill of Exchange in its present form.

*2.2* With the dominance of cash credit system in financing domestic trade and industry, Bill Finance, despite its inherent advantages from the point of view of the lending

banker, has been relegated to play only a marginal role in the credit delivery system of the country. The need for the development of Bill culture among borrowers was stressed by the various committees, appointed by the Government of India and the Reserve Bank of India, while examining certain aspects pertaining to bank lending/ money market/ banking sector reforms. These Committees had gone into depth as to the different aspects of working capital financing and stressed the need to promote the Bill culture, so as to inculcate a measure of financial discipline among borrowers. As early as in 1931, the Indian Central Banking Enquiry Committee recommended the establishment of a market in commercial bills. Later, in 1937, an attempt was made by the RBI to bring in the indigenous bankers within the ambit of monetary control, by providing them the facility of re-discounting of their hundies, and granting of advances against the Government securities and remittance facilities similar to those enjoyed by the scheduled banks, provided the indigenous bankers shed their non-banking (mostly trading) business, maintained accounts in the prescribed manner and permitted inspection and audit of their accounts. In the year 1952, a formal attempt was made to create a Bill Market and the "Bill Market Scheme of 1952" (subsequently referred to as "the old Bill Market Scheme") was introduced. The scheme was in vogue for well over 18 years. However, it was the New Bill Market Scheme (NBMS) introduced by the Reserve Bank of India in November 1970 that provided some impetus to the development of Bill Market. Since the introduction of the New Bill market scheme, the RBI introduced several measures to encourage and widen the use of Bills such as, simplification of the rediscounting procedures, promotion of Drawee Bills Scheme, remission of Stamp duty on bills of exchange of three months tenor, selectively increasing the participants in Bill Rediscounting Market, setting up of the Discount and Finance House of India (DFHI), enabling multiple rediscounting of bills and delinking of prime lending rates of banks in respect of bill discounting facilities. Despite all these measures, bill financing has not so far taken off as the preferred mode of financing in any significant manner.

## Bill Financing – Key Issues

**3.0** Bill Financing, as stated earlier, has not been able to even partially substitute cash credit, despite the various Committees' scholarly studies and erudite recommendations and constitutes less than 10% of the total bank credit. It is also pertinent to mention in this context that the loan system too, as one of the three alternative styles of credit delivery in domestic working capital funding, did not meet with any greater degree of success, which underscores the imperative need to revisit the current

style of working capital funding. In this context, it would be pertinent to mention, that discounting of usance bills of exchange to finance domestic trade, as obtaining in our country, seems to be losing its relevance in most other countries. In developed markets like U.K., USA, Europe, Australia, Germany, New Zealand etc., bill discounting facility, as a product, as commonly understood in India is not in use.

**3.1** In India, the major reason cited for the non-development of bill financing is the hesitation of the industry and trade to subject themselves to the rigours of bill discipline. The Group recognizes that vendor payment discipline of a company is an indicator of the ethos of the management of the company and is sine-quo-non for the development of bill culture, which pre-supposes the willingness of trade and industry to subject themselves to the strict commitment to honour financial obligations on the contracted date. Operational and procedural hassles currently obtaining in banking system too are said to impede the growth of bill financing even amongst those business segments where it has found acceptance. These apart, commercial transactions are now generally tending to be more in the nature of open account sales. With the spread of e-Commerce, this trend may get accentuated and there is also growing expectation from trade and industry for on-line completion of transactions.

**3.2** In sum, the convenience offered by other modes of financing, the rigours of payment discipline warranted on bill finance, the market preference for open account sales and the ongoing compression of transaction and settlement time, would all imply that bill finance, with the inherent procedural hassles and transaction cost, will only have a limited role to play in the credit delivery system. The Group considered it imperative to articulate this perspective, so that undue expectations are not continued to be laid on bill financing. At the same time, it would be pertinent to note that some segments of trade and industry may continue to avail bill financing, provided the facility is offered at competitive price with lower margin stipulations, shorn of operational hassles. In some sectors like automobiles, pharmaceuticals and fast moving consumer goods (FMCG), bill financing is found to be gaining a degree of acceptance. Reflecting this trend, about 22% of the respondents to the customer questionnaire felt that bill financing is a convenient mode of availing credit. Thus, it is clear that still a segment of trade and industry, particularly small and medium enterprises, is and would be willing to avail of bill finance and hence the Group makes the following recommendations to ensure that bill financing caters effectively to the needs of these clientele segments.

**3.2.1** In order to propagate bill finance, Banks should take advantage of the freedom to determine the rate of interest on bill finance without linkage to PLR. Conscious efforts are to be made by banks as well as trade and industry, to move over to

a three-tier interest rate structure, corresponding to the style of credit (loans / bills / cash credit), for financing working capital. **Bill finance, being the preferred style of credit from the banker's point of view, should carry interest lower than loan or cash credit, whilst interest rate on loan component of working capital may be charged according to the tenor of the loan, cash credit may carry a higher interest rate. This is in keeping with the international practice, where overdraft, which serves more or less an identical purpose as cash credit, attracts higher interest rate. [para no.3.4.2.1 & 3.4.2.2]**

3.2.2 **With a view to mitigating the operational and procedural hassles entailed in bill finance, the Group recommends that in respect of bill transactions, individual banks may lay down norms for satisfying themselves about the genuineness of underlying commercial transactions and/or the movement of goods. [para 3.4.3(a)]**

3.2.3 **Commercial banks have to revisit their core operating processes in respect of bill transactions and simplify the same with transparent time and cost norms, from the time the bills are tendered for discounting till their realisation.**

3.2.4 **Banks, in order to address the oft-cited problem of delays in realisation of bills, should adopt the system of 'value dating' of client's account, taking advantage of the improved computer and communication network. [para 3.4.3.(b)]**

3.2.5 **In view of the existing trade practice of elongation of credit period beyond 90 days and taking note of the procedural hasssles entailed in stamping of bills hindering the development of bill culture, the Group recommends that stamp duty for all bills of usance upto 182 days be abolished. [para 3.4.4.1]**

3.2.6 **The exemption from stamp duty should be made available to bills discounted by Financial Institutions and Registered Non-bank Finance Companies also. [para 3.4.4.1]**

3.2.7 **The procedure for stamping of documents may be rationalised and made hassle free. [para no. 3.4.4.2]**

3.2.8 **To promote payment discipline, which would to a certain extent encourage acceptance of bills, the Group recommends that all corporates and other commercial entities**

**who have a turnover above a threshold level be mandated to disclose the 'ageing schedule' of their overdue payables in their annual reports as well as in their periodical reports to their banks. [para no.3.4.5.1]**

**3.3.1** While recommending various measures to promote Bill culture, the Group has not lost sight of certain issues of relevance for the healthy development of the Bill market. In fact, supervisory concern was voiced in the year 1992, on the conduct of bill discounting business by banks and non-banking finance companies. The irregularities that surfaced were in the nature of discounting of accommodation bills and bills for long usance, covering sale of shares/debentures or payments like electricity bills, customs charges, lease rentals, etc., excess financing beyond the net worth and/ or credit needs of the clients outside the consortium, leading to diversion of funds, drawal of refinance against ineligible bills, etc. The Reserve Bank of India, therefore, issued on 27$^{th}$ July 1992, a detailed circular Ref. DBOD.NO. BC. 8/16.13.100/92-93 to all commercial banks stressing the need to exercise due diligence in handling their bill portfolio; cautionary advice was reiterated to non-banking finance companies in October 1995 as also in March 1997. Concern was also expressed in the matter of banks extending "one-off" transaction facilities, or discounting of bills against LCs, without assessment of credit needs of the borrowers on the well-established credit norms. The supervisory view was that L/C was merely a guarantee against payment risk and not assurance of proper credit appraisal. The Group shares equally the supervisory concern as regards the need for banks exercising utmost caution and due diligence in administering the bills portfolio. Without in any manner detracting the supervisory concern in this regard, the **Group considers that the irregularities pointed out by the Supervisory Authorities in respect of LC Bill discounting were more in the nature of operational deficiencies, stemming from lax internal processes and controls that were obtaining in the respective banks than any inherent flaw in this as an instrument of credit. It is against this background, the Group recommends that the erstwhile micro-level guidelines concerning bill financing contained in Circular DBOD.NO.BC.8/16.13.100/92-93 dated 27/7/1992, be amended, leaving it to individual banks to lay down appropriate internal guide lines and prescribe suitable controls**.

**3.3.2** In the matter of discounting of bills drawn under LCs or establishing LC as one-off transaction, some of the banks which have extended such one-off facilities outside the consortium contended that when a bill under LC is discounted with a bank, the underlying trade receivable is extinguished and if the loan covenant so stipulates, the seller is obligated to credit the proceeds to his account with the existing bank and any breach of such a covenant can entitle the banker to initiate action against such a borrower. To reinforce their view, they argued that the position of the existing banker is no less vulnerable with respect to receivables against which it would have advanced, as the seller receives payment for such sales directly from his customers;

if he so decides, he can divert such sales realisation to other banks. **In view of the above and considering the prevailing competitive market conditions and the various financing options available in the market to quality borrowers, the Group recommends that borrowers may be permitted to discount bills drawn under Letters of Credit with any bank of their choice, outside the existing consortium / multiple banking arrangement.** To guard against diversion of funds by the borrower, the discounting bank should, however, remit the proceeds of the bills so discounted to the lead bank in the case of consortium arrangement or to the bank, which has the largest credit exposure in the case of multiple banking arrangement. While submitting the bills to the banker for discounting, the borrower should be required to make a declaration giving details of consortium/multiple banking arrangement and to authorise the discounting bank to remit the proceeds to the lead bank or the bank which has the maximum exposure under multiple banking arrangement. It is also necessary for the discounting bank to exercise due diligence before entertaining the clientele for such "one-off" transactions.

**3.4** During the interactive meeting of the Group with Corporates, the representatives of non-banking finance companies submitted that bills discounting was part of their normal business activities and hence they should be allowed to rediscount with banks all the bills discounted by them without any restriction. **The Group after careful consideration recommends that the existing restriction on banks in rediscounting the bills discounted by NBFCs be removed, subject to individual banks prescribing the eligibility criteria for such rediscounting in line with their credit policy and laying down adequate safeguards, with the approval of their respective Boards. (para 3.4.6.11)**

**3.5** The Group is conscious of the fact that banks have to structure their loan products to suit clientele needs and thereby bring about innovation and product differentiation. Hence, **new alternatives to bill financing like Invoice Financing and Secured Fixed Rate Note on the lines of asset-backed Commercial Paper, prevalent in developed markets may be introduced. Factoring services could also be revitalised. The regulatory framework could also play a facilitating role in regard to such product innovation/development, as long as the funds are channeled to finance genuine commercial transactions. (para 3.4.7.1 to 3.4.7.4)**

**3.6** **Financing against receivables will gain momentum if a system of Credit Insurance as is obtaining in the West, is in place. Hence the Group recommends that a Credit Insurance Scheme for insuring domestic receivables on lines similar to the ones prevailing abroad may be introduced. [para no.3.4.8.1 to 3.4.8.3]**

## Alternatives to Bill Financing

**4.0** In the light of inherent hesitation on the part of majority of trade and Industry to subject themselves to bill discipline as well as the various costs and operational hassles entailed in bills financing, it is but necessary that a cost effective flexible alternative system to bill finance is evolved and introduced with appropriate legal framework to aid the creditor recover his dues with least hassles. With open account sales becoming the preferred mode, there are practices obtaining in some developed countries where banks extend working capital finance on an ongoing basis against invoices raised by their clients' on their buyers. One such financing arrangement is factoring, which is yet to take roots in India. A variant of factoring is Invoice Financing, which is also becoming popular in mature markets like the United Kingdom, Australia etc. In Australia, the market for Invoice Financing is placed at $ 3.4 billion p.a. with an annual compounded growth rate of 20%.

**4.1** Invoice financing, as a loan product, offers the financial benefits of factoring, while allowing the client company full control over the receivable management. This will be ideally suited to the Services Sector, where due to the inherent nature of its operations not involving movement of tangible goods, drawing of Bills of Exchange is not generally in vogue. Under Invoice Financing, there is also scope for flexibility as to the quantum of potential funding, as it is based on the level of debtors. Also, the credit line is based on the financial strength of the borrowing client's debtors as well as the borrower's own financial strength. Invoice Financing is provided under a 'non-disclosed' basis, which implies that the client's customers would not be aware of the arrangement, as long as there is no default. The client is bound to make payment on the due date, irrespective of the fact whether the debtor has paid or not. The bank has a right to disapprove debtors / any invoice raised and make them ineligible for financing under this scheme for reasons of adverse credit report or their payment record. In many domestic industries, it is observed that sales do not occur on a uniform basis and fluctuate from month to month. Hence the present system of receivable financing through cash credit is found to be inappropriate, leading to intermittent over-financing or under-financing. Invoice Financing would be more appropriate to cater to such clientele segment, particularly Small and Medium Enterprises, start-up units with potential for rapidly expanding sales and units with unpredictable cash flows and a high proportion of receivables in their working capital cycle.

**4.2** **The Group, therefore, recommends that Invoice Financing may be introduced in the domestic market to cater to the needs particularly of small and medium enterprises, as one of the alternative loan products to bill financing.** Legal recognition may be accorded to equitable assignment of debts financed by banks in favour of the lending banker, which can facilitate banks in recovering dues without

any loss of time. The Group also recommends exemption of stamp duty on such equitable assignment, so that the cost of credit is not pushed up.

4.3 As mentioned earlier, one of the major factors inhibiting Bill Financing is the lack of payment discipline amongst buyers. It is in this context that the Group took note of the growing acceptance of usage of post-dated cheques to assure the creditors of payment on due date. This practice has gained momentum with the provision of criminal action under Sec.138 of the Negotiable Instruments Act, for dishonour of cheques for insufficiency of funds in the account. **Hence, in order to improve payment discipline, it is suggested that wherever possible, clients can back up their credit availments from banks under facilities like bill discounting, Invoice financing, etc., with post-dated cheques of their respective debtors. Instruments like GIRO, a post-dated instrument in use in some markets like Indonesia or Debit Mandate issued in favour of the creditor by its debtor, all of which serve the ultimate objective of certainty of payment on the due date, can also be introduced. The client can deposit such cheques or the like instruments with the financing bank to facilitate recovery on due dates. (para 4.2.1 to 4.2.6)**

## Banker's Acceptance

5.0 The Group, under one of its terms of reference, also examined the role and scope of introducing 'Banker's Acceptance' (BA) facility in the Indian Financial Markets. BA has been in use in markets like USA and Europe primarily in financing international trade. Historically, BA backed by Trade Bills had readily available discount windows like the Discount Houses in the U.K. and the Central Banks like the Bank of England and Fed Reserve.

5.1 BA is a time draft or bill of Exchange drawn on and "accepted" by a bank as its commitment to pay a third party. The parties involved in a banker's acceptance are the Drawer (the bank's customer - importer or exporter), the Acceptor (a bank or an Acceptance House), the Discounter (a bank which could be the accepting bank itself or a different bank or a discount house) and the Re-discounter (another bank, discount house or the Central Bank). A "BA" is accepted, when a Bank writes on the draft its agreement to pay it on maturity. The Bank becomes the primary obligator of the draft or bill of exchange drawn on and accepted by it. In effect, BA involves substituting bank's creditworthiness for that of a borrower. The accepted bill bears an irrevocable, unconditional guarantee of a bank to pay the bill on maturity, in the process creating a negotiable instrument that is also attractive to investors in short term paper. BA compared favourably as a funding avenue

in terms of cost vis-à-vis LIBOR based loans. However, in the US market in recent years the popularity of BA has been on the wane due to a host of market developments, particularly the emergence of cost-effective instruments from borrower's point of view like the asset-backed Commercial Paper and Euro-Commercial Paper and narrowing spreads between yields on Euro-dollar deposits and BA, leading to investor indifference between the two as the preferred investment avenue.

5.2 BA, as such, is not currently prevalent in the Indian financial market. The closest to BA is the co-acceptance by the Bankers in the case of deferred payment guarantee (DPG) extended primarily for acquisition of capital equipments. Though in the matured financial markets like the U.S., BA is on the decline, in a developing financial market like ours where credit products and substitutes are too restricted, the Group feels that there is scope for introduction of Banker's Acceptance. **The Group, therefore, recommends that Banker's Acceptance be introduced in the Indian market to finance import, export and domestic trade transactions. However, care has to be taken to ensure that BAs are issued to cover only genuine trade transactions. Since banker's acceptance is the substitution of bank's creditworthiness to that of the borrower, it is necessary to ensure that adequate safeguards are in place through prescription of appropriate regulatory norms and bank's own internal guidelines, which are briefly discussed below. (para 5.7.2)**

5.3 Banker's Acceptance, being a tradable money market instrument, its liquidity and pricing in the secondary market would largely hinge upon the rating of the bank that grants the acceptance. In a market dominated by banks having substantial government holding, assessment of bank's creditworthiness and pricing of BA's may be largely driven by the perceived comfort level afforded by such sovereign holding. But with the entry of more private sector players and the possible phased dilution of government's stake in public sector banks, pricing of the instrument may over a period of time tend to reflect individual bank's rating. **Therefore, proper rating mechanism for Banker's Acceptances may become necessary as the market develops.**

5.4 Since BA entails substitution of bank's credit for that of the borrower, **to restrain temptation of banks' over gearing, prudential regulation may prescribe a ceiling for such off-balance sheet exposure and also due disclosure from time to time on the extent of such exposure** - both the amount of acceptances issued and the outstanding position to the supervisory authority. Such information should be available to all market participants too.

5.5 The accepting banker should ensure that the **acceptance facility is extended only to well rated clients. The pricing of acceptance fee by banks would depend upon the rating of clients.** To avoid any delegatee transgressing the authority and also to ensure full control over such acceptances issued, banks may have to

restrict acceptances to pre-approved clients and for high value transactions. According "Acceptances" can be centralised and have to be computerised; in the case of large banks, two or three BA processing centres can be established to accord 'Acceptances'.

**5.6** All the above safeguards are required to be in place, since BA's unlike LC's and bank guarantees, being tradeable instruments primarily on Bank's Credit, carry the risk of systemic contagion.

**5.7** Considering the unique nature of our existing cash credit system, the Group also suggests a variant of Banker's Acceptance, so as to provide liquidity to domestic banks in their credit portfolio. **Accordingly, the Group recommends that borrowing clients who enjoy working capital limits of say Rs.10 crore and above, and whose rating with the bank has been consistently satisfactory, may be allowed drawals against the Working Capital Demand Loan (WCDL) component, on the basis of a tradable promissory note in favour of the lending bank, called "Bank Paper" (BP) [para no.5.8.1].** The lending banker could discount such instrument in the money market. Individual banks could decide the tenor of such instrument as also the minimum amount. Such Bank Paper (BP) should have an inscription that the amount represents drawing in the WCDL account of the borrower. There could be a prudential supervisory stipulation of bank-wise ceiling for such bank paper allowed to be floated in the market and outstanding at any point of time.

