Lesson Objectives
- To understand the Concept of Bills Discounting and its advantages and disadvantages.
- Regulations related to Bills Discounting.

Introduction
Bill discounting, as a fund-based activity, emerged as a profitable business in the early nineties for finance companies and represented a diversification in their activities in tune with the emerging financial scene in India. In the post-1992 (scam) period its importance has substantially declined primarily due to restrictions imposed by the Reserve Bank of India. The purpose of the Chapter is to describe bills discounting as an asset-based financial service. The aspects of bills discounting covered include its concept, advantages and disadvantages, bills market schemes, procedures and processing, post-securities scam position and some gray-areas. The main points are also summarised.

Concept
According to the Indian Negotiable Instruments Act, 1881:
“The bill of exchange is an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay a certain sum of money only to, or to the order of, a certain person, or to the bearer of that instrument.”

The bill of exchange (B/E) is used for financing a transaction in goods which means that it is essentially a trade-related instrument.

Types of Bills
There are various types of bills. They can be classified on the basis of when they are due for payment, whether the documents of title of goods accompany such bills or not, the type of activity they finance, etc. Some of these bills are:

Demand Bill This is payable immediately “at sight” or “on presentment” to the drawer. A bill on which no time of payment or “due date” is specified is also termed as a demand bill.

Usance Bill This is also called time bill. The term usance refers to the time period recognized by custom or usage for payment of bills.

Documentary Bills These are the B/Es that are accompanied by documents that confirm that a trade has taken place between the buyer and the seller. Because of this, the interest rate charged on such bills is higher than the rate charged on documentary bills.

Clean Bills These bills are not accompanied by any documents that show that a trade has taken place between the buyer and the seller. Because of this, the interest rate charged on such bills is lower than the rate charged on documentary bills.

Creation of a B/E Suppose a seller sells goods or merchandise to a buyer. In most cases, the seller would like to be paid immediately but the buyer would like to pay only after some time, that is, the buyer would wish to purchase on credit. To solve this problem, the seller draws a B/E of a given maturity on the buyer. The seller has now assumed the role of a creditor; and is called the drawer of the bill. The buyer, who is the debtor, is called the drawee. The seller then sends the bill to the buyer who acknowledges his responsibility for the payment of the amount on the terms mentioned on the bill by writing his acceptance on the bill. The acceptor could be the buyer himself or any third party willing to take on the credit risk of the buyer.

Discounting of a B/E The seller, who is the holder of an accepted B/E has two options:
1. Hold on to the B/E till maturity and then take the payment from the buyer.
2. Discount the B/E with a discounting agency. Option (2) is by far more attractive to the seller.

The seller can take over the accepted B/E to a discounting agency bank, NBFC, company, high net worth individual] and obtain ready cash. The act of handing over an endorsed B/E for ready money is called discounting the B/E. The margin between the ready money paid and the face value of the bill is called the discount and is calculated at a rate percentage per annum on the maturity value.

The maturity a B/E is defined as the date on which payment will fall due. Normal maturity periods are 30, 60, 90 or 120 days but bills maturing within 90 days seem to be the most popular.

Advantages: The advantages of bill discounting to investors and banks and finance companies are as follows:

To Investors
1. Short-term sources of finance;
2. Bills discounting being in the nature of a transaction is outside the purview of Section 370 of the Indian Companies Act, 1956, that restricts the amount of loans that can be given by group companies;
3. Since it is not a lending, no tax at source is deducted while making the payment charges which is very convenient, not only from cash flow point of view, but also from the point of view of companies that do not envisage tax liabilities;
4. Rates of discount are better than those available on ICDs; and
Solution

The bill, Rs 10,000.

L/C - based bill and (b) 60 days for the clean bill and value of

Required: Compute the effective rate of interest implicit in the

i. L/C - backed bills, 22 per cent per annum

ii. Clean bill, 24 per cent per annum

The Hypothetical Finance ltd. discounts the bills of its clients at

Illustration

The salient features of the scheme were as follows:

i. The scheme was announced under Section 17(4)(c) of RBI

ii. The scheduled banks were required to convert a portion of

iii. The existing loan, cash credit or overdraft accounts were,

iv. This procedure did not bring any change in offering same

v. The amount advanced by the RBI was not to exceed the

vi. The scheduled bank applying for accommodation had to

vii. The RBI could also make such appropriate enquiries as it

viii. Advances to banks under the scheme, in the initial stages,

Bill Market Scheme, 1952

The development of bill discounting as a financial service

depends upon the existence of a full-fledged bill market. The

Reserve Bank of India (RBI) has constantly endeavored to
designed to develop the commercial bills market. Several committees set-up
to examine the system of bank financing and money market

had strongly recommended a gradual shift to bills finance and

phase-out of the cash credit system. The most notable of these

were: (i) Dehejia Committee, 1969, (ii) Tandon Committee, 1974,

(iii) Chore Committee, 1980 and (iv) Vaghul Committee, 1985. This section briefly outlines the efforts made by the RBI

in the direction of the development of a full-fledged bill

market.

Bill Market Scheme

The salient features of the scheme were as follows:

i. The scheme was announced under Section 17(4)(c) of RBI

Act which enables it to make advances to scheduled banks

against the security of issuance of promissory notes or bills

drawn on and payable in India and arising out of bona fide

commercial or trade transaction bearing two or more good

signatures one of which should be that of scheduled bank

and maturing within 90 days from the date of advances;

ii. 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 to be able to avail of refinance under the

scheme;

iii. The existing loan, cash credit or overdraft accounts were,

therefore, required to be split up into two parts, that is:

a. one part was to remain covered by the demand

promissory notes, in this account further with-drawals

or repayments were as usual being permitted;

b. the other part, which would represent the minimum

requirement of the borrower during the next three

months would be converted into usance promissory

notes maturing within ninety days.

iv. This procedure did not bring any change in offering same

facilities as before by banks to their constituents. Banks

could lodge the usance promissory notes with RBI- for

advances as eligible security for borrowing so as to replenish

their loanable funds.

v. The amount advanced by the RBI was not to exceed the

amount lent by the scheduled banks to the respective

borrowers.

vi. The scheduled bank applying for accommodation had to

certify that the paper presented by it as collateral arose out

of bona fide commercial transactions and that the party was

creditworthy.

vii. The RBI could also make such appropriate enquiries as it

deemed fit, in connection with eligibility of bills and call for

any further information from the scheduled banks

concerned.

viii. Advances to banks under the scheme, in the initial stages,

were made at one-half of one per cent below the bank rate.