**5.8** With the proposed move to confine the inter-bank call money market to banks, Banker's Acceptance and Bank Paper proposed above, being tradable short term money market instruments, would provide attractive alternative investment outlets to non bank entities too., **The Group also considers that extension of repo facilities to these instruments would improve the liquidity and tradability of these instruments. The Group accordingly recommends that Repo facility be granted to Banker's Acceptance and Bank Paper issued by commercial banks [para no.5.9].**

## Bill Financing – Services Sector

**6.0** The Working Group was required under the terms of reference to examine the possibility of extending bills discounting facility to services sector, in the context of its growing importance in the country's economy. Given the growth trajectory of this sector, there is little doubt that the banking system in the country has to

gear up its credit delivery mechanism to meet the increasing credi requirements of this sector. The traditional asset-based lending approach may not be suitable for many of the services sector projects. Banks have to adopt cash flow based lending approach. Working capital finance may have to be extended on the basis of estimation of periodic cash gaps. To certain segments in service sector like software, the credit facility may be extended on contract-to-contract or assignment-to-assignment basis. In some segments, defining milestones in advance, which facilitate disbursement and monitoring of loans will be a crucial aspect.

**6.1** In some of the high-risk areas, traditional lending products, with fixed rates of interest may not be appropriate. Banks may have to come out with alternative financing option like convertible loans, conditional loans (part of the revenue may come by way of royalty on sales) etc. Such products may compensate adequately the lending banks for the additional risk which they may take in financing such high risk service oriented activities.

**6.2** In view of the diverse nature of service sector and customer specific intensity of the services provided within each sector, nay by each service provider vis-à-vis the user, banks have to evolve their own operational guidelines, depending upon the segment to which and customer to whom they lend. Traditional facilities like bill discounting in respect of services rendered by the service provider may not be the preferred mode or style of credit, for historically bill discounting entailed movement of tangible goods. In view of the customer centric service rendered, the expectation of the user and the fulfillment of such expectation by service provider will have a direct influence on the payment cycle. Hence the possibility of the user of services accepting the Bill of Exchange at the time of delivery of the services is not bright. Invoice financing/factoring may be a better alternative to bill financing for such service providers. In some service sectors like public utilities, cellular telephone, hospitality services etc., there would be multitudes of users of such services, entailing small payments. With the advancement of technology and e-commerce, such micro payments may in due course of time be substituted by on line electronic payments. The credit needs of such public utility service providers may be met through securitisation of receivables.

**6.3** Having said this, the Group does not rule out the possibility of some segments in the Service Sector, still being amenable for Bill Finance, like software, particularly when there is an established relationship between service provider and user. Given the past record and the standing of the service provider, the user may not have hesitation in accepting the bill; so also, the service provider may be willing to extend credit to user of the services, based on his past track record of payment. For instance, when software companies undertake projects to develop various applications,

the vendors draw export bills on the user of the application and banks discount bills since there is an underlying trade transaction. Such projects are undertaken on a large scale and are often extended to new parties also. **The Group, therefore, recommends that the services rendered/delivered by firms/companies engaged in services sector may be considered on the same footing as of sale of goods. Banks may be permitted to entertain purchase/discount of bills drawn by service providers on their debtors, subject to the satisfaction of the banker that the service has been rendered. The definition of a bill eligible for discounting be also suitably amended to include services rendered on par with bills arising from other trade related transactions [para no.6.10].**

**6.4** As for safeguards to be put in place in extending bill discounting to a new area like services sector, it would not be feasible to lay down any generic norms, because of the diverse nature of the sector. Suffice it to say that the banks can verify documents like copies of the service contract entered into between the service provider and the user, the terms of payment, conformity of the bill raised on the user to the terms of contract, conditionalities, if any, attached, past transaction record with the user and his track record of payment etc. Banks also have to exercise due diligence in assessing the credit worthiness of service provider, who must have good control systems and demonstrate clear financial success as the bank would be taking direct exposure on the service provider.

## Challenges of e-Commerce

**7.0** The Group considered it appropriate to briefly advert to one of the key emerging trends in the world of business, viz., the use of Internet as a potent cost effective tool for electronic commerce. The developments in this field may, with the passage of time, render some of the issues discussed/suggestions offered in the report less relevant. The various e-Commerce initiatives would certainly impact, if not immediately, but in the medium-term, the way banks finance industry and trade. The style of credit to trade and industry will undergo change. Some of the current business opportunities like handling documentary collection may cease to exist. For instance, one of the reasons cited by the trade and industry for not preferring the bill discounting mode of financing is the delay involved in the transmission of documents. It was represented that the goods reach much faster than the documents. In the e-Commerce era, digital documents would reach instantly, much ahead of the physical goods and the paying bank has to make payments against receipt of the digital documents. The Banks have to be part of that supply chain if they want to stay in the payment business and earn fee income. They have to provide other value

added services being part of the entire transaction cycle. Developments abroad indicate that financial sector is already moving forward in the direction of building the necessary infrastructure. For instance, a few global financial institutions have got together to provide, *inter alia,* Certificate Authority services on real time basis, enable legally enforceable **e**-commerce transactions and offer **e**-commerce ready products and services, backed by uniform systems of participating rules and operating procedures.

**7.1** In this emerging scenario, domestic banks have to prepare themselves to re-visit the financing needs of business in the new environment and devise products and services to meet the new business paradigm, especially in view of the fact that the creation of electronic market would result in the collapse of supply chain into one integrated procurement exchange.

Invoice Financing by banks, which accept debit instructions/pay order of their clients via the EDI route or in any secure electronic form for payment/settlement of B2B **e**-commerce, may become a substitute for financing trade in the same way as discounting of bill.

**7.2** Looking at the wave of optimism being shared in the developed markets on the future potential of e commerce and their preparedness to meet them, the Group recommends that an **expert group drawn from the fields of technology, banking and corporate finance be constituted to prepare the blue-print for meeting the e-commerce challenges that may be thrown up in the financial sector of the country [para no.7.14]**.

CHAPTER - 1

# Introduction

## 1.1 Constitution of the Working Group

The Reserve Bank of India constituted a Working Group on Discounting of Bills by banks in December 1999 to examine the possibility of expanding the scope of bill discounting and to extend the facility to services sector in view of its growing importance.

The Working Group was constituted under the Chairmanship of **Shri K R Ramamoorthy**, Chairman of Vysya Bank Ltd., and comprised the following members drawn from commercial banks and different central office departments of RBI. The Group co-opted representatives from trade, industry and services sector as additional members to have the benefit of their views and to ensure that the findings of the Group are relevant to the trade, industry and services sector.

### Members of the Working Group :

| | | |
|---|---|---|
| 1. | **Shri Harbans Lal**<br>Chief General Manager (Credit),<br>National Banking Group, State Bank of India, C.O., Mumbai | Member |
| 2. | **Ms. Anuradha Nadkarni**<br>Director and Head of Financial Institutions Group<br>ANZ Grindlays Bank, Mumbai | Member |
| 3. | **Dr. G S Bhati**<br>Adviser, Monetary Policy Department, Reserve Bank of India, Mumbai | Member |
| 4.: | **Shri J B Mhatre**<br>General Manager, Department of Banking Operations & Development<br>Reserve Bank of India, Mumbai | Member |
| 5. | **Shri R M Thakkar**<br>Deputy General Manager, Department of Banking Supervision,<br>Reserve Bank of India, Mumbai | Member |
| 6. | **Shri T S Sohal**<br>Director, Department of Economic Analysis & Policy,<br>Reserve Bank of India, Mumbai | Member |
| 7. | **Shri K Chandrachoodan**<br>Deputy General Manager<br>Monetary Policy Department, Reserve Bank of India, Mumbai | Member Secretary |
| 8. | **Shri S D Sapkal**<br>Deputy General Manager<br>Industrial & Export Credit Department, Reserve Bank of India, Mumbai | Member Secretary |

**Members co-opted to the Main Group :**

| | |
|---|---|
| 1. | **Shri Praveen Kadle**<br>Sr.Vice-President, Finance, TELCO, Mumbai |
| 2. | **Shri S. Thyagarajan**<br>Head of Finance & Accounts, Thomas Cook (I) Ltd., Mumbai. |
| 3. | **Shri J. Jussawalla**<br>General Manager, Finance, Mastek Ltd., Mumbai. |
| 4. | **Shri Shivaji Dam**<br>Executive Director, Kotak Mahindra Finance Ltd., Mumbai. |
| 5. | **Shri Umesh Shah**<br>Finance Manager, Hindustan Lever Ltd., Mumbai. |

## 1.2 Terms of Reference

The terms of reference of the Group are:-

a) To examine the feasibility and suggest measures to strengthen the existing bill discounting mechanism as an instrument for facilitating financing in particular trade and services sectors, including discounting of Trade bills against letters of credit opened by banks.

b) To examine the role and scope for introducing "Bankers' Acceptance" facility.

c) To examine all critical and relevant issues including the necessary safeguards to be put in place before extending bills discounting to new areas like services and introduction of "Bankers' Acceptance" facility.

d) Any necessary changes in the existing legal/regulatory frame work that may be needed.

e) Any other issue relevant/incidental to the subject which the Group considers necessary.

A copy of the memorandum of RBI constituting the Working Group is given at Annexure-I.

## 1.3 Approach of the Working Group

1.3.1 At its first meeting, the Group decided that the terms of reference could be best addressed by constituting Sub-Groups which would focus exclusively on specific

areas. Accordingly, three Sub-Groups were formed to focus on the areas of trade, service sector and regulatory/legal aspects. Sri Harbans Lal headed the trade sector group, Ms.Anuradha Nadkarni the services sector group and Sri J.B.Mhatre the regulatory/legal aspects group. The services sector group co-opted Dr. S R Shinde, Associate professor, NIBM, Pune, Sri S.C.Shekhar, Executive Vice President, Welcome Group of Hotels, Delhi and Sri Vinay Goel, Chief Executive Officer, South Eastern Roadways, Bangalore as additional members to represent the Hotel industry and the transport sector, respectively. Similarly, the legal and regulatory frame work group co-opted S/Shri K.N.Sunil Kumar, Legal Officer, Legal Department, Reserve Bank of India, A.T.Thorat, Chief Manager, Legal Department, SBI and M.T.Udeshi, Dy.General Manager, Legal Department, Bank of Baroda as additional members.

**1.3.2** The Group evolved two questionnaires – one for the banks and the other for the customers. A copy each of the questionnaires is at Annexure II and III. The respective questionnaires were sent to about 200 corporate customers, public and private sector banks and foreign banks. Several trade bodies/associations were requested to circulate the questionnaires among their members to elicit their responses. The bankers were also requested to circulate the questionnaires to their major clients. The questionnaire addressed to corporates was hosted on the website of RBI to reach wider audience and for eliciting early response. The response to the questionnaire was very encouraging; about 100 corporates and 40 banks responded with their detailed suggestions/ recommendations. The responses so received have provided valuable insights into the various pertinent issues and an analysis of the responses is appended in Annexure-IV.

**1.3.3** The Group also held interactive meetings with Trade Associations/ Chambers of Commerce like Federation of Indian Chambers of Commerce and Industry (FICCI), ASSOCHAM, Bombay Chamber of Commerce and Industry, Indian Merchants Chamber, Bengal Chamber of Commerce, Federation of Karnataka Chambers of Commerce and Industry (FKCCI), The Greater Mysore Chamber of Industry etc., at various centres like Delhi, Mumbai, Calcutta, and Bangalore and with select Corporates at Chennai. The Group also met the various commercial banks under the aegis of IBA and had the benefit of their views as well as of IBA in this regard.

The members of the Group had also the benefit of the views of a cross-section of eminent bankers on the terms of reference. The list of persons with whom the Working Group had discussions in this regard is given at Annexure-V.

The main group/sub-groups also benefited by the presentations made by various banks, NIBM, DFHI (list at Annexure-VI) on Bankers' Acceptance and Invoice Financing/ Factoring.

**1.3.4** Based on the responses received to the questionnaire, the interaction the Group had with the trade associations, corporates and banks and the findings of the Sub-Groups, the Group finalised its report.

## 1.4 Acknowledgements

The Monetary Policy Department and the Industrial and Export Credit Department, RBI had provided the secretariat for the Working Group. The Working Group wishes to place on record its appreciation for the assistance provided by the Member Secretaries and the officials of the Monetary Policy Department in conducting the meetings. The Working Group would like to thank the Indian Banks' Association as well as the various Trade Associations/Bodies for arranging interactive sessions with the members of the Working Group and for arranging the early response to the questionnaires from their members. The Group would like to acknowledge the valuable suggestions made by eminent personalities in the Banking Industry with whom the Group had interactive sessions. The Working Group would like to thank Sri P.K.Malhotra, Assistant General Manager, SBI, Sri S.Viswanathan, Deputy General Manager, Vysya Bank Ltd, and Sri K.S.Gopal, Chief Manager, Vysya Bank Ltd, who were actively associated in the Working Group's interactive sessions with the various Trade Associations/Chambers of Commerce and also in drafting the report.

CHAPTER - 2

# Bill Financing – Historical Perspective

2.1 The origin of the trade Bill dates back to the 4th century BC when the Greeks were known to have made use of the bills for settlement of commercial transactions. Historical evidence suggests that in Italy, too, some time at the end of the 12th century AD, a form of written promise akin to a promissory note in the context of foreign trade replaced coin exchange and that the practice of granting credit to the holder of the note was also in existence. During the middle ages in Europe, Bills were also known to have been drawn to fall due at the time and place where fairs were held. However, much before the advent of Bill, the principal instrument of collecting commercial debt was the 'Bond' executed by the debtor before a Court or Public Notary to impart legality. Since the process of executing bond was time-consuming and expensive, merchants of the era developed a less expensive but more private and informal document acknowledging debt and thus, the concept of 'Commercial Bill' was born. However, unlike the Bond, the Bill when it was conceived, was not a legal document, though lack of legal formalities made it more readily transferable in practice than the bonds which required the formalities of registration with a Court and the consent of the debtor for assignment. **The characteristic of easy transferability of the Bill was the key feature of the instrument, which really paved the way for its development as a full-fledged commercial and financial instrument.** It enabled the Bill to be assigned to a bank for the drawer to obtain cash immediately and thus, evolved the practice of Discounting of Bills. **A further landmark in the evolution of Bill was its being accorded the characteristic of negotiability sometime during the 16th century,** whereby all the endorsers of a Bill became liable on the debt represented by the instrument in order of their endorsement - a form of guarantee, which made it easier for the bills to be sold. The bill thus, became a freely exchangeable instrument evidencing commercial transaction and came to be known as the Bill of Exchange and was accorded full legal sanctity in England in the 18th century through legislation. With the growth in international trade, Bill of Exchange became the principal instrument of settlement in international trade.

2.2 In India, too, indigenous bankers and other business houses have been historically using some kind of Bill-like instruments written in vernacular languages, known as 'Hundies' in their many variants to pay and receive the value of goods exchanged in the course of trade. In the none too distant past, the internal trade in India was largely financed through a formal well developed bill (Hundi) market, dominated

by indigenous bankers. Hundies were also traditionally used to finance the movement of agricultural produce. Hundies were, like Bill of Exchange, drawn and payable at sight (Darshani Hundi) or payable after a stipulated period mentioned in the Hundi (Muddati Hundi) and were used to raise money, remit funds and finance inland trade. These Hundies were even got discounted with the commercial banks on the basis of the creditworthiness of indigenous bankers. However, **with the development of organised financial markets over the years, and the spread of commercial banking, the role of the indigenous bankers in the financial system diminished in importance and Hundies too gradually started losing their status as the principal instrument of credit and were replaced by Bill of Exchange in the present form.**

**2.3** Financing post-sale operations against bill of exchange is always considered beneficial from the bankers' point of view since bills represent the receivables stage of the operating cycle of a commercial activity, short-term in tenor, self liquidating in nature, provide credit enhancement through acceptance by the drawee, a third party, and offer liquidity to the bank through re-discounting window. Bill as a short term money market instrument, also facilitates better asset liability management for the banker, particularly, due to the predictability of the cash flows in the bills portfolio. The supplier-borrower also prefers this mode of financing as it helps him in planning his cash flows.

**2.4** With the dominance of cash credit system in financing domestic trade and industry, Bill finance despite its inherent advantages from the point of view of the lending bankers, has been relegated to play only a marginal role in the credit delivery system of the country. The need for the development of Bill culture among borrowers was stressed by the various committees appointed by the Government of India and the Reserve Bank of India, while examining certain aspects pertaining to bank lending/ money market/banking sector reforms. The Committees which had gone into the different aspects of working capital financing stressed the need to promote the Bill culture, so as to inculcate some measure of financial discipline among borrowers. The Group was handicapped in its task of tracking the recommendations on Bill Financing by the various Committees. Therefore, it felt that it would be useful to capture below the key recommendations of such committees to serve as a single point referencer.

**2.5** As early as **in 1931, the Indian Central Banking Enquiry Committee recommended the establishment of a market in commercial bills**, as it was perceived that a well developed commercial bill market and discount market were essential components of an efficient money market.

**2.6** Subsequently, **in 1937, an attempt was made by the RBI to bring in the indigenous bankers within the ambit of monetary control,** by providing them the facility of

re-discounting of their hundies, and granting of advances against the Government securities and remittance facilities similar to those enjoyed by the scheduled banks, provided the indigenous bankers shed their non-banking (mostly trading) business, maintained accounts in the prescribed manner and permitted inspection and audit of their accounts. This effort by the RBI did not succeed as most of the indigenous bankers were reluctant to give up their non-banking business, observing the required financial discipline. Thereafter, it was only in 1952 that a formal attempt was made to create a Bill Market, which was commonly referred to as the **"Bill Market Scheme of 1952**" subsequently referred to as "the old Bill Market Scheme". The scheme was in vogue for well over 18 years.

2.7 The **Dehejia Committee** constituted by the National Credit Council in **1968** observed that short-term finance provided by banks for sale of stocks in the form of cash credit against the collateral of book debts, in most cases, results in extending the period of bank credit as no discipline is imposed on the purchaser to pay the dues within a stipulated period. **The Committee, therefore, suggested that the practice of culminating credit sales by issue of usance bills is to be promoted to impose financial discipline on the purchasers and also to help the suppliers or the producers to plan their financial commitments in a realistic manner.** With a view to encouraging development of bill market, the Committee recommended that the Central Government may consider **reduction in the Stamp Duty on usance bills.**

2.8 Close on the heels of the Dehejia Committee, **the Study Group on enlarging the use of the Bill of Exchange as an instrument of credit and creation of a Bill Market (1970), chaired by Sri M.Narasimham**, the then Secretary of the Reserve Bank of India, also observed that it would be advantageous to take steps to enlarge the use of bill of exchange as an instrument of credit and to create a Bill Market in the country, where bills could be purchased or sold according to the requirements of the institutions concerned and that efforts should, therefore, be directed towards a system in which the **credit needs of the borrowers are met partly by way of cash credit/overdraft limits, partly by way of term loan where necessary and partly by way of bills of exchange** covering genuine trade bills, evidencing sale and/or dispatch of goods. The Committee further observed that the practice of the drawee's banker putting its signature as endorsee or guarantor on the bill in order to enhance the creditworthiness of the drawee entails delay and therefore, suggested an arrangement whereby **a bank of standing** at the place where the seller is stationed, **would accept the bill on behalf of the purchaser of the goods.** The Committee, also emphasised the need for exploring the possibilities of setting up a **credit investigation agency** and made a case for setting up **specialised acceptance houses,** in addition to acceptance business being undertaken by banks. The Committee even examined the possibilities of bringing the **Government supply bills within the purview of the suggested new bill market scheme to enlarge the supply of eligible bills in the market.** The Committee further outlined the need for institutionalizing bill brokers'

– intermediaries, who may act as a link between the sellers and purchasers of bills and at times may take up bills on their own account too.

2.9 Later, in **1975,** the study group to frame guidelines for follow-up of bank credit under the Chairmanship of Sri Prakash Tandon **– Tandon Committee –** too, opined that it was desirable that, as far as possible, **receivables should be financed by way of bills rather than cash credit against book debts** and further suggested that to the extent possible, **the banking system should move towards financing the purchaser (the debtor) rather than the seller (the creditor) and one of the methods of financing the purchaser could be through Bills,** which enables credit to be related to the actual need of the borrower (purchaser) unlike the case with sellers' bills, where credit is extended as a measure of sales promotion, irrespective of the purchaser's ability to pay or his need for credit.

2.10 Subsequently, the Working Group to review the system of cash credit under the Chairmanship of Sri K.B.Chore **(1979) - Chore Committee** - dwelt at length on the relative merits and demerits of the three main systems of financing viz. Cash credit/ overdraft, loans and bills, and observed that the bill system needs to be encouraged as it would enable the banks and others with surplus funds to buy bills of various maturities and those who are in deficit to discount such bills in the market to suit their requirements, thereby making eligible banks to approach Reserve Bank as the lender of the last resort, only if they fail to get the required amount from the market and thus, imparting flexibility in the money market by evening out the liquidity in the banking system. More importantly, from the banks' point of view it would help better credit planning and asset liability management, while from the suppliers' view point it would, on account of its pre-determined time of payment, facilitate production planning and cash budget. The Group also felt that the necessary corrective measures should be introduced to remove the impediments in the use of bill system of finance and also to remove the drawbacks observed in the Cash Credit System. **The Group advocated the use of Drawee Bill System for financing purchase of raw materials and inputs,** and recommended that banks should **compulsorily extend at least 50 percent of the Cash Credit Limit against raw materials by way of drawee bills,** in case of borrowers having aggregate working capital limits of Rs.50 lakhs and above from the banking system. The Group was also of the considered opinion that through the **creation of a Discount House**, which can function as an independent body, subject to Reserve Bank's supervision, accepted bank bills can play a useful role in augmenting the floating funds of the banking system and thus, make Reserve Bank's control over the use of these funds by the Banking system effective for purposes of regulating bank credit, besides facilitating the development of a market for bills in the country.

2.11 The **Sukhamoy Chakravarty Committee (1985)** to review the working of the Monetary System also emphasized the urgency **of removing such procedural impediments**

**as stamp duty, non-availability of stamp paper in required denominations, etc., hindering the use of Bill Finance and also suggested lower finance charges at 2% below the minimum lending rates of banks** for bill finance, as compared to loans or cash credits. The Committee also endorsed the suggestions of the Chore Committee on encouragement of Bill Finance and setting up a "Discount House" for the creation of a ready market for commercial bills, treasury bills and government securities.

**2.12** Later, the working group on the **Money Market (1987)** under the Chairmanship of Sri N.Vaghul – **Vaghul Committee** - was of the firm view that bill market cannot be activated unless a bill culture develops amongst the trade and industry circles and that the initiative for this should come from the Government, Public Sector undertakings and large business houses and that, in the light of the past experience of failure of persuasive measures, a time has come to push ahead with a set of mandatory instructions like :-

a) Payment for all Credit Purchases of Government viz., Departmental Undertakings and PSUs should be in the form of bills, which should be strictly honoured on the due dates, failing which a penal rate of 2 % above maximum lending rate of banks would be charged ;

b) A phased increase in the proportion of bill acceptances to total credit purchases to a level of 75%, over a three year period and penal provisions for non-adherence ;

c) Gradual phasing out of receivable financing and move to Bill financing to the extent of 75% in respect of clients having working capital limits of more than Rs.6 crore ;

d) A stricter review by banks of credit facilities extended to clientele, whose bills are not honoured on due dates to ensure that demand bills do not get converted into usance bills by default of payment and that confidence in the system of honouring financial obligations is not put under stress.

e) Maximum discount rate on bills should be sufficiently lower than the interest rate on cash credit, say 1.5 % below the then maximum lending rate of 17.5%.

The Group also recommended setting up an autonomous public limited company called "The Finance House of India" to impart liquidity to short-term money market instruments like Commercial Bills, Commercial Paper, Treasury Bills etc.

**2.13** The Committee **on Banking Sector Reforms (1998)** too, observed that credit institutions should help in **developing the greater use of bills** as is now required by policy,

while the **S.L.Kapur Committee (1998)** on Credit to SSI suggested that the RBI may examine the possibility of increasing the minimum stipulation of financing 25% of credit purchases of big corporates from SSIs through bills to 50%, in the following year, based on the experience gained.

## 2.14 Measures to Promote Bill Market

**2.14.1** Even though the role of commercial Bill Market as an important component of the money market was recognised as early as in the 1930's, concerted efforts were not made in this direction till 1952. In fact, the Bill Market Scheme of 1952 was floated in an altogether different context. The RBI's decision in November 1951 to hike the Bank Rate from 3% to 3.5 % and to refrain from making open market purchases of government securities, save in special circumstances and at its discretion, closed the liquidity window that was available to commercial banks, under Section 17 (4) (a) of the RBI Act, 1934, enabling them to tide over their seasonal liquidity pressures. However, banks faced with seasonal stringency of funds in the busy season tapped the RBI window and hence RBI on Jan 16, 1952 introduced the first Bill Market Scheme under Sec 17 (4) (c) of the RBI Act, 1934; it enabled RBI to make advances to scheduled banks against the security of usance promissory notes or bills drawn on and payable in India, provided they arose out of bonafide commercial or trade transactions, bearing two or more good signatures, one of which shall be that of a scheduled bank, and maturing within 90 days from the date of advance. In order to avail of refinance under the above Section, the scheduled banks were required to convert a portion of the demand promissory notes obtained by them from their constituents in respect of loans, overdrafts and cash credits granted to them into usance promissory notes maturing within 90 days. The accommodation, which was initially restricted to licensed scheduled commercial banks having deposits (including deposits outside India) of Rs 10 crore or more, was later extended to all the licensed scheduled commercial banks, irrespective of the size of the deposits on the basis of a certification from the bank applying for accommodation to the effect that the paper presented by it as collateral arose out of bonafide commercial transactions and that the party was creditworthy. Later, in 1958, the RBI extended the Bill Market Scheme to export bills also to encourage banks to extend credit facilities to exporters on a more liberal basis. The Banks, however, could not avail of these facilities, as exporters were reluctant to draw usance promissory notes as required by the RBI, after having tendered to banks for purposes of negotiation, documentary usance export bills, which the banks sent abroad for acceptance and collection. The RBI, therefore, introduced in March 1963, a new Exports Bills Credit Scheme, whereby advances could be made by the RBI to scheduled

banks against their promissory notes only and upon their declaration of holdings of eligible usance export bills, drawn in foreign currencies or Indian Rupees and purchased or negotiated by them.

**2.14.2** The next significant measure taken by the RBI for promotion of a Bill Market was in November 1970. Based on the recommendations of the Study Group on enlarging the use of Bill of Exchange as an instrument of credit and creation of a Bill Market chaired by Sri M Narasimham, the RBI introduced the New Bill Market Scheme (NBMS in short). The scheme was restricted to genuine trade bills only and provided for rediscounting of four types of bills having at least two good signatures, one of which had to be that of a licensed scheduled bank or a State Co-operative bank. The four types of eligible bills were (a) Bills drawn on and accepted by the purchaser's bank (b) Bills drawn on the purchaser and the purchaser's bank jointly and accepted by them jointly (c) Bills drawn and accepted by the buyer under an irrevocable letter of credit (d) Bills drawn on and accepted by the buyer and endorsed by the seller in favour of his bank. However, Bills arising out of transactions in commodities covered under selective credit controls were kept outside the purview of the scheme.

The bills rediscounted by RBI under the above scheme were negotiable and marketable; in fact, their negotiability was an essential condition for the development of a sound bill market. The scheme was expected to impart flexibility to the money market, help in evening out surpluses and deficits in the banking system and thereby enable RBI to exercise an effective control over the money market, since recourse to the Central Bank would normally be only when the banking system, as a whole, was short of funds, rather than when a few banks alone were in need of funds. Thus, the Reserve Bank's role was designed to be a 'lender of the last resort' instead of first resort. Expansion and contraction of money by the Reserve bank as a result of rediscounting of such bills was also expected to be in relation to the needs of the economy.

**2.14.3** Since the introduction of the New Bill market scheme, the RBI introduced several measures to encourage and widen the use of Bills such as,

- Simplification of the rediscounting procedures by dispensing with the actual lodgement of bills in respect of bills below the face value of Rs.10 lacs and replacing it with derivative bills. The minimum amount of bill at Rs 5000/- prescribed under the scheme was also done away with.

- Promotion of Drawee Bills Scheme, by making it mandatory for banks to extend atleast 25% of the cash credit limit to borrowers in the form of bills and requiring banks to ensure that their corporate borrowers financed their domestic credit

purchases from SSI units, at least to the extent of 25%, by way of acceptance bills drawn on them by their suppliers, and advising banks to monitor the compliance of this requirement through a suitable monitoring system (These mandatory stipulations were subsequently withdrawn with effect from 2nd November, 1999).

- Remission of Stamp duty by the Govt. of India on bills of exchange drawn on or made by or in favour of a commercial bank or a co-operative bank and payable not more than three months after date or sight.

- Permitting the licensed scheduled commercial banks to rediscount bills with a few financial institutions such as Life Insurance Corporation of India (LIC), General Insurance Corporation of India (GIC) and its subsidiaries and Unit Trust of India (UTI) and such other financial institutions, incorporated in India, as may be approved by the RBI on a reference made to it.

- Selectively increasing the participants in Bill Rediscounting Market in November 1981, to include all-India Financial Institutions and Mutual Funds, thus augmenting the supply of funds in the secondary market.

- Setting up of the Discount and Finance House of India (DFHI) by the RBI jointly with public sector banks and All-India Financial Institutions.

- Enabling multiple rediscounting of bills through introduction of a revised procedure, under which derivative usance promissory notes (which were exempted form payment of Stamp Duty) drawn by banks for suitable maturities up to 90 days on the strength of underlying bills discounted by the banks' respective branches could be rediscounted with other banks, approved financial institutions and DFHI.

- Delinking interest rates applicable on discounting of bills from the prime lending rates of banks thus giving the commercial banks freedom to charge market determined interest rate on bills.

**2.15** Neither the incentives like the remission of stamp duty on usance bills, simplification of procedures for rediscounting and strengthening of the institutional infrastructure, nor the mandatory prescription of fixation of Drawee Bills limit under cash credit gave the desired impetus to the bill market. The recent measure of delinking PLR with reference to bill financing however, has made trade and industry evince interest in bill financing if sub-PLR interest were charged. In sum, bill financing has not so far taken off as the preferred mode of financing in any significant manner.

CHAPTER - 3

# Bill Financing – Key Issues

**3.1** For decades now, Cash Credit/Overdraft continues to be the preponderant style of credit for working capital funding in the Indian Banking scenario, constituting about 70% of the total bank credit. Bill discounting has not been able to even partially substitute cash credit, despite the scholarly studies of the various committees and erudite recommendations. Currently, bill finance constitutes less than 10% of the total bank credit, even after decades of propagation of the virtues of bill financing. Neither the various positive measures to promote bill financing offering incentives nor the mild deterrent steps have succeeded. It is also pertinent to mention that the loan system too, as one of the three alternative styles of credit delivery in domestic working capital funding, did not meet with any greater degree of success, which underscores the imperative need to revisit the current style of working capital funding, though it would not strictly fall under the terms of reference before the Working Group.

## 3.2 Trends Abroad

**3.2.1** In this context, it would be pertinent to mention that discounting of usance bills of exchange to finance domestic trade, as obtaining in our country, seems to be losing its relevance in most other countries. The reason could be the unavoidable delay and the additional transaction costs entailed in handling of bills. As the time required to move the goods from the seller to the buyer destination is shrinking, customers do not prefer to use the Documents against Acceptance (D/A) method for financing domestic trade; transmission of documents through banking channels invariably results in delay; as a result goods reach the destination much before the relative documents reach the buyer's bank. Further, D/A method involves additional transaction costs for both the buyer and the seller, as the documents necessarily have to be sent through the seller's bank to the buyer's bank with both the banks charging their commission for handling the documents.

**3.2.2** In the London market, the system of bill financing in local or regional trade is not very common. Corporates generally meet their financing requirements from banks by taking overdrafts. Payment for supply of goods/services is made by the buyers

directly. Receivable financing is facilitated through factoring and invoice financing. It is estimated that 20% of the receivables are financed through this route, mainly by factoring companies and discount houses. Invoice Financing is reportedly growing at a rate of 10% to 20% per year.

**3.2.3** In US too, bill financing is not prevalent for domestic trade transactions. However, Banker's Acceptance, a short term money market instrument drawn on and accepted by a bank as its commitment to pay a third party, is used to finance international trade transactions. Creating an acceptance involves substituting bank's creditworthiness for that of the borrower. The instrument is a Bill of Exchange, but it differs from other bills, in so far as it bears the irrevocable unconditional guarantee of a bank to pay the bill at maturity. In effect, it creates a negotiable instrument that is attractive to investors also as short term paper.

**3.2.4** In Australia, the working capital facilities take the shape of Bank Overdrafts, Commercial Bills and Commercial Paper. Under the commercial bill facility, a bill is drawn and accepted by the bank, which will in turn try to sell that paper to an investor from among the bank's customers or alternatively sell it in the market via other banks/ financial institutions.

**3.2.5** The system of issuing post-dated promissory notes to suppliers prevails in Japan and Korea. Banks in these countries issue a stock of blank promissory notes (just like cheque books) to their corporate customers. These promissory notes when completed and signed by the customer and presented through the clearing system are honoured by the bank on which they are drawn, subject, of course, to availability of funds. This system seems to have been evolved to overcome the serious legal consequences of dishnour of cheques. While dishonour of cheque is a serious offence, dishonour of promissory note is not treated as an offence under law. It entitles the holder to file a petition for liquidation of the issuer or a civil action to recover the amount of the note.

**3.2.6** In essence, the international scenario suggests that in developed markets like U.K., USA, Australia, Germany, New Zealand etc., bill discounting facility, as a product, as commonly understood in India, is not in use.

## 3.3 Domestic Trends

**3.3.1** An analysis of responses received from the bank customers and banks (Annexure-IV) reveals that the major reason for the non- development of bill financing is the

hesitation of the industry and trade to subject themselves to the strict commitment to honour financial obligations on the contracted date. Operational and procedural hassles too are said to impede the growth of bill financing even amongst those business segments where it has found acceptance. These are briefly dealt with below :

### 3.3.2 Payment Discipline

Reluctance of the buyers, especially the large corporates/PSUs to accept bills of exchange drawn on them and to subject themselves to payment discipline continues to be cited as a major reason for the non-development of bill culture. In fact, the Vaghul Committee observed that "any attempt to activate the bill market is bound to fail unless a bill culture develops among the trade and industry circles and the initiative for this should come from the Government, public sector undertakings and large business houses". This observation remains valid even today. Coupled with this, the procedural delay involved in the creditor getting a prompt legal remedy in case of dishonoured bills, can also be cited as a factor retarding the development of bill culture among trade and industry.

### 3.3.3 Changing Trade Pattern

**3.3.3.1** With the onset of liberalisation, the domestic market has become highly competitive and has turned into a buyer's market. As a result, sellers are not able to bring around the buyers to accept bill of exchange for supplies effected. From the buyers' point of view, they would like to retain the character of the transaction as a pure commercial one, with simple debtor-creditor relationship, rather than elevate it to a negotiable instrument, clothed under bill of exchange, with a firm obligation to pay to the seller on the due date of the bill, irrespective of any commercial dispute that may arise subsequently. These apart, commercial transactions are now generally tending to be more in the nature of open account sales; with the spread of e-Commerce this trend may get accentuated; there is also growing expectation from trade and industry for on-line completion of transactions;

**3.3.3.2** It must however, be mentioned here that in a few specific sectors like automobile industry, pharmaceuticals and fast moving consumer goods (FMCG), both sales and purchase bills discounting have been in usage. In the automobile industry,

for instance, the practice of development of dedicated vendors, who supply exclusively to one or more of the automobile manufacturers and whose production systems, quality etc., are constantly under manufacturers' supervision, is in vogue. There are committed production and delivery schedules by the vendors to the manufacturers. As select vendors are developed for each component, there is considerable inter-dependence between the manufacturer and the vendor. In this background, there is not much of a hesitation on the part of the manufacturer-buyer to accept bills drawn on him by such a dedicated vendor. If the components supplied in any consignment suffer quality defects, the manufacturer - buyer has the option to set off such claims against future bills. Similarly, in a few other sectors like fast moving consumer goods, pharmaceuticals, etc. bills drawn by the small-scale suppliers on the manufacturers are being accepted. In some of these sectors, bill financing is also used for post sales funding.

### 3.3.4 Operational and Procedural Constraints

**3.3.4.1** Operational procedures vary from bank to bank and sometimes, even within the same bank. It is averred that, cost apart, dishnour and/or delayed payments affect the rating of the drawer with his banker, for no apparent fault of his.

**3.3.4.2** As per the extant guidelines, bill financing through the medium of bills of exchange, has to be backed by movement of goods as part of the trade transaction. Banks, therefore, insist that the bills should be supported by documents of title to goods such as railway receipt/ lorry receipt/ transport receipt, evidencing the movement of goods. Moreover, banks also generally stipulate that LR/TR should be of a transport operator, who is on the approved list of Indian Banks' Association. In places where the approved transport operators do not have branches, submission of such an LR becomes difficult. Also, where the goods are moved within the same city, transport operators do not normally provide LRs. Similarly, where the goods are moved by the transport owned by the manufacturer/ seller himself, the submission of LR will not arise. Thus, even though there has been genuine movement of goods, in the absence of LR of an approved transport operator, banks are reluctant to discount bills of exchange.