Effective Rate of Interest on Clean Bill:

<table>
<thead>
<tr>
<th>Value of the bill</th>
<th>Rs 10,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discount charge</td>
<td>Rs 550</td>
</tr>
<tr>
<td>Amount received by the client</td>
<td>Rs 9,450 (Rs 10,000 - Rs 550)</td>
</tr>
<tr>
<td>Quarterly effective interest rate</td>
<td>5.82% (Rs 90 x 100 / Rs 9450)</td>
</tr>
<tr>
<td>Annualised effective rate of interest, [(1.0582)^(1/4)] x 100 = 25.39%</td>
<td></td>
</tr>
</tbody>
</table>

Effective Rate of Interest on L/C - based Bill:

<table>
<thead>
<tr>
<th>Value of the bill</th>
<th>Rs 10,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discount charge</td>
<td>Rs 400</td>
</tr>
<tr>
<td>Amount received by the client</td>
<td>Rs 9,600 (Rs 10,000 - Rs 400)</td>
</tr>
<tr>
<td>Quarterly rate of interest</td>
<td>4.17% (Rs 400 / Rs 9,600 x 100)</td>
</tr>
<tr>
<td>Effective rate of interest per annum</td>
<td>17.75%</td>
</tr>
</tbody>
</table>

5. Flexibility, not only in the quantum of investments but also in the duration of investments.

To Banks

1. Safety of Funds The greatest security for a banker is that a B/ E is a negotiable instrument bearing signatures of two parties considered good for the amount of bill; so he can enforce his claim easily.

2. Certainty of Payment A B/ E is a self-liquidating asset with the banker knowing in advance the date of its maturity. Thus, bill finance obviates the need for maintaining large, unutilised, ideal cash balances as under the cash credit system. It also provides banks greater control over their draws.

3. Profitability Since the discount on a bill is front-ended, the yield is much higher than in other loans and advances, where interest is paid quarterly or half yearly.

4. Evens out Inter-Bank Liquidity Problems The development of healthy parallel bill discounting market would have stabilized the violent fluctuations in the call money market as banks could buy and sell bills to even out their liquidity mismatches.

Discount Rate and Effective Rate of Interest Banks and finance companies discounting bills prefer to discount L/C (letter of credit)-backed bills compared to clean bills. The rate of discount applicable to clean bills is usually higher than the rate applicable to L/C-based bills. The bills are generally discounted up-front, that is, the discount is payable in advance. As a consequence, the effective rate of interest is higher than the quoted rate (discount). The discount rate varies from time to time depending upon the short-term interest rate. The computation of the effective rate of interest on bills discounting is shown in following illustration.

Illustration

The development of bill discounting as a financial service depends upon the existence of a full-fledged bill market. The Reserve Bank of India (RBI) has constantly endeavored to develop the commercial bills market. Several committees set-up to examine the system of bank financing and money market had strongly recommended a gradual shift to bills finance and phase-out of the cash credit system. The most notable of these were: (i) Dehejia Committee, 1969, (ii) Tandon Committee, 1974, (iii) Chore Committee, 1980 and (iv) Vaghul Committee, 1985. This section briefly outlines the efforts made by the RBI in the direction of the development of a full-fledged bill market.

The salient features of the scheme were as follows:

i. The scheme was announced under Section 17(4)(c) of RBI Act which enables it to make advances to scheduled banks against the security of issuance of promissory notes or bills drawn on and payable in India and arising out of bona fide commercial or trade transaction bearing two or more good signatures one of which should be that of scheduled bank and maturing within 90 days from the date of advances;

ii. 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 to be able to avail of refinance under the scheme;

iii. The existing loan, cash credit or overdraft accounts were, therefore, required to be split up into two parts, that is:

a. one part was to remain covered by the demand promissory notes, in this account further with-drawals or repayments were as usual being permitted;

b. the other part, which would represent the minimum requirement of the borrower during the next three months would be converted into usance promissory notes maturing within ninety days.

iv. This procedure did not bring any change in offering same facilities as before by banks to their constituents. Banks could lodge the usance promissory notes with RBI- for advances as eligible security for borrowing so as to replenish their loanable funds.

v. The amount advanced by the RBI was not to exceed the amount lent by the scheduled banks to the respective borrowers.

vi. The scheduled bank applying for accommodation had to certify that the paper presented by it as collateral arose out of bona fide commercial transactions and that the party was creditworthy.

vii. The RBI could also make such appropriate enquiries as it deemed fit, in connection with eligibility of bills and call for any further information from the scheduled banks concerned.

viii. Advances to banks under the scheme, in the initial stages, were made at one-half of one per cent below the bank rate.
The confessional rate of interest was withdrawn in two stages of one quarter of one per cent each and ceased to be operative from November 1956.

ix. As a further inducement to banks, the RBI agreed to bear half the cost of the stamp duty incurred in converting demand bills into time bills.

x. In the initial stages the minimum limit for an advance which could be availed of from the RBI at any time was fixed at Rs 25 lakh and the individual bills tendered for the purpose were not to be less than rupee one lakh. Subsequently, however, the scheme was liberalised and the minimum amounts were reduced from Rs 25 lakh to Rs 10 lakh (reduced further to Rs 5 lakh in February 1967) and from Rs 1 lakh to Rs 50,000. The scheme, 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 licensed scheduled commercial banks, irrespective of the size of their deposits.

The scheme virtually ceased to function in 1970. The main reasons being:

i. Lack of specialised institutions for discharging the functions of acceptance and discount houses;

ii. Paucity of usance bills-both domestic and foreign;

iii. Traders found cash credit facility conveniently available from banks and avoided usance bills as an instrument of credit;

iv. Export bills were negotiated by banks under letters of credit opened by foreign importers and foreign correspondent banks;

v. Banks got refinance against declaration of export bills from RBI-Exim-Bank when needed;

vi. Lack of practice of discounting the bills with other banks having excess liquidity;

vii. Criteria for creditworthiness of the traders was not evolved to avoid risk of defaults of redemption on maturity of the bills.