Other operational and procedural constraints, as articulated by clients restraining them in moving over to bill financing, which are brought out vividly at Annexure-IV, in brief are: i) lack of uniformity in the documents to be submitted for availing bills discounting facility. (ii) wide geographical spread of the buyers. (iii) delay on the part of drawer's bank in sending the bills for presentation/ acceptance. (iv) delay

on the part of bank at the drawee's end in presenting the bill for acceptance. (v) delay on the part of drawee in accepting the bills within a reasonable time frame. (vi) delay in remittance of proceeds by the bank at the drawee's end. (vii) delay in the approval of new customers (drawees) in the absence of reliable credit information, especially on small/medium enterprises and unlisted companies /non-corporate entities.

Some of the operational and procedural constraints inhibiting bill financing as indicated by banks are, difficulties in getting credit reports on drawees and their periodic updation; instances of direct payment by the drawee to the drawer bypassing the bank; non-reliability of transport documents; instances of transport operators handing over goods to drawees before acceptance of relative bills; getting power of attorney registered with the government departments; and difficulties in identifying accommodation bills.

### 3.3.5 Transaction Cost

**3.3.5.1** Cost of availing credit through bill discounting is perceived to be high compared to cash credit. Apart from the inherent interest cost advantage built-in the existing cash credit system, bill financing entails additional cost to the borrowers by way of discounting charges collected up-front. The effective cost turns out to be rather high, especially in the case of bills of smaller amounts. In addition, collection and handling charges are levied. About 60% of the customer respondents felt that high cost was an important aspect coming in the way of their customers accepting usance bills.

**3.5.2** Where the discounting and collecting banks are different, clients have to bear both the banks' charges. Further, it is represented that there is considerable time lag in transmitting the proceeds of the bills within the banking system, but customers are made to bear overdue interest for such periods.

### 3.3.6 Stamp Duty

**3.3.6.1** At present, all bills up to usance of 90 days are exempt from stamp duty. Domestic sellers in today's buyers market are constrained to extend credit beyond 90 days, ranging from 120 to 180 days. As the stamp duty exemption is currently limited for a period of 90 days only, buyers who are otherwise prepared to accept the bills are also reluctant to do so, due to the additional cost.

3.3.6.2 The non-availability of stamp papers of required denomination and the procedural delays in getting the documents stamped have also impeded the development of culture of Bills Acceptance.

## 3.3.7 Dominance of Cash Credit System

3.3.7.1 The cash credit system, as it prevails today, is perceived by trade and industry as a most convenient loan product, for it has the advantage of a loan and the flexibility of a current account, in one product. There are no restrictions on the extent of borrower's day-to-day drawings, subject of course to an approved credit line being in place and availability of drawing power. The borrowing constituent can deposit in his account his surplus funds day-to-day and thus pay interest only on the daily net debit balance.

3.3.7.2 The banker, thus, not only provides credit line to the client, but also manages his day-to-day liquidity. Further, cash credit being a perpetual facility, the borrower is not put to the rigours of any repayment discipline and hence no default is discernible, except when the credit line is overdrawn or when there is erosion of current assets, depleting the drawing power or the account is non operative. Also there is reluctance on his part to move over to an alternative style of credit, like bills or loan, where there exist inherent rigidities from his view point, in the form of strict covenant to repay the loan on the due date and absence of manoeuvreability to deploy the short term surpluses that may arise in between. Banks, too, having been familiar with the cash credit system for over decades, have a comfort level in operating the same. It is only in the recent past, after the mandatory prescription of operationalising the Asset-Liability Management systems in banks, the inherent constraints imposed by the existing cash credit system in managing liquidity of the banks are being acutely felt.

3.3.7.3 Cash Credit System, despite its inherent shortcomings from the viewpoint of financing banks, has dominated the credit delivery system in the country. Even if interest rates on loans and bills are made competitive vis-à-vis cash credit, based on the tenor of the loan/bill as the case may be, cash credit will continue to hold sway. Further, between loan and bill inter se, loan as a style of credit may be preferred by clients, due to lower transaction cost and minimum procedural/operational hassles.

3.3.7.4 In the prevailing competitive market environment, banks' spreads are under pressure with fall in yields on deployment of funds not matched by commensurate fall in the rates at which resources are mobilised. This would call for an increase in the

mobilisation of demand deposits as well as short-term deposits at the margin to ease the pressure on spreads. In this context, it would become imperative for banks to proactively introduce other types of loan products like short-term loans and bill discounting, which besides matching the tenor of such shorter term liabilities, would also carry, in view of the shorter tenor, a lower incidence of credit risk and interest rate risk.

## 3.4 Recommendations

**3.4.1** In sum, the convenience offered by other modes of financing, the rigours of payment discipline warranted on bill finance, the market preference for open account sales and the ongoing compression of transaction and settlement time, would all imply that bill finance with the inherent procedural hassles and transaction cost will only have a limited role to play in the credit delivery system. The Group considered it imperative to articulate this perspective, so that undue expectations are not continued to be laid on bill financing. At the same time, it would be pertinent to note that some segments of the trade and industry may continue to prefer bill financing, provided the pricing is competitive with lower margin stipulations, shorn of operational hassles. In some sectors like automobiles, pharmaceuticals and fast moving consumer goods (FMCG), as mentioned in para 3.3.3.2, Bill Financing is found to be gaining a degree of acceptance. Reflecting this trend, about 22% of the respondents of the customer questionnaire expressed in favour of Bill Financing as a convenient mode of availing credit. Since still a segment of the trade and industry is and would be willing to avail of bill finance, the Group makes the following recommendations to ensure that Bill Financing caters effectively to the needs of these clientele segments.

### 3.4.2 Pricing

**3.4.2.1** Considering the fact that the banks are now permitted to offer tenor linked PLRs, and have the freedom to determine the rate of interest on bill finance, without linkage to PLR, conscious efforts are to be made by banks as well as trade and industry, to move over to a three-tier interest rate structure, corresponding to the style of credit (loans / bills / cash credit), for financing working capital. Pricing of each such component and its mix in the overall loan portfolio of the bank would depend upon individual bank's resource mix and transaction cost, the prevalent competitive market rates as well as the bank's own targeted maturity mix of its asset portfolio. **Bill Discounting, being advantageous from the banker's point of view, can carry interest at a lower rate than the loan, whilst interest rate on loan component of working capital may be charged according to the tenor of the loan; Cash Credit**

**may carry a higher interest rate in keeping with the international practice, where overdraft, which serves more or less an identical purpose as cash credit, attracts higher interest rate.** Still the banks have to contend with the transaction charges for handling the bills, which, if too high, may dissuade clients to opt for loan or cash credit in preference to bills.

3.4.2.2 **The Group is conscious of the fact that in the context of dismantling of micro-level regulatory prescription on lending, the initiative to move over to such a three tier structure of lending should come from within the banking system; interest rate, in the wake of deregulation, ought to be determined by individual banks themselves.**

### 3.4.3 Removal of Operational Constraints

a) **Individual bank may lay down norms for satisfying itself about the genuineness of the transaction and the movement of goods. Banks may accept other documents like goods received note also as evidence of genuine trade transaction instead of exclusive reliance on transport receipts.**

b) **As there are inherent advantages to commercial banks in encouraging bill financing, particularly in the small and medium sector, it would but be necessary for the commercial banks to re-visit the existing procedures and processes and simplify the same with transparent time and cost norms, from the time the bills are tendered for discounting till their realisation, including value dating of client's account, taking advantage of the improved computer and communication network.**

With the advent of e-Commerce, transmission of documents, conveying acceptances and remittance of proceeds will be possible on electronic mode and thus the inherent delays, which are currently a major constraint, will be eliminated. The recently passed Information Technology Act, 2000 enables records to be maintained in electronic form and recognises digital signatures.

### 3.4.4 Stamp Duty Exemption

3.4.4.1 **In view of the existing trade practice of elongation of credit period beyond 90 days and taking note of the procedural hasssles entailed in stamping of bills hindering the development of bill culture, the Group recommends that stamp duty for all bills of usance upto 182 days be abolished.**

3.4.4.2 **The exemption, which is presently available only on the bills discounted by banks, may also be made available to all bills discounted by financial institutions and registered non-banking finance companies.**

3.4.4.3 The Group recognises that the abolition of stamp duty may take time, as this is a subject falling within the jurisdiction of State Governments. In the interregnum, at least, **the procedure for stamping of documents ought to be simplified and cost/time efficient alternatives be introduced on top priority.** This will bring about savings to the State Exchequers too.

## 3.4.5 Payment Discipline

3.4.5.1 Vendor payment practice of a company is an indicator of the ethos of the management of the company. Banks as well as other creditors in general will have to be equally watchful about managements, which do not take care to pay their vendors in time. One of the methods to promote payment discipline which is gaining currency in recent times is the use of post-dated cheques. Post-dated cheques and its variants are discussed in detail in the next chapter.

With a view to improve payment discipline, **the Group suggests that Corporates and other commercial entities who have a turnover above a threshold level be mandated to disclose the "ageing schedule" of their overdue payables in their annual report as well as in their periodical reports to their banks.**

3.4.5.2 During the interactive meetings with customers and bankers, concern was expressed at the inordinate delay in payment of accepted bills by drawees and it was suggested by some that penal provisions on the lines of dishonour of cheques be incorporated for non-payment of bills on due dates. The Group, is however, not in favour of introducing any such provisions, as it may only further inhibit acceptance of bills, which is already at a low ebb, as evidenced by the experience of 84% of the bank respondents, who expressed that their customers found it difficult to get their bills accepted by the buyers.

## 3.4.6 Supervisory Guidelines – Need for Review

3.4.6.1 Supervisory concern was voiced in the year 1992, on the conduct of bill discounting business by banks and non-banking finance companies. The irregularities that

surfaced were in the nature of discounting of accommodation bills and bills for long usance, covering sale of shares/debentures or payments like electricity bills, customs charges, lease rentals, etc., excess financing beyond the net worth and/or credit needs of the clients outside the consortium, leading to diversion of funds, drawal of refinance against ineligible bills, etc. The Reserve Bank of India, therefore, issued on 27th July 1992, a detailed circular Ref. DBOD.NO. BC. 8/16.13.100/92-93 to all commercial banks stressing the need to exercise due diligence in handling their bill portfolio; cautionary advice was reiterated to non-banking finance companies in October 1995 as also in March 1997.

**3.4.6.2** Concern was also expressed in the matter of banks extending "one-off" transaction facilities, or discounting of bills against LCs, without assessment of credit needs of the borrowers on the well established credit norms. The supervisory view was that L/C was merely a guarantee against payment risk and not assurance of proper credit appraisal. The Reserve Bank of India was also critical of the accounting practices followed by some banks in the disclosure of the borrowers' liability under such facility.

**3.4.6.3** The supervisory guidelines, therefore, emphasised that Bill financing be provided as part of the working capital, after due credit appraisal, based on well established norms. Banks were advised not to extend any fund based or non-fund based or additional/adhoc credit facilities, including discounting of bills under L/c to non-constituents. It was also stipulated where provision of such facility for non-constituents become that inevitable, prior concurrence of existing lending bankers should be taken.

**3.4.6.4** The Group shares equally the supervisory concern as regards the need for banks exercising utmost caution and due diligence in administering the bills portfolio. Without in any manner detracting the supervisory concern in this regard, **the Group considers that the irregularities pointed out by the Supervisory Authorities in respect of LC Bill discounting were more in the nature of operational deficiencies stemming from lax internal processes and controls that were obtaining in the respective banks than any inherent flaw in this as an instrument of credit. It is against this background, the Group recommends that the erstwhile micro-level guidelines concerning bill financing contained in Circular DBOD.NO.BC.8/16.13.100/ 92-93 dated 27/7/1992, be amended, leaving it to individual banks to lay down appropriate internal guide lines and prescribe suitable controls**.

**3.4.6.5** In the matter of discounting of bills drawn under LCs or establishing LC as one off transaction, the Group felt it would be desirable to specifically elicit the views of commercial banks on this issue. Opinion was sharply divided amongst banking

fraternity. Banks, which continue to operate under the erstwhile mandatory consortium or multiple banking arrangement, aired the view that trade bills represent the receivable stage of the cash cycle, which has been financed by the working capital consortium and that if such proceeds do not come to the credit of the consortium banks, it would be a clear case of diversion of funds, apart from dilution of security cover of current assets under charge to them and hence the consent of the leader of the consortium in the form of "No objection certificate" was felt necessary.

**3.4.6.6** On the other hand, banks which extend such one-off facilities, outside the consortium contended that when a bill under LC is discounted with a bank, the underlying trade receivable is extinguished and if the loan covenant so stipulates, the seller is obligated to credit the proceeds to his account with the existing bank and any breach of such a covenant can entitle the banker initiate action against such a borrower. To reinforce their view point, the bankers argued that the position of the existing banker is no less vulnerable with respect to receivables against which it would have advanced, as the seller receives payment for such sales directly from his customers; if he so decides, he can divert such sales realisation to other banks.

**3.4.6.7** In the light of the prevailing competitive market conditions, quality borrowers needing credit at competitive interest rates, have a range of financing options available in the market. However, in view of the past happenings in the market place and the attendant supervisory concern and the fact that a large segment of the banking system still continues to operate under the erstwhile consortium guidelines, the Group recommends the following as a transitory step.

**3.4.6.8** Borrowers may discount bills drawn under Letters of Credit with any bank of their choice, outside the existing consortium/multiple banking arrangement. To guard against diversion of funds by the borrower, the discounting bank should, however, remit the proceeds of the bills so discounted to the lead bank in the case of consortium or to the bank, which has the largest credit exposure in the case of multiple banking arrangement. While submitting the bills to the banker for discounting, the borrower should be required to make a declaration giving details of consortium/ multiple banking arrangement and to authorise the discounting bank to remit the proceeds to the lead bank or the bank which has the maximum exposure under multiple banking arrangement. It is also necessary for the discounting bank to exercise due diligence before entertaining the clientele for such "one-off" transactions.

**3.4.6.9** It is equally necessary for banks which establish LC line of credit, especially in cases of LCs favouring parties in the same city, to exercise due diligence as many of local LCs had in the past turned out to be pure financial accommodation transactions.

3.4.6.10 Banks were prohibited from re-discounting bills discounted by non-banking finance companies. This was partially relaxed in November 1998 and banks were permitted to re-discount all genuine bills arising out of sale of commercial vehicles discounted by non-banking finance companies. Obviously, the step was taken to stimulate demand for commercial vehicles and thus break the recessionary phase the industry was then passing through. Further relaxation has been allowed in May 2000, whereby Banks are permitted to re-discount bills discounted by NBFCs arising from sale of two wheelers and three wheelers. During the interactive meeting of the Group with Corporates, the representatives of non-banking finance companies submitted that bill discounting was part of their normal business activities and hence they should be allowed to rediscount with banks all the bills discounted by them without any restriction. **The Group after careful consideration, recommends that the existing restriction on banks in rediscounting the bills discounted by non-banking finance companies may be removed, but with adequate safeguards in order to protect the Banks' interest. Banks may frame the eligibility criteria for such rediscounting in line with their credit policy and with the approval of their respective Boards.**

## 3.4.7 Product Innovation

3.4.7.1 Banks have to structure their loan products to suit clientele needs and thereby bring about innovation and product differentiation. Such innovation and product differentiation become paramount in a competitive market environment and are often driven by the diktats of the market place. One such product is "Factoring", introduced in India in the early 1990s through subsidiaries of two major banks following the recommendations of Kalyana Sundaram Committee (1988). Factoring is a method of financing receivables which combines funding with management of receivables, particularly for the benefit of smaller suppliers operating in an increasingly buyers' market. Though banks too were later permitted to offer factoring services inhouse, they have not ventured so far to offer factoring as a product line, due to reasons like the lack of necessary focus to administer such a specialised service in a decentralised branch set up, their own comfort levels with the existing styles of lending, and absence of specialised institutions offering credit information on Small and Medium Enterprises. The existing factoring companies too, are beset with a host of problems hindering their growth, like lack of access to cheaper funding sources rendering factoring a costlier mode of finance, certain grey areas in legal aspects in the absence of an exclusive legislation governing factoring and banks' reluctance to issue Letter of Disclaimer (LOD) to factoring companies allowing them to factor identified receivables etc., Nevertheless, the changing face of competition in the credit market, the emergence of specialised institutions offering credit information services and an early resolution of the legal ambiguities relating to factoring etc., may yet encourage banks to have a relook at factoring and realise its untapped

potential as a means of financing the SME segment. In this context, it may be recalled that the High Level Committee on Credit to SSI (Kapur Committee, 1998) underscored the need for a fresh study on the mechanism of 'Factoring' by an expert committee.

3.4.7.2 As a complementary product, Invoice financing, a variant of Factoring, which is popular in some of the western countries may also be introduced. Under this method of lending, the seller's bank provides finance based on the invoices raised on the buyers on a non-disclosed basis.

3.4.7.3 **Banks could convert the existing drawals under the Working Capital Demand Loan (WCDL) into liquid instruments in the nature of buyer's usance promissory notes which, when discounted in the market place, will emerge as bank paper, an instrument akin to Banker's Acceptance. These are dealt with in greater detail in subsequent chapters.**

3.4.7.4 **The Group recommends that, on a selective basis, top rated Corporates could be permitted to float Secured Fixed Rate Notes (Usance Promissory Notes) to mobilise short term funds to finance their working capital including receivables.** A Bank or Financial Institution could be a Trustee to these issues. Charge on current assets of the company shall vest in the Trustee on behalf of holders of the notes. The company's working capital needs, as assessed by the bank, may be the overall limit within which the company may bring out issues that could be privately subscribed by the investors, banks etc., The borrowing programme of the company shall be assessed by a Credit Rating Agency. This will enable highly rated corporates to directly access the market for short-term funds at lower discount rates to finance their working capital needs. The Group felt that the Fixed Rate Notes of highly rated corporates will increase the supply of bills/notes in the market. These fixed rate notes will be, in certain respects, similar to the Asset-Backed Commercial Paper prevalent in the US market.

3.4.7.4 **The regulatory framework could play a facilitating role in regard to such product innovation / development, as long as the funds are channeled into financing genuine commercial transactions**.

## 3.4.8 Credit Insurance

3.4.8.1 A system that has evolved in Europe, and more recently in the U.S., for facilitating domestic sales on credit is the credit insurance or credit indemnity. Under this

system, the credit insurer insures receivable due from specified parties up to specified amounts upon payment of a fee, which varies from 0.5% to 2.0% of the amount insured. If the seller is unable to realise the amount due from such insured parties within a reasonable time after it is due, the credit insurer pays to the seller. This system is similar to the ECGC cover available to exporters in India with one difference in that it is available for both exporters and domestic sellers. Banks in Europe and the U.S are more willing to provide finance against receivables which are insured. There is a need for such intermediaries which will assume the credit risk in trade transactions. Introduction of a system of domestic credit insurance would be able to increase credit flow, without altering the existing trade practice.

**3.4.8.2** A pre-requisite for introduction of credit insurance will be the establishment of credit information bureaus which can provide information required by the credit insurers essential for their underwriting activities. Steps for setting up a credit information bureau which can facilitate the introduction of credit insurance scheme have already been initiated. Looking at the overall quantum of business, there is scope for a number of bureaus, including specialised rating institutions to evaluate the credit worthiness of small and medium enterprises.

**3.4.8.3** **The Group, therefore, recommends that a credit insurance scheme for insuring domestic receivables on the lines similar to ones prevailing abroad may be introduced**.

CHAPTER - 4

# Alternatives to Bill Financing

## 4.1 Invoice Financing

4.1.1 In the light of inherent hesitation on the part of majority of trade and Industry to subject themselves to the bill discipline as well as the various costs and operational hassles entailed in bills financing, it is necessary that a cost effective flexible alternative system to bill finance is evolved and introduced with due legal clothing. With open account sales becoming the preferred mode, there are practices obtaining in some developed countries where banks extend working capital finance on ongoing basis against invoices raised by their clients' on their buyers. One such financing arrangement is factoring, which is yet to take deep roots in India. A variant of factoring is Invoice Financing, which is becoming quite popular in mature markets like United Kingdom, Australia etc. In Australia, the market for Invoice Financing is put at $ 3.4 billion p.a, with an annual compounded growth rate of 20%.

4.1.2 Invoice Financing emerged as a variant of factoring. Factoring generally involves control over the sales ledger of the client and the entire receivables management is taken over by the factor and is on a disclosed basis. But as companies grew, their internal systems too developed, with easier and cheaper access to information technology and the associated accounting packages, minimizing the need for third party involvement in sales ledger administration and management of receivables. This led to a situation whereby clients wanted to control their own sales ledger administration, which ran counter to the factor's comfort level of having control over client's sales ledger. Invoice financing, as a loan product, offers the financial benefits of factoring, while allowing the client company full control over the receivable management. It is an integral part of the overall bank-borrower relationship and will be ideally suited to the Services Sector, where due to the inherent nature of its operations not involving movement of tangible goods, drawing of Bills of exchange is not generally in vogue.

### 4.1.3 Methodology of Invoice Financing

Under Invoice Financing, the lending bank agrees to purchase a company's outstanding invoices (debtors) which are payable over a period of time, on an ongoing basis,

and then provides funding by way of pre-payment of invoice value of the approved debt. The level of funding is determined by a host of factors, including the quality of debtors book, historical bad debt levels, customer's financial position etc. Normally, funding up to the extent of 80% of the amount of the invoices is provided.

In brief the steps involved in Invoice Financing are: the client sends their invoice to their customer, copy (or sales ledger details) to the discounting bank; the discounter releases up to the agreed amount of the invoice value; the client follows up the payment of the invoice raised with the customer directly and deposits the receipts into a pooling account held to his credit with the discounting bank and the discounting bank appropriates against its dues and releases the balance to the client.

### 4.1.4 Special Features

**4.1.4.1** Under Invoice Financing, there is scope for flexibility as to quantum of potential funding, as it is based on the level of debotrs. Also, the credit line is based on the financial strength of the borrowing client's debtors, as well as on the borrower's own financial strength. The borrower's bank approves the list of debtors whose invoices, it is prepared to finance and accordingly, the level of funding varies as per the amount due from such approved debtors. Invoice Financing is provided under a 'non-disclosed' basis, which implies that the client's customers would not be aware of the arrangement, as long as there is no default. The control of the debt collection remains with the client and the payment from his debtors is received by the clients direct and passed over to the bank. The client is bound to make payment on the due date, irrespective of the fact whether the debtor has paid or not. The bank has a right to disapprove debtors / any invoice raised and make them ineligible for financing under this scheme for reasons of adverse credit report or their payment record.

**4.1.4.2** Under the traditional method of funding receivables, the prevalent style of credit is cash credit against book debts and the credit line is fixed, based on the estimated sales as also the average level of holdings of debtors, which is generally based on past trends. Thus the maximum amount of the receivable funding is based on the average level of debtors holding. In many industries, it is observed that the sales do not occur on a uniform basis, but fluctuate from month to month. Hence the present system of receivable financing through cash credit is found to be inappropriate, leading to intermittent over-financing or under-financing. Invoice Financing would be more appropriate to cater to such clientele segment, particularly Small

and Medium Enterprises, start-up units with potential for rapidly expanding sales and units with unpredictable cash flows and a high proportion of receivables in their working capital cycle. Invoice financing, however, is not suitable to companies which have the system of progress payments, retentions or where goods are sold on consignment basis.

**4.1.4.3** Under the traditional method of receivable financing against book debts, the borrowers submit a statement of outstanding book debts at the end of every month, based on which the drawing power is calculated. Eventhough the names of the debtors would be appearing in the monthly statement, bank is not aware as to whether the debts are being paid on due dates. Thus the Bank is not in a position to exercise full control over the movement of receivables. Under the Invoice Financing method, record of each and every invoice raised by the company on its approved debtors is maintained by the bank and thus the payment of each bill is tracked. If any invoice raised on a particular debtor is not paid on time, then the bank comes to know of it quite early and can stop further financing of invoices of that particular debtor. The number of invoices returned unpaid for goods rejected would also be indicative of the quality of the goods supplied by the bank's client and the bank can revisit its rating of the borrowing client. All these would, of course, require the financing bank setting up strong technology backed systems to provide the requisite MIS, to track down the individual invoice payments, overdues etc.

**4.1.4.4** To provide comfort to financing banks to enter into invoice financing with ease, it would be, but necessary to empower the banks to recover the debt due from the debtors directly, at any time, during its subsistence, without any loss of time. Being not privy to the transaction between the client and its customer, the only legal course available to the bank is assignment of such debts in its favour. As the provision stands today, an assignment of debt requires execution of an assignment deed, notification to debtor and his confirmation that he will pay the assignee on or before the accepted credit period. Moreover, it attracts stamp duty. A statutory assignment is a rather cumbersome and costly process, both from the bank's as well as the client's point of view. **The Group, therefore, recommends assignment by equitable mode as an alternative option. Under this arrangement, an agreement can be entered into between financing banker and the borrower whereunder the borrower can by means of a Power of Attorney empower the financing bank to exercise its right to recover the specific book debt financed by it, of course at any time, during its subsistence with due notice and direction to the debtor. This may particularly help the banks to step into the shoes of the creditor in the event of any adverse credit report on debtors or in any event of default. The proposal of equitable assignment would, however, entail legal clothing and should be exempt from stamp duty**.

## 4.2 Post-Dated Cheques

4.2.1 **One of the major factors inhibiting Bill Financing is the lack of payment discipline amongst buyers. It is in this context that the Group took note of the growing acceptance of usage of post-dated cheques to assure the creditors of payment on due date. This practice has gained momentum with Sec.138 of the Negotiable Instruments Act, providing for criminal as well as civil action, in cases where cheques are dishonoured for insufficiency of funds in the account.** In the Inter-Corporate deposit market, lenders collect post-dated cheques for payment on due dates. Even though the Inter-corporate deposit market has shrunk, inter-corporate short-term borrowing transactions do take place against delivery of post-dated cheque for the principal amount and interest. While interest is collected upfront, post-dated cheque is delivered for the principal amount. Even in the case of bill discounting by non-banking finance companies, post-dated cheques are collected from drawee. Consumer finance companies, as a rule, take post-dated cheques in advance for the repayment of principal amount and interest. Leasing companies too take post-dated cheques for payment of lease rentals. Lenders operating in these sectors have systematized the processes, with the aid of technology. Large players in the financial services market have even set up fully computerised processing centres for processing post dated cheques, tracking non-payment, generating default notice etc. PDC has, therefore, now emerged as an accepted mode of settlement of future debts in domestic trade and business, barring of course a few highly rated corporates.

4.2.2 PDC, as such is not a legally recognised instrument. PDC runs the risk of failing to be honoured on due date on grounds of closure of accounts in the interregnum, change in the authorised signatories etc.

4.2.3 In some markets like Indonesia, post dated instruments called GIRO are in vogue, and are clothed with some legal rights, though not recognised as negotiable instrument. Like a cheque, GIRO is signed by the Issuer and drawn on a bank; on the face of it, it has two dates, the date of issue and the date on which the amount is payable. It is a MICR instrument and is presented in clearing. Dishonour of Giro is an offence, as in case of a cheque. Stop payment instructions are not entertained by banks except in the event of loss of instrument backed by a police report. Banks in Indonesia do extend credit limit by way of overdraft facility against GIROs, generally with a margin of 20%. The specimen of the instrument is depicted below.

GIRO

**Payable at**
**ABC Bank Ltd**
**Mumbai**

Payable on : ..................................

Date of Issue : ..................................

Mr./Mrs. ........................................................................................ is due for receipt of payment of Rupees (in words) ................................................................................ only (Rs. ................................ ) (in figures) for value received.

(Sd) - **Drawer**

Giro No: 1234 5678 9012

**4.2.5** Alternatively, an instrument that would serve a similar purpose as a post-dated cheque or GIRO, is a Debit Mandate issued by the buyer on the seller. The debit mandate together with the invoice cum delivery challan is submitted to the financing bank, which presents the debit mandate for payment on the due date through clearing.

**4.2.6** It is further suggested that wherever possible, the clients can back up their credit availments from banks under facilities like bill discounting, invoice financing etc., with post dated cheques of their respective debtors. Instruments like GIRO, or Debit Mandate discussed above, which meet the ultimate objective of certainty of payment on the due date, would also serve a similar purpose.

## 4.3 Recommendations

**For the reasons discussed at length in the foregoing paragraphs, the Group recommends introduction of invoice financing as one of the alternative loan products to bill financing. It is also recommended that legal recognition be accorded to equitable assignment of debts financed by banks in favour of the**

lending banker as it can facilitate banks in recovering dues without any loss of time. The Group also recommends exemption of stamp duty on such equitable assignment so that the cost of credit is not pushed up. As the practice of obtaining post-dated cheques has been found to improve the payment discipline to some extent, possibilities for introduction of new instruments on the lines of GIRO or Debit Mandate, with due legal clothing, may be explored.

CHAPTER - 5

# Banker's Acceptance

## 5.1 Origin & Development

**5.1.1** Under one of the terms of reference, the group is to examine the role and scope of introducing 'Banker's Acceptance'(BA) facility in the Indian financial markets. BA has been in use in markets like USA and Europe primarily in financing international trade. Acceptances had their origin in the city of London. In the 18th Century, fait was the practice of reputable merchants to lend their name to trade bills against payment of a fee to impart credibility to such bills. In due course, through this activity of acceptance of bills and other associated financial services, they evolved into full-fledged merchant banks. Those merchant banks which specialised in acceptances came to be known as Acceptance Houses. Bills accepted by the Acceptance Houses are discounted by 'Discount Houses', another set of specialised institutions. Eligible acceptances discounted by these Discount Houses, are re-discounted by the Bank of England (BOE) at its intervention rate. It is one of the means through which BOE communicates interest rate signals to financial markets. Drawing from the experience in England, in the US too, at the time of establishment of the Federal Reserve System in 1913, it was felt that a market in Banker's Acceptances needed to be developed for New York to maintain its position as an important international financial centre. Towards this end, national banks were for the first time, authorised to accept time drafts and the Fed Reserve itself supported the nascent market by buying eligible bills for its own portfolio and by rediscounting them through the discount window. In Australia, as mentioned earlier in para 3.2.4, one of the modes of working capital funding was through Commercial Bills, which essentially partakes the characteristic of Banker's Acceptance.

**5.1.2** Historically, BA backed by trade bills had readily available discount windows like the Discount Houses in the U.K. and Central Banks as, for instance, the Bank of England and Fed Reserve. The discount window of the Central Banks is available only for bills backed by bona fide trade transactions. In the U.K., Bank of England discounts BA for upto 187 days. The BA has to be backed by genuine trade transactions. However, no proof is required except that the drawer must have such information as necessary in his office and the Bank of England reserves the right to call for such information within a reasonable period. In the US market, eligible Bankers Acceptances are defined as having the following characteristics.

- Trade related only
- Maximum usance of 180 days
- When movement of goods is involved, paper may be issued upto 45 days after shipment or 30 days pre-shipment.
- Issued for 180 days against warehouse receipts over readily saleable staples.
- Readily tradeable in the BA market
- Eligible acceptances qualify for a lower rate of interest than ineligible acceptances.

Finance bills, however, are not eligible for discounting.

**5.1.3** In Germany, Bundes Bank discounts BA's for upto 90 days, but a certain percentage of bills may be of financial nature not backed by underlying trade transactions. But at the time of re-discounting, banks have to declare whether the bills are backed by trade or are pure finance transactions. In Japan, the usance period of BAs range from 30 days to 270 days and such acceptances include pure finance bills not backed by trade transactions. However, re-discounting by Bank of Japan is available only to those commercial banks whose short term obligations are rated not less than A1, P1 or an equivalent rating by at least one nationally recognised credit rating agency.

## 5.2 Definition and Transaction Mechanics

**5.2.1** BA is a time draft or bill of Exchange drawn on and "accepted" by a bank as its commitment to pay a third party. The parties involved in a banker's acceptance are the Drawer (the bank's customer - importer or exporter), the Acceptor (a bank or an Acceptance House), the Discounter (a bank which could be the accepting bank itself or a different bank or a discount house) and the Re-discounter (another bank, discount house or the Central Bank).

**5.2.2** A "BA" is accepted, when a Bank writes on the draft its agreement to pay it on maturity. The Bill or draft contains an order to pay a specified amount of money at a specified time, and may be accepted by the bank. The bank becomes the primary obligator of the draft or bill of exchange drawn on and accepted by it. In effect, BA involves substituting bank's creditworthiness for that of a borrower. The accepted bill bears an irrevocable, unconditional guarantee of a bank to pay

the bill on maturity, in the process creating a negotiable instrument that is also attractive to investors in short term paper.

## 5.3 Acceptance Finance - Import Trade

**5.3.1** BA in the context of financing international trade takes the form of financing the importer based on an acceptance agreement between the importer and the Bank, or under terms of a letter of credit opened by the importer's bank in favour of the exporter. In the case of acceptance not accompanied by LC, the bank agrees to accept drafts for the importer and the importer agrees to repay the drafts accepted by the bank. The importer draws a time draft on the bank, which the bank accepts and funds the importer by discounting. The bank may choose to re-discount through the discount window or hold it till maturity, depending upon its liquidity and perception of the likely short-term interest rates. If the accepting bank does not discount, the importer can borrow in the money market against the Bank's Acceptance, effectively substituting the bank's credit rating for his own. (Flow-chart of BA financing importer under LC terms is given as Annexure-VII).

**5.3.2** Acceptance finance is also available to the importer through Letter of Credit. The importer's bank issues a letter of credit on its behalf in favour of the exporter and, if the documents negotiated under LC are in order, the accepting bank accepts the draft and discounts it for the exporter. The accepting bank, as in the former case, may hold the acceptance till maturity or re-discount. (Flow-chart of BA financing importer under non-LC terms is given as Annexure-VIII).

**5.3.3** Even though both the above forms of financing importers through BAs appear similar, there is a subtle difference between the two - in the second mode of financing, the drawer/exporter of an accepted draft is secondarily liable on it, which means the drawer must pay the holder of the acceptance on maturity in the event of the bank not honouring it.

## 5.4 Acceptance Finance - Export Trade

BA could also be used to finance the exporter, who may be required to extend credit to the importer, as per the terms of the contract. The exporter draws a time draft on his bank, which is accepted by the bank, discounted and proceeds

are credited to the exporter immediately. On the due date, the exporter pays the amount of the draft from the remittances made by the importer. BA can be used also to extend finance to exporter for procurement of raw materials in the nature of pre-shipment finance. As in the case of BA funding the importer, the Bank may hold the acceptance till maturity or rediscount. (Flow-chart of BA financing exporter given as Annexure-IX).

## 5.5 Acceptance Finance - Domestic Trade

Acceptances sometimes are also created to finance domestic sales and storage of goods but they constitute a very small proportion of the total Acceptances issued.

## 5.6 Pricing Structure

Bankers Acceptances were perceived as low-cost funding avenues by corporates as well as an attractive short-term investment avenue by investors. BA compared favourably as a funding avenue in terms of cost vis-à-vis LIBOR based loans. For top rated corporate borrowers CP is still the cheapest funding source, while for borrowers with less than prime rating, Bankers Acceptances provide a cost-effective funding route. Under an acceptance credit, the costs consist of two elements viz.(i) the acceptance commission (per cent per annum) and (ii) the discount rate (per cent per annum). The rate of acceptance commission is dependent upon the customer's credit standing. The discount rate for eligible acceptances varies according to market conditions, tenor and rating of accepting bank, but is always finer than that for ineligible acceptances. As the discount charge and the acceptance commission are usually collected upfront, discount to yield calculation is made to compare the cost of borrowing via acceptance credit, with alternative forms of short term financing. Apart from the pricing structure, customers would desire to protect themselves against subsequent increases in the base rate as in overdraft or other forms of short-term borrowing. In the US, Commercial Paper, as a short term instrument closely competes with eligible Bankers' Acceptances. International experience, specifically in the U.S. in recent years, indicates that, the popularity of BA has been on the wane due to a host of market developments. Particularly the emergence of cost-effective instruments from borrower's point of view like the asset-backed Commercial Paper and Euro-Commercial Paper and narrowing spreads between yields on Euro-dollar deposits and BA leading to investor indifference between the two as the preferred investment avenue.

## 5.7 Bankers Acceptance - Indian Scenario

**5.7.1** BA, as such, is not presently prevalent in the Indian financial market. The closest to BA is the co-acceptance by Bankers of bills drawn on their constituents for purchase of capital equipments under Deferred Payment Guarantee schemes.

**5.7.2** Though in the matured financial markets like the U.S., BA is on the decline, in a developing financial market like ours where credit products and substitutes are too restricted, the Group feels that there is scope for introduction of Banker's Acceptance. **The Group, therefore, recommends that Banker's Acceptance can be introduced in the Indian market to finance import, export and domestic trade transactions. However, care has to be taken to ensure that BAs are issued to cover only genuine trade transactions. Since banker's acceptance is the substitution of bank's creditworthiness to that of the borrower, it is necessary to ensure that adequate safeguards are in place through prescription of appropriate regulatory norms and banks' own internal guidelines. These are discussed briefly below :**

**5.7.3** Banker's Acceptance, being a tradeable money market instrument, its liquidity and pricing in the secondary market would largely hinge upon the rating of the bank that grants the acceptance. In a market dominated by banks having substantial government holding, assessment of bank's creditworthiness and pricing of BA's may be largely driven by the perceived comfort level afforded by such sovereign holding. But with the entry of more private sector players and the possible phased dilution of government's stake in PSB's, pricing of the instrument may over a period of time tend to reflect individual bank's own rating. **Therefore, proper rating mechanism for Banker's Acceptances may become necessary as the market develops.** From the client's viewpoint too, their credit standing would be the key determinant for pricing by the accepting bankers.

**5.7.3.1** Since BA entails substitution of bank's credit for that of the borrower, **to restrain temptation of banks' over gearing, prudential regulation may prescribe a ceiling for such off-balance sheet exposure and also due disclosure from time to time on the extent of such exposure** - both the amount of acceptances issued and the outstanding position to the supervisory authority. Such information should be available to all market participants too.