Bill Market Scheme, 1970

In pursuance of the recommendations of the Dehejia Committee, the RBI constituted a working group (Narsimham Study Group) to evolve a scheme to enlarge the use of bills. Based on the scheme suggested by the study group, the RBI introduced with effect from November 1, 1970, the new bill market scheme in order to facilitate the re-discounting of eligible bills of exchange by banks with it. To popularise the use of bills, the scope of the scheme was enlarged, the number of participants was increased, and the procedure was simplified over the years. The salient features of the scheme are as follows:

Eligible Institutions All licensed scheduled banks and those which do not require a licence (i.e. the State Bank of India, its associate banks and nationalised banks) are eligible to offer bills of exchange to the RBI for rediscount. There is no objection to a bill accepted by such banks being purchased by other banks and financial institutions but the RBI rediscounts only such of those bills as are offered to it by an eligible bank.

Eligibility of Bills The eligibility of bills offered under the scheme to the RBI is determined by the statutory provisions embodied in section 17(2)(a) of the Reserve Bank of India Act, which authorise the purchase, sale and rediscount of bills of exchange and promissory notes, drawn on and payable in India and arising out of bona fide commercial or trade transactions, bearing two or more good signatures, one of which should be that of a scheduled bank or a state co-operative bank and maturing:

a. In the case of bills of exchange and promissory notes arising out of any such transaction relating to the export of goods from India, within one hundred and eighty days;

b. In any other case, within ninety days from the date of purchase or rediscount exclusive of days of grace;

c. The scheme is confined to genuine trade bills arising out of genuine sale of goods. The bill should normally have a maturity of not more than 90 days. A bill having a maturity of 90 to 120 days is also eligible for rediscount, provided at the time of offering to the RBI for rediscount it has a usance not exceeding 90 days. The bills presented for rediscount should bear at least two good signatures. The signature of a licensed scheduled bank is treated as a good signature;

d. Bill of exchange arising out of the sale of commodities covered by the selective credit control directives of the RBI have been excluded from the scope of the scheme to facilitate the selective credit controls and to keep a watch on the level of outstanding credit against the affected commodities; and

e. The following types of bills are acceptable to RBI for the purpose of re-discount:

i. Bills drawn on and accepted by the buyer’s bank;

ii. Bills drawn on buyer and his banker jointly and accepted by them jointly;

iii. Bills drawn on and accepted by the buyer under an irrevocable letter of credit and certified by the buyer’s bank which has opened the letter of credit in the manner specified by RBI, that is, that the terms and conditions of the letter of credit have been duly complied with by the seller.

iv. Bills drawn on and accepted by the buyer and endorsed by the seller in favour of his bank and bearing a legend signed by a licensed scheduled bank which should endorse the bill, confirming that the bill will be paid by the bank on the three days before the date of maturity;

v. Bills drawn and accepted in the prescribed manner and discounted by a bank at the instance of the drawee.

Where the buyer’s bank is not a licensed scheduled bank, the bill should additionally bear signature of a licensed scheduled bank.

Procedure for Rediscounting Eligible banks are required to apply to the RBI in the prescribed form giving their estimated requirements for the 12 month ending October of each year and limits are sanctioned / renewed for a period of one year running from November 1 to October 31 of the following year. The RBI presents for payment bills of exchange rediscounted by it and such bills have to be taken delivery by the rediscounting banks against payment, not less than three working days before
the dates of maturity of the bills concerned. In case bills are
retired before the dates, pro-rata refund of discount is allowed
by the RBI.

For rediscounting purposes, bills already rediscounted with RBI
may be lodged with it. The un-expired period of the usance of
the bills so offered should not be less than 30 days and the bills
should not bear the endorsement of the discounting bank in
favour of a party other than the RBI.

Banks to Hold Bills Rediscounted In the first year of the
operation of the scheme, the banks are required to lodge all
eligible bills with the RBI for availing themselves of the
rediscounting facilities. 11 November 1971, actual lodgement of
bills of the face value of Rs 2 lakh and below was dispensed
with as the banks were authorised to hold such bills with
themselves. This limit was increased to Rs 10 lakh in November
1973. The banks are required to make declarations to the effect
that they hold eligible bills of a particular aggregate value on
behalf of the RBI as its agents, and on this basis the RBI pays
to them the is counted value of such bills. The discounting
banks are also required to endorse such bills in favour of the BI
before including them in the declarations and also re-endorse
the bills in their own favour when they “e retired. Since 1975,
banks are permitted to rediscount bills with other commercial
banks as well as retain other approved financial institutions.
Since June, 1977, there is a ceiling on the rate of rediscount on
Ich bills which has been varied by the banks from time to time.

The bill rediscounting scheme over the years has been gradually
restricted and at present this facility is treated by the RBI on a
discretionary basis. During the year 1981-82 (July-June) no fresh
bill rediscounting limits were sanctioned to the banks and as
such there were no outstanding under the scheme from
October 23, 1981. The amount of bills rediscounted each year
has shown wide variations, but during the year the four years
(1974-75 to 1977-78) (April-March), the volume had been well
over Rs 1,000 crore; in recent years a quarterly declining trend set
in the utilisation of the facility due to its being
available only on discretionary terms.

In order to revitalise the bill market scheme, several committees
made recommendations in the light of experience of the
operations of the scheme. On the basis of these, several
measures were initiated by the n to promote bill financing. The
important ones being: (1) a ceiling on the proportion of
receivable (75 percent) eligible for financing under the cash credit
system, (2) discretion to banks to sanction additional hoc limits
for a period not exceeding 3 months, up to an amount equivalent
to 10 percent of the existing I limit subject to a ceiling of
Rs 1 crore, (3) stipulation on ratio of bill acceptance to credit
purchases (25 percent), (4) setting up of the Discount and
Finance House of India (DFHI) to buy/ sell/ discount short-
term Is, (5) reduction in the discount rate on usance bills, (6)
remission of stamp duty on bills drawn on/ made ‘in favour of
a bank/ cooperative bank. The procedure requiring the bill to the
endorsed and delivered to re-discount at every time of
rediscounting has been done away with. A derivative usance
promissory note is issued by the discounter on the strength of
the underlying bills which have tenor corresponding to, or lesser
than, tenor of the derivatives usance promissory note and in
any case not more than 90 days. The derivative promissory note
is exempted from stamp duty.

The re-discounting facility from the RBI has gradually slowed
and banks have been encouraged to rediscount bills, with one
another as well as with approved financial institutions such as
LIC, GIC, UTI, ICICI, IRBI, ECGC, selected cooperative
banks and mutual funds and so on. Processing/ Precaution/
Defaults/ Grey Areas Credit Assessment Banks and NBCFs (the
main discounting agencies) undertake a detailed ap-praisal of a
customer and thoroughly assess his creditworthiness before
providing the bills discounting (BD) facility. Regular credit
limits are fixed by banks and NBFCs for individual parties for
purchase and discounting of clean bills and documentary bills
separately. These limits are renewed annually and are based on
the following considerations:

i. Quantum of business undertaken by the party, that is,
turnover of inventory;

ii. Credit worthiness of drawer (client);

iii. Credit worthiness of drawee and details of dishonor, if
any;

iv. Nature of customer’s industry.

Appraisal of the customer is done through several means:

1. The most important step is a careful scrutiny of the
customer’s operations and its financial viability. For this, a
detailed analysis of his financial statements is carried out.

2. Since the liability of the drawee also arises in case he accepts
and dishonors the bill, credit informa-tion about the
drawee is also collected. The drawer is asked to furnish a list
of his purchasers and their banks so that a report of their
credit risk can be compiled. This is especially easy for banks,
as a confidential report can be easily routed through banking
channels.

3. Banks have access to frequently published Indian Banks
Association (IBA) bulletins which indicate the names of
unsatisfactory drawees banks and their default rates.

4. Both banks and NBFCs have built up substantial credit
intelligence database which are constantly updated based on
market information. Once a client defaults, he is blacklisted
and may find it difficult to discount his B/E subsequently.

Thus, in case of an existing client it is assessed that there is no
overdue bill pending and the clients’ limits cover the amount of
the bill submitted for discounting. In the case of a new client
thorough enquiry about the creditworthiness of the party is
made from the banker of the client, market and other finance
companies. Once satisfactory report is obtained, a limit is
normally fixed for the party. An effort is made to ensure that
the risk is well spread amongst several drawees. In order to keep
a proper control, there should be proper follow up of the bills
due and the limits fixed for the clients should be reviewed/
reassessed at an appropriate interval of time. Special attention is
paid to the following points while reviewing bills discounting
limits:

i. The earlier sanctioned limits are fully utilised by the client;

ii. The bills were promptly paid on maturity date;

iii. In case of unpaid bills, funds were paid by the drawer.
Once the party is granted a bill discounting limit, the party approaches the finance company for each and every bill for discounting. The following documents are submitted along with the letter of request:

a. Invoice;
b. Challan;
c. Receipt of goods acknowledged by buyer;
d. Hundi/Promissory note;
e. Truck receipt/Railway receipt;
f. Post dated cheque for the interest amount.

While fixing the limit for bill discounting the balance sheet and profit and loss account are properly analysed and various ratios are calculated to arrive at a sound business decision.

Precautions The finance companies take following precautions while discounting bills:

i. The bills are not accommodation bills but are genuine trade bills.
ii. Bills are drawn on the places where the finance company is operating or has a branch office as it would facilitate contact with drawee in case of exigencies.
iii. The goods covered by the documents are those in which they party deals.
iv. The amount of the bills commensurate with the volume of business turnover of the party.
v. Bills are drawn on a place where the goods have been consigned.
vi. The credit report on the drawee is satisfactory.
vii. The description of goods mentioned in the invoice and railway receipt/truck receipt are same.
viii. The goods are not consigned directly to the buyer.
ix. The goods are properly insured.
x. The usage bill is properly stamped.
xi. Bills offered for discount do not cover goods whose prices fluctuate too much.

Dealing with Default The cycle of liabilities in a bill discounting transaction is as follows: The drawee is liable to the drawer; and the drawer to the discounting agency. However, the bank/INBFC looks mainly to its customer (drawer or drawee) for recovery of its dues. In case of default, the discounting agency can resort to noting and protesting as laid down by the Negotiable Instrument Act. In reality, however, since litigation is both cumbersome and expensive, a combination of negotiation and compromise is used. At worst, some dues may be written off. NBFCs generally build-in a large number of safeguards to guard against default. Banks generally discount LC-backed bills which are default-proof.

Grey Areas There are certain features of the Indian industry which have impeded the growth of a healthy bill discounting market (BD):

Participants Most of the customers approaching banks/NBFCs for bills discounting are SSI (Small scale industries) units. For such enterprises, it is very difficult to undertake proper credit assessment.

Kite Flying The practice of discounting accommodation bills is known as kite flying. When A draws a BI on B without there being any underlying movement of goods and B accepts it to accommodate A, the BI is called an accommodation kite bill. If A now ‘discounts it, he has uninterrupted use of funds for the maturity period of the bill. These funds are generally routed into the capital market to earn a very high return on the due date. The amount of the B/E is repaid by A. This practice has severely stilted the genuine bill market, by imparting false liquidity to the system.

Supply Bills B/E drawn by suppliers/contractors on government departments are called supply bills. These are not accepted by the Government. However, contractors are able to get them discounted with nationalised banks. If there is a default on the due dates, banks simply debit the dues to the ‘Government a/c’. This practice depresses the level of cash flow in the bill market because a B/E is being discounted without a corresponding flow of cash.

Reduced Supply Several corporate houses and business groups do not accept B/E drawn on them. Accepting such bills is seen to be damaging to their pride. Such attitudes reduce the supply of bills and discourage the culture of drawing and discounting bills.

Stamp Duties No stamp duties are levied on LC (letter of credit) backed bills upto 90 days. This has resulted in a lop sided growth in the bills market with practically no bills being drawn for a period exceeding 90 days. The market, therefore, lacks depth.

Present Position of Bills Discounting Financial services companies had been acting till the early nineties as bill-brokers for sellers and buyers of bills arising out of business transactions. They were acting as link between banks and business firms. At times they used to take up bills on their own account, using own funds or taking short-term accommodation from banks working as acceptance/discount houses. They had been handling business approximating Rs 5,000 crores annually. Bill discounting, as a fund-based service, made available funds at rates 1 per cent lower than on ash credit finance and bill finance constituted about one-fourth of bank finance.