**5.7.3.2** The accepting banker should ensure that the **acceptance facility is extended only to clients of high credit standing.** To avoid any delegatee transgressing the authority and also to ensure full control over such acceptances issued, banks may have to

restrict acceptances to high rated pre-approved clients and for high value transactions. Also, according "Acceptances" can be centralised and have to be computerised and in the case of large banks, two or three BA processing centres can be established to accord 'Acceptances'.

**5.7.3.3** All the above safeguards are required to be in place, since BA's unlike LC's and bank guarantees, being tradeable instruments primarily on Bank's Credit, carry the risk of systemic contagion.

## 5.8 Bank Paper - A New Instrument

**5.8.1** Considering the unique nature of our existing cash credit system, the Group also suggests a variant of Banker's Acceptance, so as to provide liquidity to domestic banks in their credit portfolio. **Accordingly the Group recommends that top-rated borrowing clients who enjoy working capital limits of say Rs.10 crore and above, and whose rating with the bank has been consistently satisfactory, may be allowed drawals against the Working Capital Demand Loan (WCDL) component against a promissory note in favour of the lending bank, called "Bank Paper" (BP).** This could be discounted by the bank in the money market. The tenor of such instrument as also the minimum amount could be decided by the individual bank. Such Bank Paper (BP) should have an inscription that the amount represents drawing in the WCDL account of the borrower. There could be a prudential stipulation of bank-wise ceiling for such bank paper allowed to be floated in the market and outstanding at any point of time.

**5.8.2** The rate of discount/rediscount of BP at any time would be determined by market rates and not related to the underlying interest rate on working capital borrowings of the issuing companies. Thus, BP could supplant commercial paper. Nevertheless, BP's distinctive differing characteristic is that it derives its value as an instrument, essentially on the bank's credit and not of the borrower as of commercial paper. In a way it may also appear to be an extension of the concept of 'Inter Bank Participation Certificate' (IBP). In the case of IBP, a portion of the advances portfolio of the bank is hived off and sold by the bank, which originally provided the loan, to the participating bank/s with or without risk. IBP did not take off in a big way, for reasons like: the limited number of participants in the market, its lack of tradability, the ceiling on the extent of participation and the procedural formalities involved. Banker's Paper proposed herein however, being a tradable instrument in the market, targets a wider base of investors like banks, financial institutions and cash surplus

corporates, and offers full liquidity at all points of time. Once the volume of BP increases, banks could use them both for borrowing in the money market and for lending to other banks by buying BP from the latter. The BP could also be dematerialised, facilitating easy transferability. In due course, usage of BPs would facilitate accelerated development of the term money market in India; Corporates with surplus funds could also invest in BPs.

**5.9** With the proposed move to confine the inter bank call money market to banks, the Group feels that Bank Paper and Banker's Acceptance being tradeable short-term instruments would provide attractive alternative investment outlets to those institutions exiting from the inter bank markets for deployment of their short-term surpluses; simultaneously the market for Repos too can be widened by extending Repo facility to Bank Paper and Banker's Acceptance and making them accessible to non-bank participants, as well. **The Group, therefore, recommends that Repo facility may be extended to Bank Paper and Banker's Acceptances issued by scheduled commercial banks. Such a measure would, besides imparting liquidity to the embryonic market for such instruments, would also add depth, flexibility and vibrancy to the domestic money market.**

CHAPTER — 6

# Bill Financing – Services Sector

6.1 The Working Group by one of the terms of reference, is to examine the possibility of extending bills discounting facility to services sector in the context of its growing importance in the country's economy. At the outset, it must be said that the services sector, in recent years, is transforming the economic profile of the country. It is poised to register tremendous growth and would continue to make a very significant contribution to the overall economy in terms of wealth creation. The services sector now accounts for 46% of the country's GDP and has been growing in the range of 7-10% per annum since 1995-96 (Source : CMIE, July 2000) and given the momentum of information technology, it is bound to increase exponentially.

6.2 The peculiarity of the services sector lies in its heterogeneous character. The variegated and differentiating characteristic of services sector could be perceived from its very composition, comprising wholesale and retail trade, transportation and storage of goods, finance and banking, insurance, health, education, telecommunication, entertainment, hospitality, public utility services like transport, electricity, water/waste management, pollution cleanup, professional services like accountancy, legal, medical, marketing, consultancy, counselling, after-sales services and maintenance, public administration and host of such other services. With the structural changes sweeping the industrial sector, many corporates may outsource their support service activities to enable them to focus on their core business.

6.3 A study group sponsored by Reserve Bank of India through National Institute of Bank Management on "Lending to Services Sector" categorized the services sector under the following broad segments viz.

a) Software

b) Telecommunication - Basic telephone services, pagers, cellular telephone services, Internet services, multimedia etc.,

c) Transportation - Warehousing, logistic services, fleet operators, truck operators, passenger transport, courier services etc.

d) Construction and engineering services - Labour contracting; areas covered under infrastructure facilities which includes power transmission and distribution, ports, airports, sewerage/water/effluent treatment etc.,

e) Health related activities - Hospitals, diagnostic centers, nursing homes, specialty nursing homes, polyclinics, ambulatory care hospitals, old age care centers, child care centers, health clubs, etc.

f) Tourism related activities - Hotels (star category, economy, youth hostels), restaurants, resorts, time sharing, sanctuaries/wild life parks, travel agencies, tour operators, taxi/bus operators/companies, tourist coaches etc.,

g) Recreation related activities – Recreation clubs, amusement parks, casinos, golf courses, luxury cruises, science parks, water parks etc.

h) Entertainment activities - Cable operators, films, Tele-films etc.

i) Financial Services.

j) Educational services - Commercial education (IT based), professional courses, basic education etc.

k) Self employed professionals - Chartered Accountants, architects, doctors, advertising agents etc.

The above, of course, is only an illustrative but not an exhaustive enumeration.

**6.4** The legal definition on services sector, under the Consumer Protection Act, captures major segments of the services sector:

"Services means services of any description which is made available to a potential user and includes the provision of facilities in connection with Banking, financing, insurance, transport, processing supply of electrical or other energy, boarding or lodging or both, housing construction, entertainment, amusement or the purveying of views of other information but does not include rendering of any services free of charge or under a contract of personal services". (Section 2(O)).

**6.5** The study group referred to in para 6.3 above, observed that though the services sector contributes more than 50% of the GDP, the bank credit to the services sector has not been quite significant and that even among the services sector, a major part of the credit by the banking system has been extended to transport operators, non-banking financing companies, construction companies and tourism and travel

services providers. The Reserve Bank of India has recently issued broad suggestive guidelines to commercial banks on the approach to be adopted in lending to one of the country's key driver of growth in services sector viz. Software sector. The Indian Banks Association too has formulated broad guidelines with regard to financing of film industry.

**6.6** Given the growth trajectory of this sector, there is little doubt that the banking system in the country has to gear up its credit delivery mechanism to meet the increasing credit requirements of this sector. The service production, the product, consumption and the market have all peculiar characteristics and this is well captured in the Annexure-X. The traditional asset-based lending approach may not be suitable for many of the services sector projects. The re-sale value of the assets, if any, may be negligible; (e.g., software, films, TV Serials, etc); and difficulties would be encountered in disposing of such assets (e.g., hospitals, hotels with long term management contracts, golf courses etc.,). Banks have therefore, to adopt cash flow based lending approach. Working capital finance for these projects may be on the basis of estimation of periodic cash gaps. To certain segments in service sector like software, the credit facility may be extended on contract-to-contract or assignment-to-assignment basis. Defining milestones in advance, which facilitate disbursement and monitoring of loans is a crucial aspect.

**6.7** In some of the high-risk areas, traditional lending products, with fixed rates of interest may not be appropriate. Banks may have to come out with alternative financing option like convertible loans, conditional loans (part of the revenue may come by way of royalty on sales) etc. Such products may compensate adequately the lending banks for the additional risk which they may take in financing such high risk service oriented activities. In view of the diverse nature of services sector and customer specific intensity of the services provided within each sector, nay by each service provider vis-a-vis the user, banks have to evolve their own operational guidelines, depending upon the segment to which and customers to whom they lend.

**6.8** Working capital requirements of service sector will have to cater to both pre and post production credit needs. Currently, in the segments where the banks have exposure, credit needs are being met with a package of traditional products, both fund based and non-fund based. Fund based credit limits like term loan for building of the infrastructure, demand loan and cash credit for pre-production requirements and cash credit against book debts for receivables are provided. In service entities, where the services are intangible and process and products are hard to distinguish, valuation of services customized to specific customer needs, is proving difficult.

**6.9** Traditional facilities like bill discounting in respect of services rendered by the service provider may not be the preferred mode or style of credit as historically bill discounting entailed movement of tangible goods. In view of the customer centric service rendered, the expectation of the user and the fulfillment of such expectation by service provider will have a direct influence on the payment cycle. Hence the possibility of the user of services accepting the Bill of Exchange at the time of delivery of the services is not bright. Invoice financing/factoring may be a better alternative to bill financing for such service providers. In some service sectors like public utilities, cellular telephone, hospitality services etc., there would be multitudes of users of such services, entailing small payments. With the advancement of technology and e-Commerce, such micro payments may in due course of time be substituted by on-line electronic payments. Credit needs of such public utility service providers may be met through securitisation of their receivables. While bill discounting, factoring or invoice financing make finance available only on the strength of existing receivables, securitisation encompasses both current and future. Future flow securitisation is gaining momentum, whereby cash-flows that would be earned/generated by the originator through delivery of products/services in future can also be securitised. Securitisation offers 100% financing and will be a preferred option in respect of services like public utilities, telecom services, hospitality services etc, wherein the receivables are manifold and in small lots. As securitised papers are to be rated, there would be access to a wider base of investors and cost of borrowing may also become comparatively cheaper. Receivables in respect of certain services like annual maintenance of equipment, insurance premia receivable by an Insurance Company, are also a few other illustrative cases in the Services Sector, which may lend themselves to securitisation.

**6.10** Having said this, the Group does not rule out the possibility of some segments in the Service Sector, still being amenable for Bill Finance, like software, particularly when there is an established relationship between service provider and user; given the past record and the standing of the service provider, the user may not have hesitation in accepting the bill; so also, the service provider may be willing to extend credit to user of the services, based on his past track record of payment. For instance, when software companies undertake projects to develop various applications, the vendors draw export bills on the user of the application and banks discount bills since there is an underlying trade transaction. Such projects are undertaken on a large scale and are often extended to new parties also. **The Group, therefore, recommends that the services rendered/delivered by firms/companies engaged in services sector may be considered on the same footing as of sale of goods. Banks may be permitted to entertain purchase/discount of bills drawn by service providers on their debtors, subject to the satisfaction of the banker that the services have been rendered. The definition of a bill eligible for discounting can**

**also be suitably amended to include services rendered on par with bills arising from other trade related transactions.**

**6.11** As for safeguards to be put in place in extending bill discounting to a new area like services sector, it would not be feasible to lay down any generic norms, because of the diverse nature of the sector. Suffice it to say that the banks can verify documents like copies of the service contract entered into between the service provider and the user, the terms of payment, conformity of the bill raised on the user to the terms of contract, conditionalities, if any, attached, past transaction record with the user and track record of payment etc. Banks also have to exercise due diligence in assessing the credit worthiness of service provider, who must have good control systems and demonstrate clear financial success as the bank would be taking direct exposure on the service provider.

CHAPTER - 7

# Challenges of e-Commerce

7.1 Before concluding, the Group considered it appropriate to briefly advert to one of the key emerging trends in the world of business, the use of Internet as a potent cost effective tool for electronic commerce. The developments in this field may, with the passage of time, render some of the issues discussed/suggestions offered in the report less relevant.

7.2 Internet has changed the concept of communication. Communication being the central point in today's world of information, Internet influences practically every walk of life: Commerce is no exception. Commerce on Internet, termed e-Commerce (Electronic Commerce), essentially, means setting up of a virtual business space on the net, negotiating deals over net and settling the monetary part of the transaction over the net. The speed and the cost at which all these transactions can be carried out makes e-Commerce a superior, speedier and cost-efficient mode of conducting business, besides enabling organizations to realize productivity gains and new opportunities for generating revenue.

7.3 e-Business goes far beyond mere execution of business or financial transactions: it is expected to bring about a fundamental change in the way the business is run, the way companies link-up their suppliers, dealers and consumers, manage their customer relationships, including online auctions, e-customization – all necessitating the imperative need to redefine their core business processes.

7.4 The privatisation of long distance telephony is expected to result in a manifold increase in bandwidth. This would reduce the call costs and provide faster internet access and downloads thereby offering substantial potential for e-Commerce

7.5 The net has not only started crunching transaction costs dramatically, but is also facilitating outsourcing and making it possible to transact with many partners and design manufacture collaboratively. Though e-business is currently at its evolutionary stage, some of the leading domestic corporates in the country are gearing themselves to conduct business on line.

**7.6** Basically, e-Commerce presents three types of models: viz., Business to Consumer (B2C), Business to Business (B2B) and Consumer to Consumer (C2C). In B2C model, the business establishment puts up a virtual shop on the net. Consumer can shop on the net, order and pay for it. Here the volume of transactions may be large, but the value would be generally low. In B2B model, two business establishments – say the manufacturer and the vendor in the supply chain, or the manufacturer and the distributor on the distribution chain, interact over the net. They may negotiate on price, service and other product related issues on the net itself and place orders. Given the nature of short-term contractual relationship in marketplace, the need for immediate settlement of the financial transactions may become inevitable and business entities may instruct their respective banks to make/receive payments for goods purchased/sold. . All these would mean that the entire business would get done electronically, shorn of the usual paper based processes.

**7.7** Corporates would wish to have B2B linkages with their suppliers and as well their distributors and dealer network. Those who have established their presence on net with consumers may need B2C linkages. Ultimately, they would desire complete integration of their supply and sales chains, providing seamless integration for transaction and information flows to facilitate their e-Procurement, e-Customization, e-Marketing and e-Sales. These linkages would not become complete without integrating the banking channel for payment/settlement. Security for electronic payments would of course be very crucial.

**7.8** The pace of development of business on net would, however, depend upon the provision of a right B2B and B2C solution to the business houses by service providers, availability of a highly secure, reliable, robust on-line payment infrastructure, cost effective data interchange standards and independent certifying authorities, who will provide certification of the identities of the transacting parties, validation of deals and authentication of the electronically transmitted financial and commercial transactions like fund transfers, letters of credit, invoices, debit and credit advices, etc.

**7.9** Information Technology Act, 2000 that has just been enacted accords legal recognition for transactions carried out by means of electronic interchange or through electronic medium including the Internet. The Act provides for record keeping in electronic form and also recognises digital signature. Thus the IT Act 2000 accords legal validity for all but five types of transactions specifically excluded from the Act viz.,

- a Negotiable Instrument" as defined in section 13 of the Negotiable Instruments Act, 1881;
- a Power-of-Attorney" as defined in section 1A of the Powers-of-Attorney Act, 1882;
- a Trust as defined in section 3 of the Indian Trusts Act, 1882;
- a Will as defined in clause (h) of section (2) of the Indian Succession Act, 1925;
- a Contract for the sale or the conveyance of Immovable Property or any interest in such property.

**7.10** With the passage of the Information Technology Act, most of the contracts that we need in the commercial world can be created without a written document. Any "offer" can be made through electronic documents and, if the recipient is prepared to respond by accepting the offer electronically, a legally valid agreement is concluded.

**7.11** All the above developments in the e-Commerce field would certainly impact if not immediately, but in the medium-term, the way banks finance industry and trade. The style of credit to trade and industry will undergo change. Some of the current business opportunities like handling documentary collection may cease to exist. For instance, one of the reasons cited by the trade and industry for not preferring the bill discounting mode of financing is the delay involved in the transmission of documents. It was represented that the goods reach much faster than the documents. Under the bill discounting mode of financing, the documents are to be routed through two banks, one at the seller's end and the other at the buyer's end and this invariably results in delay. Therefore, clients prefer to send the goods and documents directly to their buyers and thus bill discounting mechanism is not preferred. In the e-Commerce era, digital documents would reach instantly, much ahead of the physical goods and the paying bank may have to make payments against receipt of the digital documents. Perhaps, bill as an instrument of financing may cease to exist and may be replaced by a tripartite agreement amongst the seller, buyer and the buyer's bank by which, the receiver of the goods will intimate the bank the receipt of the goods and instruct the banker to electronically debit his account on due

date. The banks have to be part of that supply chain if they want to stay in the payment business and earn fee income. They have to provide other value added services being the part of the entire transaction cycle.

**7.12** Developments abroad indicate that financial sector is already moving forward in the direction of building the necessary infrastructure. For instance, a few global financial institutions have got together to provide *inter alia* Certificate Authority Services on real time basis, enable legally enforceable e-Commerce transactions and offer e-Commerce ready products and services, backed by uniform systems of participating rules and operating procedures. New software offerings, designed to provide standardized data formats like application for loans and other services are on the offering. Bolero International, launched as a cooperative endeavour of SWIFT and other partners, has the objective of providing electronic substitutes for paper based documentation with emphasis on international business. The main components of Bolero are a central title registry and a core-messaging platform that facilitates the exchange of instructions, commercial documents and title documents. Bolero's registry controls, monitors and transfers title and ownership.

**7.13** In this emerging scenario, domestic banks have to prepare themselves to re-visit the financing needs of business in the new environment and devise products and services to meet the new business paradigm, especially in view of the fact that the creation of electronic market would result in the collapse of supply chain into one integrated procurement exchange. Invoice Financing by banks, which accept debit instructions/pay order of their clients via the EDI route or in any secure cost effective electronic form for payment/settlement of B2B e-Commerce, may become a substitute for financing trade in the same way as discounting of bill. Banks have also to upgrade themselves technologically to be in readiness to handle transactions with its business partners in the electronic market place. Their role, particularly in payment and settlement will be critical. They have to re-engineer the workflow and process substantially to cut costs of delivery of banking services. The supply chain and distribution chain linkages would provide new business opportunities like channel financing on the net. Banks may be asked to bid for standardised services and products on the net.

**7.14** To conclude, the Group, while articulating the realm of possibility and potency of e-Commerce and its likely impact on bank financing, would not at this evolutionary stage wish to offer any definitive recommendations, particularly as technology challenges to handle the enormous demands of the market place, including provision of highly secure reliable robust online payment infrastructure, are tremendous. However,

looking at the wave of optimism being shared in the developed markets on the future potential of e commerce and their preparedness to meet them, **the Group recommends that, an expert group drawn from the fields of technology, banking and corporate finance be constituted to prepare the blue-print for meeting the e-commerce challenges that may be thrown up in the financial sector of the country.**

**K R Ramamoorthy**
Chairman

**Harbans Lal**

**Praveen Kadle**

**Anuradha Nadkarni**

**S Thyagarajan**

**Dr. G S Bhati**

**J Jussawalla**

**J B Mhatre**

**Shivaji Dam**

**R M Thakkar**

**Umesh Shah**

**T S Sohal**

**K Chandrachoodan**
Member Secretary

**S D Sapkal**
Member Secretary

## Annexure - I

### Monetary Policy Department

# Memorandum for setting up of a Working Group on Discounting of Bills by Banks

At present, banks are allowed to discount only bills covering purchase of raw material / inventory for production purposes and sale of goods. Bills covering payment of electricity charges, customs duty, hire purchase / lease rental instalments and sale of securities are not eligible for discounting by banks. Further, in general, banks are prohibited from discounting bills covering services. But, in the context of the growing importance of the services sector especially industries such as, information technology and software services, travel, tourism etc., it is considered necessary to examine the possibility of extending bills discounting facility to this sector.