However, the bill re-discounting facility was misused by banks as well as the bill-brokers. The Jankiraman Committee appointed by the RBI which examined the factors responsible for the securities-scam identified the following misuse of the scheme:

Banks have been providing bill finance outside the consortium without informing the consortium bank-ers;
They have been drawing bills on companies and they themselves discounted such bills to avail of rediscount facilities;

In cases where banks provided additional finance outside the consortium arrangement by way of bill limits covering sales of goods, the sales proceeds had been unavailable to them to provide production finance;

Bill finance had been provided to dealers/stockiest of large manufacturing companies without proper appraisal of their credit needs;

Bills discounted by front companies set up by industrial groups on their parent companies which were obviously accommodation bills were discounted/rediscounted by banks;

The rediscounting of bills by finance companies with banks was done at a much lower rate of interest;

Although bills are essentially trade documents, bills related to electricity charges, custom charges, lease rentals etc. were also discounted. This was mainly due to the lack of depth in the bills market and NBFCs felt the need for new instrument or schemes to increase their business.

No records regarding bill discounting were ever maintained by banks.

In order to stop misuse of the bill discounting facility by banks, the RBI issued guidelines to banks in July 1992. The main elements of these guidelines are as follows:

i. No fund/non-fund based facility should be provided by banks outside the consortium arrangement;

ii. Bill finance should be a part of the working capital credit limit;

iii. Only bills covering purchase of raw materials/inventory for production purposes and sale of goods should be discounted by banks;

iv. Accommodation bill should never be discounted;

v. Bill re-discounting should be restricted to usance bills held by other banks. The banks should not rediscount bills earlier discounted by finance companies;

vi. Funds accepted by banks for portfolio management should not be deployed for discounting bills.

vii. Overall credit limit to finance companies including bills discounting should not exceed three times the net worth of such companies and

viii. For discounting LC-backed bills by NBFCs, the bill must be accompanied by a no-objection certificate from the beneficiary bank.

As a result, there was substantial decline in the volume of bill discounting. Presently, the volumes are on an average Rs 80-100 crore per month and Rs 800 - 900 crore per year. The ban on re-discounting has also resulted in falling margins for the NBFCs. They are not able to find cash rich companies/individuals ready to discount/rediscount bills.

Research Papers, Articles in Journals and Magazines on Bills Discounting
(for reference)
typical businessman does not feel comfortable with any linkage of specific type of liability to any specific type of asset. For him, money is money, and it has to be managed on the basis of overall cash surpluses or cash deficits arising out of the operations during a particular period of time. Of course, the financial world has always made a distinction between the capital employed or the resource finance on the one hand, and the short-term credit or the recourse finance, on the other. They have always linked the short period cash gaps with financial credit.

The two views are no doubt different. The economist would like to correlate the usage of financial credit with the output and seek to maximise the credit multiplier. This is the basic reasoning relating investment and output, on the one hand, and with money and prices, on the other, with which the central monetary authorities all over the world are always concerned. Viewed in this perspective, no doubt, it makes sense. But, the business world has always looked beyond such relationships and asserted that financial credit should be related to cash gaps arising not only as a result of investment but also because of changes in the liabilities. Thus far, this reasoning appears to be justified. The trouble arises when the businessman’s view is extended and assumes the character of money games, what lacocca (1985) calls as going beyond manufacturing and marketing to earn money on money. Such games always carry with them the element of controversy. They can, and generally have degenerated into market crashes. Moreover, the history has always faced the ethical question of earning rewards without any sacrifice or taking of risk. In today’s world when attempts are being made to popularise the Islamic banking, the ethical issue of Riba cannot be totally set aside.

The other important conceptual issue is the distinction between the two definitions of working capital. Assuming the economist’s identification of the problem as that of financing investment in working capital assets, one definition of working capital is the investment in circulating assets, or in inventory and book debts comprising the operating cycle of a manufacturing-cum-marketing firm. With trade creditors or the account payable deducted, it is also known as the net operating cycle. It may also be noted that investment in assets comprising the gross operating cycles are conventionally called the current assets. These, in turn, are defined as assets which in normal course of operations are meant to be converted into cash within a period not exceeding one year. Correspondingly, for the concept of current liabilities, the definition restricts them only to those liabilities which, in normal course of operations, are meant to be paid within a period of next 12 months. It is apparent that circulating working capital or current assets, and, current liabilities are basically in the nature of renewable aggregates. Their levels fluctuate within a year. There may be higher or lower degrees of seasonalities in their levels for different firms. But there is always a core element which may keep continuously rising over the long run.

The other concept is that of the net working capital. It is defined as the difference between the current assets and the current liabilities. Implicit in this definition is the principle that the entire amount of current assets should not be financed out of current liabilities which includes short-term financial credit.

In other words, the ratio between the current assets and the current liabilities should always be greater than one. One reason which supports the principle is that the excess of current assets over current liabilities, the net working capital, represents the safety margin available to the creditors of the firm, and therefore, represents the liquidity strength of the company. It determines in a large measure its creditworthiness in the market. The other reason is that the core part of investment in working capital assets which has the character of long-term investment should be financed not out of financial credit or recourse finance but out of the resource finance or the capital funds. Most of the current controversies in the area of financing working capital in India today are based on the conceptual differences presented above. In the latter part of the paper, an attempt will be made to highlight these in the context of the emerging scenario in India.

It may also be added, as part of introduction, that the statistical data used in the paper are contained in the three tables in the text. All the figures have been taken from various publications of the Reserve Bank of India. Data on variables relating to the corporate world are taken from the Reserve Bank studies on financing of large and medium sized companies in India based on a sample of 1,650 companies. The Reserve Bank has been changing the size of the sample. The statistics contained in the tables used in this paper has been worked out on the basis of the uniform size of the sample for all the years, from 1969 to 1989.

**Historical Context**

In general, it can be stated that bank credit has all over the world been a major source of financing the working capital. However, in their details, policies and practices in India have been very different from those obtaining in the developed countries. In the west, the major focus has been on short-term financing or the seasonal bank credit to meet the requirements of the fluctuating component of the cash gaps. In other words, the banks in the developed countries provide financial credit for filling short-term cash gaps as part of the working capital finance and not the fixed component or the long-term cash gaps.

Moreover, the amount of bank credit made available to industry is determined by cash gaps and not by the amount of investment in inventory and book debts. This has two implications. First, the availability of financial credit from banks is determined by the need for cash liquidity and the lending is not related to the availability of security of current assets. The banks try to carefully assess that the borrowing company will be able to repay the short-term loans/credit within a period of 365 days, that is, bring liability to bank to zero for some time during the year. The banks provide credit on the strength of the creditworthiness of the borrowing company which, in turn, is also determined by the strength of the current ratio and the amount of net working capital. In other words, a sizable part, the fixed component of investment in working capital, is financed out of long-term capital funds.

In India, the present policies and practices have evolved in a particular historical context. It may be stated that in this country creditworthiness as judged by the strength of the current ratio
and the net working capital has never been the overriding criterion for the commercial banks to decide to lend funds for financing the working capital. The major consideration has been the current assets charged in favour of the bank as security against borrowing. Therefore, the correlation between the bank credit available to industry and the holding of inventory and book debts by it should be positive and very high. In reality, this is not so because the security basis is, in fact, not followed strictly. Compliance is largely only on paper.

Further, it also implies that bank credit in large part is not meant to assume the character of the filler of short-term cash gaps. Under the Indian conditions, banks, in general, finance the fixed component or investment in core current assets as well. No distinction is made in practice between the fixed and fluctuating components of the working capital finance by the commercial banks. The result is that in a vast majority of cases, and most of the time, the current ratios are low, and the net working capital is thin.

There are reasons to justify this major deviation from the international practice. India has in recent years built up a big industrial set-up and is generally rated, judged by the size of investment in its industry, as the eighth or the ninth - industrial nation in the world. This industrial growth has been made possible because of the national policies aiming at targeted investment for deliberate import substituting industrialisation. Easier access to bank credit has, no doubt, contributed towards faster growth of investment in industry.

In short, in an economy engineered by national planning, the economist’s view has dominated the policy formulation. This means that the focus has largely been on relating bank credit to investment in working capital. This approach has also derived its strength from the long-standing practice of the banks of lending against the security of the assets.

While in the two decades of the 50s and the 60s, the emphasis was on asking the banks to lend, or, as it has euphemistically been called to provide larger short-term bank credit to industry, the underlying idea was to get away from “security based” lending to “need based” lending. During those years, it was felt that the banks were restricting the availability of credit to industry by following strict norms relating to margins and by lending against the security of current assets. The industry wanted security margins to be lowered and more credit made available to them by the banks so as to meet the need for more investment in inventory and book debts so as to keep their operations growing.

Liberalisation of policies and practices during those years led to criticism in the banking circles. It was said that the banks were getting farther and farther away from financing the fluctuating or the short-term requirements of the industry and were getting involved deeper and deeper into financing of what was described as permanent core financing by the Deheja Committee report in the late 60s. It was also asserted that the relationship between the availability of bank credit and growth of industrial output was getting weaker, because bank credit was being utilised for acquiring long-term fixed assets and for holding speculative and flabby inventories.

It is in this background that the Tandon Committee (1975) reviewed the bank credit policies and practices in the early 70s. It recommended that adequate information on prescribed format should be made available by the borrowing companies to the commercial banks to enable the latter to practice need based lending. Secondly, it also recommended norms for investment in inventories and book debts, so that the borrowing companies should not cross the outer limits of reasonable requirements of working capital finance. Thirdly, it also laid down that a certain minimum amount of investment in working capital should be financed by long-term capital funds which really meant laying down a minimum current ratio. Its recommendations were implemented; they formed the basis of policies and practices in 70s and the 80s.

Two points are important in this connection. First, the Tandon committee emphasised need based credit, but it could not adequately provide for the criterion of creditworthiness. It ignored the fact that Indian commercial banks were moving into a position in which they were taking more than normal risks. A distinction between fixed and fluctuating components of bank credit was made. But on the requests of the banker and the borrowers, the policy makers decided later to drop this feature after a brief experimentation. Second, it cannot also be claimed that the guidelines issued by the Reserve Bank to the commercial banks based on the Tandon Committee recommendations were in practice implemented with adequate care during the two decades. However, on paper, the guidelines still remain the basis to be followed by the commercial banks for providing working capital finance to the industry.

Despite many attempts for improvement (including Tandon Committee formulations), policies and practices in the area of financing working capital by commercial banks in India are full of bifoculism, paradoxes, and ambiguities. The fact is that three different sets of criteria which in many respects do not agree with each other are being followed simultaneously in practice. The first is the basis laid down by the Tandon Committee which is used in - credit appraisals for determining the credit needs of the borrowing companies so as to enable the commercial banks to fix and sanction credit limits which cannot be exceeded during the period for which they are sanctioned. These are based on the calculation of the maximum permissible bank finance worked out as per the norms and the method laid down originally by the Tandon Committee and revised marginally by the Reserve Bank of India in subsequent years.

For an illustration, let it be assumed that the maximum permissible bank finance, and based on that the total limit sanctioned works out to Rs 100 crores in the case of Company X. The practice also demands simultaneous observance of the old security criterion. In other words, the company would not be permitted on any day during the period for which the limit has been sanctioned, to draw an amount exceeding its drawing power, which is arrived at by deducting the stipulated margins from the book value of the inventories and book debts hypothecated to the banks as securities. This drawing power, in practice, is most likely to be either more or less than Rs. 100 crores for the company X, that is, the total limit sanctioned. Therefore, interesting situations arise where companies have
higher limits sanctioned but lower drawing power and vice versa. Then there is the third paradox. As part of reality, there will be actual drawings from the bank(s) by the companies which will fluctuate on day-to-day basis. These drawings are made, in accounting terminology, largely from the cash credit accounts. It is interesting to note that this account which is the centrepiece of the Indian system is operated on the basis of cash flow mechanism. Any cheque, irrespective of the fact, whether it is related to payments in respect of current assets or fixed assets or repayment of current or non-current liabilities, can be debited to this account. The same applied to credits. In other words, the essence of the matter is that operationally the borrower finances the overall cash gap based on cash flows. Since, in practice, for the company X all three figures of the total limit sanctioned, the drawing power and the drawings are at any time not likely to equal 100, it gives rise to dissatisfaction, criticism, and lack of faith in the wisdom of the policies and practices.

**Empirical Context**

A look at the statistical facts relating to the last two decades leads to interesting results. Important conclusions are as follows:

1. It can be said that availability of bank credit which has been the main source of financing working capital of the Indian industries has not been a problem. More credit flowed to industry with the passage of time. In other words, demand and supply matched very well. On an average, during the two decades of the 70s and 80s, bank credit availed by industry in India grew at a linear rate of 14.4 per cent per year. This takes care of the average annual rate of growth of industrial output of 5.6 per cent per year plus the inflation rate of 8.6 per cent. This was made possible largely because of easy market conditions or the high liquidity position of the banks. During these years, the savings rate was high and the bank deposits grew, on an average, by about 20 per cent per year.