2. In connection with the above, it has been decided to set up a Working Group consisting of the following :

| | | |
|---|---|---|
| 1. | **Shri K R Ramamoorthy**<br>Chairman, Vysya Bank Ltd | Chairman |
| 2. | **Shri Harbans Lal**<br>Chief General Manager (Credit), National Banking Group<br>SBI, CO, Mumbai | Member |
| 3. | **Ms. Anuradha Nadkarni**<br>Director and Head of Financial Insitutions Group, ANZ Grindlays Bank | Member |
| 4. | **Dr. G S Bhati**<br>Adviser, Monetary Policy Department | Member |
| 5. | **Shri J B Mhatre**<br>Deputy General Manager, DBOD | Member |
| 6. | **Shri R M Thakkar**<br>Deputy General Manager, DBS | Member |
| 7. | **Shri T S Sohal**<br>Director, DEAP | Member |
| 8. | **Shri K Chandrachoodan**<br>Deputy General Manager, MPD | Member Secretary |
| 9. | **Shri S D Sapkal**<br>Deputy General Manager, IECD | Member Secretary |

3. The Group may co-opt others including bankers and trade representatives as considered necessary.

4. The Working Group shall have the following terms of reference :

   a) To examine the feasibility and suggest measures to strengthen the existing Bills Discounting mechanism as an instrument for facilitating financing, in particular trade and services sectors, including discounting of Trade Bills against letters of credit opened by banks.

   b) To examine the role and scope for introducing "Bankers' Acceptance" facility.

   c) To examine all critical and relevant issues including the necessary safeguards to be put in place before extending Bills Discounting to new areas like services and introduction of "Bankers' Acceptance" facility.

   d) Any necessary charges in the existing legal / regulatory framework that my be needed.

   e) Any other issue relevant / incidental to the subject which the Group considers necessary.

5. The Group may constitute sub groups and call special invitees for its meeting as appropriate.

6. The secretarial assistance to the Group shall be provided jointly by the Monetary Policy Department and Industrial and Export Credit Department, Reserve Bank of India.

7. The Working Group shall submit its report within a period of two months after its first meeting.

Mumbai – 400 001 **Y V Reddy**
3.12.1999 Deputy Governor

## Annexure - II

*Questionnaire to Customers*

# Working Group on Bills of Exchange

Bill Rediscounting Scheme of Reserve Bank of India was formulated to facilitate development of Bill culture in the country and move towards financing of receivables from the existing financing of inventories. The scheme has, however, not picked up momentum in the market. Consequently, Indian Financial System has been deprived of an important financing tool being used the world over. This questionnaire has been devised to get the feed back from the users of Bills discounting scheme. You are requested to give your opinion with emphasis on the irritants, as they exist today, in the scheme. Your suggestions to make the scheme smoother are welcome. Please give your comments and suggestions under each one of the questions

## Introduction

1. What percentage of your turnover comes through credit sales ............%
2. Do you avail credit facilities from any Bank? Yes/No
3. Do you avail bill facilities from your Bank? Yes/No
4. Do you avail finance against receivables? Yes/No
5. Any other credit facilities? (Please state type)

   Cash Credit Yes/No

   Packing Credit Yes/No

   Overdraft Yes/No

   Others 1..............................

   2..............................
6. Does your Bank offer any other type of bill facilities?

   ..........................................................................................................
7. What type of financing, in your opinion, is convenient for you and why?

   ..........................................................................................................

## Drawing the Bill

Do you face difficulties in drawing usance bills on your customers? If yes, nature of difficulty

### Cost related

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### Others

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### Getting the bill accepted

Do you face difficulties in getting your usance bills accepted by your customers? If so, nature of difficulties.

i. Cost related

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ii. Reluctance on the part of buyers

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iii. Formalities involved

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iv. Delays

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v. Others

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What is the reaction of your customers on acceptance of usance bills?

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### Submitting the Bill for discounting to Banks

Do you find the procedure for discounting the bills cumbersome ? Yes / No

If yes, which area of the discounting process is considered unreasonable?

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### Dishonour of bills

What is the average rate of dishonour of bills experienced by you?

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What are the reasons for dishonour?

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Are existing laws sufficient to deal with the defaulters?

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How secured are you legally in case of default?

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### Payment of bills

Is the existing payment mechanism considered adequate? Yes / No

If no, please suggest measures to strengthen it.

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### Banking Practices

Are you aware of any practice prevalent at any other Bank which you consider more user friendly and would like your Bank to adopt?

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In practice, is it easier to have a bill limit sanctioned as compared to other type of credit facilities? Please assign reasons.

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Do you consider bill financing a viable mode of credit in terms of cost (bank interest, service charges, penal rate etc.)? If not, what measure would you propose to bring it at par with, say, cash credit?

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## Legal

Do you feel that existing laws and procedures facilitate adoption of bill discounting? If not what measures - regulatory and legal - would you suggest to activate the bill market?

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## Overall Suggestions

What changes, in your opinion, should be brought about in the existing scheme to make bills of exchange a popular means of finance for the industry?

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Do you think bill culture can facilitate provision of need based finance to services sector? If yes, which services could be considered for this type of finance?

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Signature :

Name :

Designation :

(Your name and other particulars are optional. You can remain anonymous if you so desire)

## Annexure — III

*Questionnaire to Banks*

# Working Group on Bills of Exchange

## Questionnaire on Bill Discounting

**Name of the Bank :**

Is your bank active in Bill Discounting Scheme Yes/No

If yes, what is the composition of bills discounted by your bank for the last 3 years?

(Rs in crores)

| Period | Demand | | Usance | | %age to Total |
|---|---|---|---|---|---|
| | No. of bills | Amount | No. of bills | Amount | Advances |
| 1996-97 | | | | | |
| 1997-98 | | | | | |
| 1998-99 | | | | | |

Has your Bank availed of Bills Rediscounting facilities from the Institutions? If so, please give institution-wise details for the last three years.

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### Business Operations

What advantages / disadvantages you would attribute to bill financing and its existing popularity or unpopularity amongst your customers?

Advantages

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Disadvantages

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### Costs

What is the Cost burden estimated in handling the bill business?

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Suggestions to reduce the costs

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At the costs suggested above, is this scheme worthwhile?

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Is the Stamp Duty levied on bills beyond the maturity of 90 days considered an impediment in the development of bill market?

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Whether the existing usance period for exemption in stamp duty should be extended beyond 90 days across the board?

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Suggestions, if any limit to the period is envisaged

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### Procedures related

What are the problems faced by the Bank in handling the bills?

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Suggestions to ease the problems

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What are the problems faced by the customers in handling the bills?

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Suggestions to ease the problems

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Do your customers find it difficult to get the bills accepted from the buyers?

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Suggestions to make acceptance attractive/acceptable for buyers?

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## Payments

What is the general experience of your customers, as drawers of bills regarding payment on maturity

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Suggestions for disciplining the drawees to make payments at due date

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Is the time taken for acceptance considered reasonable by the customers

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Suggestions to reduce the time lag

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Have you received any suggestions from your customers to make the bill financing user friendly?

Suggestions received

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If so, please give your comments

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At present, the bills discounted by NBFCs are not rediscounted by the banks except those arising out of sale of commercial vehicles? Do you think this is too restrictive and NBFCs should be allowed to get their bills rediscounted with banks?

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If so, what measures would you suggest to safeguard the banks' interest?

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Do you think that the participation in the rediscounting of bills should be enlarged? If so, should be NBFCs become a part of this?

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### Acceptability

Is Banker's acceptance as a credit enhancement
measure in vogue in your Bank? Yes/No

If yes, please suggest how it could be popularised so as to widen the bill market?

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Can a bill with Banker's acceptance be treated as good and genuine trade bill as envisaged in Section 17(2) & 17(4) of Reserve Bank of India Act?

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Can the bill market be activated further if the borrowers are rated by a rating agency?

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### Legal

Are existing laws sufficient to deal with the defaulters?

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How secure do the bankers feel, legally, in case of default?

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Do you think that existing laws and procedures facilitate adoption of bill discounting?; If not what measures - regulatory, administrative and legal - would you suggest to activate the bill market?

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Are any special measures required in the context of liberalised environment?

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Are any special measures considered essential in the context of the coming environment of e-commerce?

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### Extension of Scheme to Services Sector

Can the bill discounting scheme be extended to services sector also? Yes/No

If yes, please indicate the types of services your bank would like to finance?

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What, in your opinion, are the stumbling blocks in providing finance to this sector?

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How would you like to appraise the requirements of this sector?

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How would you like to finance knowledge-based industries, in particular, Information Technology?

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What mechanism would you suggest to ensure that the bills are genuine and of fair value?

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Any other area which you feel has not been tackled in the questionnaire?

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Any other matter, which, in your opinion, should be considered by the committee?

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# Annexure - IV

*Analysis of Response to Questionnaire*

## A. Customer Questionnaire

### Aspects Covered

a) Extent of credit sales by the respondents, type of credit facilities availed from banks, type of credit facilities availed to finance receivables and type of bill finance, if any, availed.

b) Difficulties faced in drawing bills on customers.

c) Difficulties encountered in getting bills accepted by customers, covering areas such as willingness, costs, formalities involved, delays etc.,

d) Procedural delays in discounting bills with banks.

e) Problems related to dishonour of bills.

f) Inadequacies in the existing bank payment mechanism for bills.

g) Other prevailing banking practices in receivables/bills financing, legal aspects, etc.

### Response Summary

#### Credit facilities availed

About 80% of the respondents stated that almost three fourth of their sales were on credit terms. Obviously, receivables financing is one of the most important needs of the corporates. More than 90% of the respondents availed credit facilities from banks, while three fourth of them availed bill facilities, though the quantum of bill financing represented a very small portion of the total credit facilities availed by them.

### Convenient Mode of Receivables Financing – Cash Credit

The respondents were asked as to which mode of receivables financing was most convenient to them and why. A large majority of them (63%) of the respondents said that cash credit/overdraft against book debts was most convenient. On the other hand, only 22% of them said that bills discounting facility was a convenient mode. Some of the reasons given as to why cash credit against book debts was found more convenient were :

- Flexible mode of finance
- Operational convenience
- Time Saving
- Lower Cost
- Convenient, especially when:
- the buyers are at multiple locations.
- the number of buyers is large
- individual bill amounts are small.

### Transaction Cost

Two thirds of the respondents felt that higher cost was an important issue coming in the way of drawing the bills. Some of the specific comments in this regard were :

- higher effective interest cost since discount is deducted upfront
- bank charges are levied twice, once by drawer's bank and later by drawee's bank
- high incidence of stamp duty.
- high rate of penal interest on overdue bills
- additional fees charged by the banks for obtaining status reports on buyers.

### Operational & Procedural Constraints

Some of the major difficulties faced while drawing usance bills on customers, as indicated by the respondents, were :

- wide geographical spread of the buyers
- procedural delays on the part of both the drawer's and the drawee's banks
- cumbersome documentation formalities
- the usual 90 days usance allowed by the banks is not sufficient
- difficulties in submitting supporting documents
- banks are hesitant to discount bills on new buyers

## Difficulties Experienced in Getting Bills Accepted

The difficulties in getting usance bills accepted by the customers, as mentioned by the respondents, could be classified into the following categories :

a) Cost related: About 60% of the respondents said high cost was an important aspect coming in the way of their customers accepting usance bills.

b) Reluctance on the part of the buyers: It was mainly due to the reasons such as commitment to pay the amount on due date, buyers themselves not realising their due in time, government departments/PSUs and some multinationals not accepting bills as a matter of policy, etc.

c) Formalities involved: The areas identified were stamping, requirement of board resolution, attested specimen signature, etc.

d) Delays: They were mainly due to operational and logistical difficulties in sending and receiving the documents and delays in acceptance of bills by buyers.

e) Other difficulties: They covered areas such as:

   - buyers' reluctance to accept bills for fear of problems in accounts reconciliation in case the materials were rejected.
   - banks insist upon production of original documents(e-mail or fax not accepted)
   - buyers' reluctance due to general slow down in the economy.

## Discounting of Bills with Banks cumbersome

42% of the respondents felt that the procedure for discounting of bills with banks was cumbersome. Some specific areas mentioned were :

- stamping of documents
- banks not accepting bills of smaller values
- non-acceptance by government agencies(as buyers) of power of attorney given by the seller to his bank
- procedural delays
- delays in receiving information from collecting bank regarding acceptance/ non-acceptance of bills
- banks not discounting bills without verifying the credentials of the buyers.

## Dishonour of Bills

As per the responses, in most of the cases, the extent of dishonour of bills was less than 10%. This is not a very significant percentage. The major reasons for dishonour were:

- buyers do not have funds
- return of the materials
- deliberate dishonour
- adverse business conditions

A majority of the respondents (56%) felt that the existing laws were not sufficient to deal with the defaulters. The main reasons attributed by them were – legal delays and high costs. Naturally, many of the respondents did not feel adequately secured legally in case of default.

## Payment of Bills – Strengthening the Payment Mechanism

More than half of the respondents considered the existing bank mechanism for payment of bills as inadequate. Some suggestions for strengthening the payment mechanism were:

- speedy remittance of collected amounts
- introduction of electronic clearing and settlement mechanism between banks

## Banking Practices

Responding to the question whether they were aware of any practices prevalent in any other banks which were more user friendly, the following practices were mentioned :

- cash management services offered by some of the banks
- use of courier services, telex, fax, e-mail for speedy clearance.

Some of the respondents also felt that Non-Banking Financing Companies (NBFCs) followed better practices.

The respondents were asked whether they found it easier to have a bills limit sanctioned by a bank, as compared to other credit facilities. Almost three fourths of them said 'yes'. It is important to note here that despite the relative ease of sanction, the bills discounting facility has not really become popular. This is possibly due to other operational handicaps such as high cost, unwillingness of the buyers to accept bills etc.,

The respondents were asked to suggest measures to bring the cost of bill financing at par with cash credit facility. Some of the suggestions made were :

- handling charges may be reduced
- stamp duty may be levied only for bills having usance period of more than 180 days.
- rate of penal interest on overdue bills may be reduced.

## Legal Measures

Legal measures to activate the bill market as suggested by the respondents were:

- More stringent legal provisions with fixed time frame for disposal of cases pertaining to dishonour of bills.
- Dishonour of bills may be treated at par with dishonour of cheques and to be made a criminal offence.

## Suggestions of General Nature

Some suggestions, of a general nature, for making bill of exchange a popular means of finance for the industry were :

- banks may educate the clients about benefits of bill finance scheme
- extra credit limits to drawers to meet the commitments arising out of overdue bills debited to their accounts.
- bills discounting limits may be delinked from the maximum permissible bank finance (MPBF)
- introduce bill discounting without recourse
- special bills collection schemes on the lines similar to speedy cash management system recently introduced by some of the banks.
- bank officers may be properly trained to handle bills discounting business.
- timely feed back to the drawers in the case of non-payment of bills. This will enable the drawers to follow-up with the drawees.

# B. Bank Questionnaire

## Aspects Covered

a) extent of bills discounting business undertaken by the bank and bills rediscounting facilities availed from other institutions.

b) advantages / constraints in bills financing to the customers

c) cost aspects including burden of stamp duty

d) problems faced in handling bills business

e) experience regarding payment of bills on maturity

f) desirability of free access to NBFCs for getting their bills rediscounted with commercial banks.

g) extent of popularity of banker's acceptance facility

h) legal aspects of bills discounting

i) feasibility of extending bills discounting scheme to the service sector (discussed in the Chapter pertaining to the Services Sector)

## Response Summary

### Extent of Bills Business Undertaken

A majority, 61% of the responding banks, said that they were operating the bill discounting scheme. However, bills business constituted very small portion of their total advances. In almost 70% of the cases, it was less than 15% of the total advances during the 3 year period 1996-97 to 1998-99. Only 3 out of the 23 responding banks reported bills business of more than 30% of their total advances during the year 1998-99. A large percentage of the banks (78%) availed rediscounting

facilities from other institutions, which included IDBI, SIDBI, LIC/GIC, UTI, EXIM Bank, RBI, NABARD etc.,

## Advantages of Bills Finance

According to the bankers, following were some of the major advantages to the banks providing bills finance :

- self liquidating mode of financing
- liquidity management of the banks becomes easier
- easy to monitor the genuineness of the transactions
- monitoring of borrowers' receivables becomes easy
- quality of receivables can be ascertained
- bank has recourse, both to the drawer as well as the drawee
- sale transactions are routed through the bank
- effective yield is higher since discount is deducted upfront
- bank earns fee-based income
- facility of rediscounting
- disciplined way of financing

## Constraints in Banks operating Bill Portfolio

### Procedural Aspects

Following were some of the main procedural difficulties mentioned by the banks in handling the bills business:

- operational work load – cumbersome documentation and need for thorough scrutiny of documents
- non-reliability of transport documents
- transport operators handing over goods to drawees before acceptance of relative bills
- difficulties in identifying accommodation bills

- instances of direct payment by the drawee to the drawer
- delays in realisation of bills
- difficulties and delays in getting credit reports on drawees from buyers' bankers and need for their periodic updation
- getting power of attorney registered with the government departments
- delays in the banking procedures as compared with the speedy delivery of goods - routing the documents through two banks (drawer's and drawee's) causing delays.

Some of the suggestions made by the respondents to ease the various difficulties mentioned above were:

- procedures may be simplified
- criminal action may be taken against defaulting transporters
- increasing role of credit information bureau

Banks may be given discretion to waive submission of transport documents if they are otherwise satisfied about the delivery of goods.

The banks were also asked to identify problems faced by their customers in handling the bills. Some major problems mentioned were:

- unwillingness of the drawees to accept bills
- cumbersome paper work
- delays in payment by the drawees
- delays at the drawers' and drawees' banks
- banks' insistence upon approved transport operators.

Some suggestions made by the banks to ease the above mentioned problems were:

- reduce the paper work
- make it mandatory for large companies and government departments to accept bills
- electronic transfer of funds
- acknowledgement of goods received by reputed drawees may be sufficient for local sales

- acceptance by the drawee over fax may be permitted
- the invoice itself should contain the format of the bill of exchange
- banks should educate the customers about the procedures involved
- banks may purchase invoices/unaccepted bills.

### Cost Aspect

The respondents, by and large, agreed that the cost burden to the borrowers availing bills discounting facility was relatively high. The effective cost turned out to be rather high, especially in the case of bills of smaller amounts. Some of the suggestions given by them to reduce cost were :

- allow clubbing of smaller bills
- stamp duty may be waived.

In fact, a large majority (80%) felt that the stamp duty levied on the bills of over 90 days maturity was an impediment in the development of the bills market. Practically all of them felt that usance period for exemption of stamp duty should be extended beyond 90 days. Majority of them were of the opinion that the period for exemption of stamp duty might be extended upto 180 days.

### Acceptance of Bills

As regards acceptance of bills, 84% of the bank respondents said that their customers found it difficult to get their bills accepted by the buyers.

A significant portion (39%) of the respondents felt that the time taken by the drawees to accept the bills was unreasonable. Some of the suggestions received to reduce the time lag in acceptance of bills were:

- banks should promptly present the bills for acceptance
- if the drawee fails to accept a bill within a stipulated time, it may be treated as non-acceptance.
- suppliers should be encouraged to approach the bank with accepted bills
- law to recognise acceptance by fax/e-mail
- sellers may intimate the buyer separately about dispatch of bills through the bank, in order to facilitate timely acceptance.

### Payment of Bills

The banks were also asked to comment on the general experience of their customers regarding payment of bills on maturity. Many of the banks said that the payments were generally delayed, especially in the case of outstation buyers. The following suggestions came up for disciplining the drawees to make the payments on due dates :

- legal provision for penalty on delayed payment
- section 138 of Negotiable Instruments Act may be made applicable to defaulters in payment of bills
- bankers should discourage discounting of bills drawn on defaulting drawees.
- the collecting bank should strictly follow the instructions of the discounting bank regarding collection of overdue interest.

### Making Bill Finance More User Friendly

The banks were asked whether they had received any suggestions from their customers to make bill financing more use friendly. The following suggestions were reported:

- banks should not insist upon transport documents in case of local deliveries
- waiver of stamp duty
- freedom to choose the bank
- allow purchase of sales invoices
- simplify procedures and formalities

The bankers, by and large, seemed to have agreed with most of the suggestions made by their customers. 87% of them felt that the bill market can be activated further if the borrowers were rated by a rating agency.

### Bill Finance and NBFCs

Banks were asked their opinion whether the NBFCs should be allowed full freedom in getting their bills rediscounted with banks (at present, the bills discounted by NBFCs are not rediscounted by the banks except those arising out of sale of commercial vehicles). Majority (64%) of the banks responded in the affirmative. They suggested the following safeguards to protect the banks' interest:

- re-discounting facility should be extended only to the reputed NBFCs or those with a good credit rating.
- bills drawn only by and on corporates should be rediscounted
- create additional charge on unencumbered assets of the NBFCs.
- availability of sufficient collateral should be ensured.
- set-up suitable exposure limit for each NBFC
- banks may decide the margin and rate of rediscount based on the rating of the NBFC
- more transparency in the accounts of NBFCs

Banks were also asked their views on whether NBFCs should be permitted to enter the business of rediscounting of bills. An overwhelming majority (92%) responded positively.

## Banker's Acceptance Facility

The responding banks were asked whether banker's acceptance, as a credit enhancement measure was in vogue in their bank. A large majority (83%) said that they were operating this facility. The following suggestions were given by them to popularise the acceptance facility so as to widen the bill market :

- acceptance facility should be in addition to the fund based facilities
- banks may market this product (viz. Bills acceptance facility) in lieu of letters of credit and guarantees
- reduce the cost of acceptance of bills.

An equally large number of respondents felt that a bill with banker's acceptance might be treated as good as a genuine trade bill as envisaged in sections 17(2) and 17(4) of the RBI Act.

## Legal Aspects

A large majority (86%) of the respondents felt that the existing laws were not sufficient to deal with the defaulters. They also felt that the existing laws and procedures did not facilitate adoption of bills discounting. Some of the regulatory, administrative and legal measures suggested by them to activate the bill market were as follows:

- Section 138 of the Negotiable Instruments Act should be made applicable to dishonour of bills
- simplify the legal procedures and reduce delays
- under Criminal Procedure Code (CPC), a defaulter may be required to deposit the bill amount before defending his case
- expeditious setting up of Credit Information Bureau
- bill financing may be kept outside the purview of the guidelines pertaining to consortium lending
- system of Auction House may be developed so as to facilitate disposal of goods covered under bills business in case of default.

**Bill Finance in Liberalised Environment**

The banks were asked to suggest special measures which might be required to popularise bills finance in the present liberalised environment. Following were some of the major suggestions:

- timely enforcement of legal provisions
- RBI may set up Credit Information Bureau to give timely and quality information on the drawees.
- besides accepted bills, promissory notes may also be made eligible for rediscounting
- RBI may come out with uniform documentation/procedures for the bills discounting scheme.

The banks were also requested to suggest special measures considered essential by them in the context of the coming environment of e-commerce. Following important measures were suggested:

- changes in the Contracts Act, Sale of Goods Act, Negotiable Instruments Act and Indian Evidence Act are necessary to give effect to the business transactions entered digitally.
- security features should be developed to prevent frauds/misuse of credit facilities in a computerised environment.
- banks should be able to access credit information on the drawees through the website of RBI.

- interbank linkages through advanced means of communication and electronic data transfer.
- introduction of necessary legal protection for default under e-commerce.
- legalise acceptance of bills on the net.

## General Aspects

Following suggestions of a general nature were also received from the banks :

- the Working Group may examine other alternatives to bills finance such as cash credit against receivables, factoring services, invoice discounting, etc.
- banks should focus more on invoice discounting and factoring services than bills discounting
- rather than thrusting bills discounting facility on them, the borrowers may be given an option to choose the type of lending facility suitable to them for financing their receivables.
- the payment system of banks should be made more efficient with the availability of advanced means of communication and computer networking.
- encourage liberal discounting of bills backed by letters of credit. Such credit facility should be outside the MPBF.

## Annexure - V

# List of Persons with whom the Working Group had discussions

| Sl. No. | Name of the Person | Designation |
|---|---|---|
| 1. | **Shri Chowdhary K.C.** | Chief Executive and Secretary,<br>Indian Banks' Association |
| 2. | **Shri Gopalakrishnan S.** | CMD, Vijaya Bank |
| 3. | **Shri Kannan K.** | Former CMD, Bank of Baroda |
| 4. | **Shri Maiya P.V.** | Former CMD, ICICI Bank |
| 5. | **Shri Ravi Kumar P.H.** | Executive Vice President, ICICI Bank |
| 6. | **Prof. Sampath Singh** | Retd. Professor, NIBM |
| 7. | **Shri Tarapore S.S.** | Former Dy. Governor, RBI |
| 8. | **Shri Verma M.S.** | Chairman, TRAI<br>Formerly Chairman of SBI |
| 9. | **Shri Vishwanathan R.** | Former DMD, SBI |

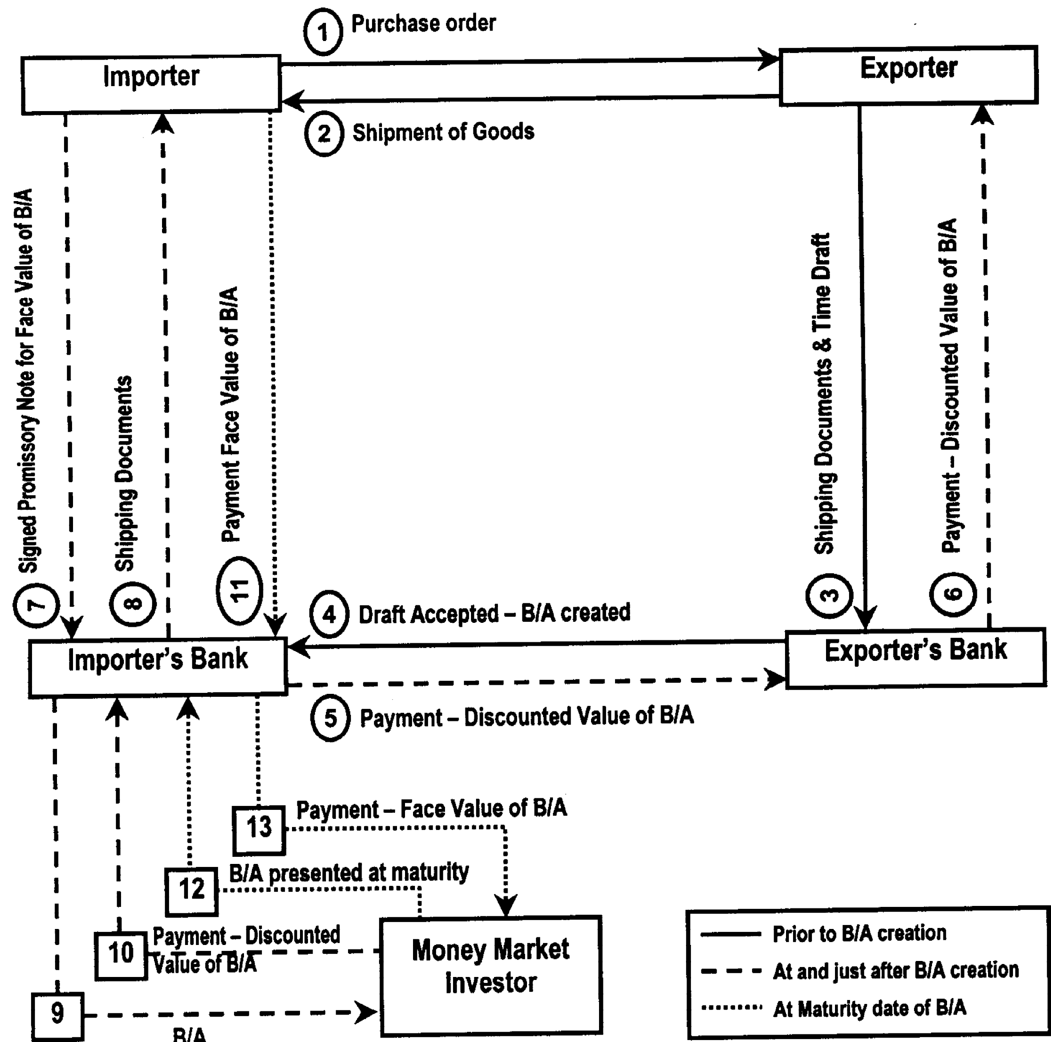
## Annexure - VI

# List of Institutions who made presentations to the Working Group

| Sl. No. | Name of the Institution |
|---|---|
| 1. | ABN Amro Bank |
| 2. | Citibank |
| 3. | Discount & Finance House of India |
| 4. | HDFC Bank |
| 5. | Hongkong Shangai Banking Corporation |
| 6. | National Institute of Bank Management |
| 7. | Standard Chartered Bank |

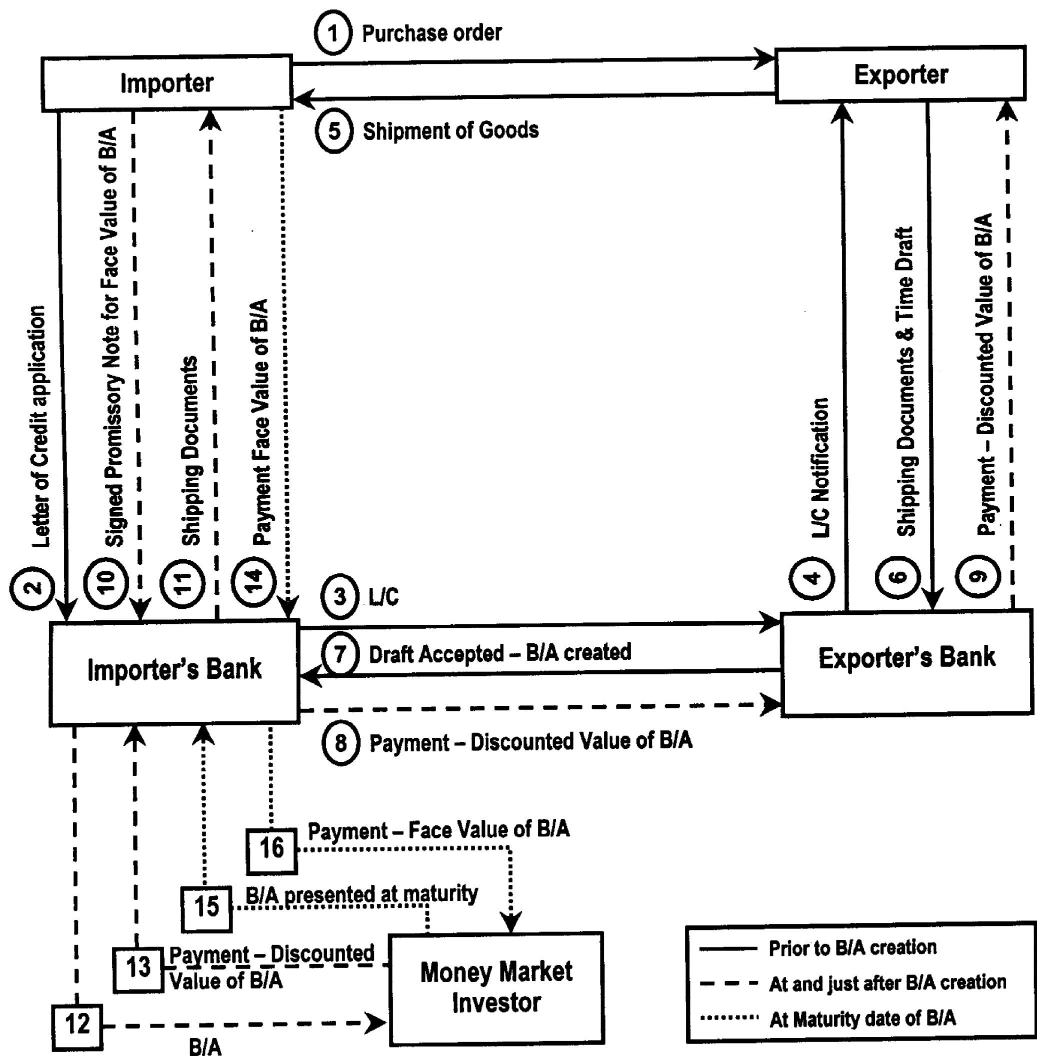
Annexure - VII

## Funding Importer through Banker's Acceptance – Non-LC Transaction



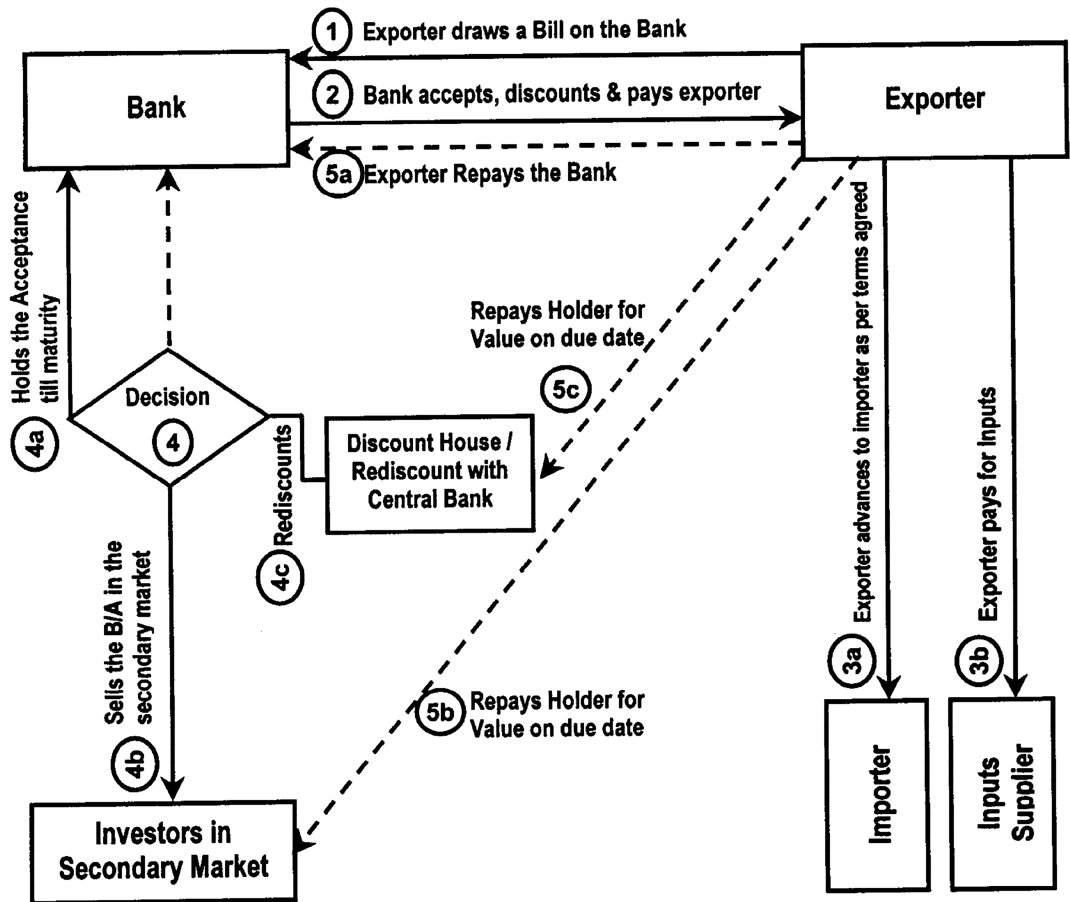
Annexure - VIII

# Funding Importer through Banker's Acceptance – LC Backed Transaction



Annexure - IX

# Banker's Acceptance – Funding an Exporter



## Annexure - X

# Peculiarity of Services Sector

| Product | Consumption |
|---|---|
| ·· **Nature of Product** : Immaterial, often information-intensive; Hard to store or transport; Process and product hard to distinguish.<br>·· **Features of Product** : Often customised to consumer requirements. | ·· **Delivery of Product** : Production and consumption coterminous: client or supplier may have to sometime move to meet each other.<br>·· **Role of Consumer** : Services are 'client-intensive', requiring inputs from consumer into design/ production process.<br>·· **Organisation of Consumption** : Often hard to separate production from consumption. Often formal or informal self-service. |
| **Production** | **Markets** |
| ·· **Organisation of Labour Process** : Workforce often engaged in craft-like production with limited management control of details of work.<br>·· **Labour** : Some highly professional (esp. requiring interpersonal skills) involving casual or part-time labour.<br>·· **Features of Production** : often non-continuous and economies of scale are limited.<br>·· **Organisation of Industry** : range from state-run public services to small-scale family firms and self-employed. | ·· **Organisation of Markets** : Some services delivered via public sector. Some costs are invisibly bundled with goods (e.g., retail sector).<br>·· **Regulation** : Professional regulation common in some services.<br>·· **Marketing** : Difficult to demonstrate products in advance. |

**Source** : based on Ian Miles, 1993, "Services in the New Industrial Economy" Futures (Vol.25 No 6 pp 653-672)

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