2. Although more credit was allocated to the priority sectors, the industry could be accommodated fully to meet its growing demand of bank credit to finance its working capital. Access to credit has not been a problem, but interest burden on the industry has been growing fast and the cost of credit has been a major area of concern. This has largely been caused by high rates of interest, high borrowings, and high investment in inventories and book debts; which, in turn, happened because the industry tended to record a low turnover of their current assets and because lower percentage of capital funds were used for financing the working capital.

3. In table 3, the compound annual rates of growth have been worked out in percentage for the RBI sample of 1,650 large- and medium sized companies over the years 1971-72 and 1986-87. These growth rates show that the interest expenses grew at the rate of 16.1 per cent per year, whereas the sales grew only by 12.1 per cent per year. It is also interesting to observe that the inventory grew over the period only at an annual compound rate of 7.5 per cent. But, at the same time, the book debts increased by 17.4 per cent which is much higher than the rate of growth of sales thereby affecting the over-all investment in inventory plus book debts. This did not permit improvement in over-all ratio of turnover of current assets. At the same time, because of the current ratio and net working capital position did not improve the short-term borrowing from banks increased for the sample companies at an annual rate of 16.5 per cent. It may also be noted that the increase in net investment in fixed assets increased by 15 per cent per year, that is, faster than the sales, necessitating a much higher rate of growth of 26.4 per cent per year in long-term borrowings. All these factors put together explain the high rate of increase in interest expenses. Therefore, as it has already been pointed out earlier, the high interest costs have been a cause of serious concern of the Indian industry, particularly now when the environment is becoming more competitive.

**Year Wholesale price index [% rate of growth] Industrial production [% rate of growth] Total Industry Small Industry Large & Medium Industry**

<table>
<thead>
<tr>
<th>Year</th>
<th>WPI</th>
<th>IPI</th>
<th>Total</th>
<th>Small</th>
<th>Large</th>
</tr>
</thead>
<tbody>
<tr>
<td>1970-71</td>
<td>5.5</td>
<td>5.1</td>
<td>29.7</td>
<td>38.5</td>
<td>36.4</td>
</tr>
<tr>
<td>1971-72</td>
<td>5.6</td>
<td>4.4</td>
<td>24.1</td>
<td>15.6</td>
<td>25.9</td>
</tr>
<tr>
<td>1972-73</td>
<td>10.0</td>
<td>5.9</td>
<td>10.2</td>
<td>19.2</td>
<td>8.3</td>
</tr>
<tr>
<td>1973-74</td>
<td>20.2</td>
<td>0.5</td>
<td>22.6</td>
<td>32.8</td>
<td>20.4</td>
</tr>
<tr>
<td>1974-75</td>
<td>25.2</td>
<td>1.9</td>
<td>22.0</td>
<td>18.5</td>
<td>22.9</td>
</tr>
<tr>
<td>1975-76</td>
<td>1.0</td>
<td>5.3</td>
<td>16.4</td>
<td>12.8</td>
<td>17.3</td>
</tr>
<tr>
<td>1976-77</td>
<td>2.0</td>
<td>12.2</td>
<td>2.6</td>
<td>24.9</td>
<td>2.2</td>
</tr>
<tr>
<td>1977-78</td>
<td>5.2</td>
<td>3.4</td>
<td>10.8</td>
<td>19.9</td>
<td>8.3</td>
</tr>
<tr>
<td>1978-79</td>
<td>0.0</td>
<td>6.9</td>
<td>7.6</td>
<td>26.5</td>
<td>1.6</td>
</tr>
<tr>
<td>1979-80</td>
<td>17.1</td>
<td>17.2</td>
<td>17.8</td>
<td>22.1</td>
<td>16.1</td>
</tr>
<tr>
<td>1980-81</td>
<td>18.2</td>
<td>0.7</td>
<td>14.2</td>
<td>19.1</td>
<td>12.2</td>
</tr>
<tr>
<td>1981-82</td>
<td>9.3</td>
<td>9.2</td>
<td>19.4</td>
<td>26.1</td>
<td>16.4</td>
</tr>
<tr>
<td>1982-83</td>
<td>2.6</td>
<td>3.1</td>
<td>33.9</td>
<td>12.9</td>
<td>44.1</td>
</tr>
<tr>
<td>1983-84</td>
<td>9.4</td>
<td>6.7</td>
<td>1.3</td>
<td>20.7</td>
<td>3.5</td>
</tr>
<tr>
<td>1984-85</td>
<td>7.0</td>
<td>8.5</td>
<td>10.3</td>
<td>21.3</td>
<td>4.9</td>
</tr>
<tr>
<td>1985-86</td>
<td>5.7</td>
<td>8.7</td>
<td>12.6</td>
<td>19.8</td>
<td>8.7</td>
</tr>
<tr>
<td>1986-87</td>
<td>5.3</td>
<td>9.1</td>
<td>16.0</td>
<td>16.6</td>
<td>15.7</td>
</tr>
<tr>
<td>1987-88</td>
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<td>7.5</td>
<td>30.0</td>
<td>4.3</td>
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<td>1988-89</td>
<td>-</td>
<td>-</td>
<td>19.4</td>
<td>17.2</td>
<td>20.4</td>
</tr>
<tr>
<td>1989-90</td>
<td>-</td>
<td>-</td>
<td>27.3</td>
<td>22.5</td>
<td>29.4</td>
</tr>
</tbody>
</table>

**Recent Past**

Taking an overall view, the two decades of the 70s and the 80s were characterised by the domination of the economists’ view over the view of the business community. There are several important implications on this development.

First, it is difficult to judge the success of the new need based basis of lending followed by commercial banks for working
capital investment based on the system recommended by the Tandon Committee. Statistically, there was some improvement in inventory turnover ratios, but there was no impact on book debts resulting ultimately in higher short-term borrowings and higher interest expenses. The net working capital position also did not improve. But, in qualitative terms, the improvement in terms of greater awareness and systemic changes within industry as well as within the commercial banks was significant. Many companies in the country started taking management of their working capital and its financing more seriously than before.

<table>
<thead>
<tr>
<th>Year</th>
<th>Sales /</th>
<th>CCA NWC /</th>
<th>TCA x 100 CR = CA / CL</th>
</tr>
</thead>
<tbody>
<tr>
<td>1971-72</td>
<td>2.19</td>
<td>17.9</td>
<td>1.21</td>
</tr>
<tr>
<td>1972-73</td>
<td>2.32</td>
<td>17.3</td>
<td>1.21</td>
</tr>
<tr>
<td>1973-74</td>
<td>2.24</td>
<td>16.4</td>
<td>1.20</td>
</tr>
<tr>
<td>1974-75</td>
<td>2.25</td>
<td>20.4</td>
<td>1.26</td>
</tr>
<tr>
<td>1975-76</td>
<td>2.31</td>
<td>17.8</td>
<td>1.22</td>
</tr>
<tr>
<td>1976-77</td>
<td>2.30</td>
<td>18.4</td>
<td>1.23</td>
</tr>
<tr>
<td>1977-78</td>
<td>2.54</td>
<td>6.6</td>
<td>1.10</td>
</tr>
<tr>
<td>1978-79</td>
<td>2.52</td>
<td>16.8</td>
<td>1.20</td>
</tr>
<tr>
<td>1979-80</td>
<td>2.48</td>
<td>17.9</td>
<td>1.22</td>
</tr>
<tr>
<td>1980-81</td>
<td>2.51</td>
<td>17.9</td>
<td>1.22</td>
</tr>
<tr>
<td>1981-82</td>
<td>2.49</td>
<td>17.9</td>
<td>1.22</td>
</tr>
<tr>
<td>1982-83</td>
<td>2.40</td>
<td>17.1</td>
<td>1.21</td>
</tr>
<tr>
<td>1983-84</td>
<td>2.45</td>
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<td>1984-85</td>
<td>2.57</td>
<td>15.6</td>
<td>1.19</td>
</tr>
<tr>
<td>1985-86</td>
<td>2.49</td>
<td>17.5</td>
<td>1.21</td>
</tr>
<tr>
<td>1986-87</td>
<td>2.42</td>
<td>17.6</td>
<td>1.21</td>
</tr>
<tr>
<td>Average ratios</td>
<td>2.42</td>
<td>16.9</td>
<td></td>
</tr>
</tbody>
</table>

Table: Financing of Current Assets

Second, the business community reacted sharply to some of the rigidities and conditionalties built into the new system of bank lending for working capital. It can be argued that there was a genuine need for laying down of a few norms by the central monetary authority in the country, in the early 70s. They have served a useful historical purpose in focusing on the criticalities of management of industrial finance. That phase is now over. It will be a mistake to carry forward the norm-based micro-level approach into the future. The environment has changed significantly and a new look at the system is necessary as we move into the 90s.

Third, it is also necessary to note that the statistical evidence against the norms is strong. Recent studies have shown that if the relevant key financial ratios for RBI sample companies are taken and analysed, it is found that a large number of observations are many standard deviations away from the mean. In other words, statistical distributions are too flat and the reality seems to be that almost every company has a uniqueness about it, and, it needs to be treated as such (Singh, Bhattacharyya, 1989). Moreover, even in the area of management philosophy, the approach towards management of working capital is moving away from norms and models to strategic choices (Singh, 1988).

Fourth, it is also necessary to realise that banking and finance have all over the world also undergone a sea-change during the 80s. The major idea underlying the new environment is deregulation and consequently greater reliance on market mechanisms. The business world has grown weary of the edifice of controls engineered by the economists and the planners to achieve better allocation of resources and better rates of growth. It is felt that they are tending to become counter-productive. The new wave is against micro-level controls and there is demand for the central monetary authority keeping only eyes on but hands off. As a matter of fact, a stage has come when bypass banking is tending to overtake regulation engineering. As the new environment is beginning to develop, disinter mediation and securitisation are growing resulting, in the development of new options for raising finance by industry, and they promise lower costs of funds.

New Developments

Recent developments have interesting features. They imply more competition among banks, breakdown of the concept of commercial banking and movement towards diversified banking. They also imply activation of money and capital markets, development of new financial products and services all leading towards lower costs of funds. But what is most important to note is that these developments bring in the creditworthiness to the centre of the stage. They are based on more disclosure, more transparent and clean balance-sheets, better information systems and better rates for higher credit rated borrowing companies.

It may be useful to highlight some of the basic elements of the new approach before the current Indian scene is examined in detail. There is now a distinction emerging between the operating and the financing side of financial management in the corporate sector. The operating side includes better management of inventories and book debts. But what is new is the emergence of the role of the money manager or the treasurer on the financing side, and a larger and sharper focus on the management of the cash flows. It appears that the emphasis is shifting from economics to finance. It also appears that the treasurer's or money manager's office is tending to become a separate profit centre in its own right.

This shift away from variables of assets and liabilities towards variables of cash flows can easily be seen as the expansion and partition of the cash flow matrix. The conventional matrix for cash flow management is given in Exhibit 1. It provides for planning and control of various items of receipts and disbursements of cash under separate heads for different planning periods based on weekly, fortnightly or monthly columns. Each quantity entering into this matrix has three attributes: the magnitude, the timing, and the uncertainty; and, a number of assumptions regarding sales, purchases, production, credit plans and policies. One purpose of the exercise is to forecast the cumulative cash gaps for each period. Depending upon the algebraic signs they take, they represent either surpluses or deficits, or cash gaps. The other purpose of the subsequent managerial process is to improve the bottom line by changing
magnitudes, timings, uncertainties, by changing underlying policies and practices relating to the management of the working capital, in essence, the inventories, credit and collections, or, the operating cycle.

The Indian scenario has been changing. The practice has, in recent years, undergone significant changes. In the early 70s when the rates of interest for lending to the corporate sector were in one go almost doubled, the general practice changed over to avoid credit balances in current deposit accounts. As the interest rates jumped up from about 8 or 9 per cent to 17 or 18 per cent, it was considered unwise to maintain credit balances in current accounts because they did not earn interest.

However, towards the end of the 70s after experiencing two credit squeezes, the corporate finance managers started lamenting the loss of financial flexibility arising out of complete dependence upon commercial banks for filling their cash gaps. Therefore, with early 80s the tendency to draw whenever possible money from banks and to keep credit balances in current deposit accounts again came back into practice. And, in later half of the 80s as new opportunities started emerging, the corporate finance managers started parking their temporarily idle cash balances for earning interest revenue on them with a view to minimising the interest burden on their companies. Moreover, this also coincided with the emergence of many cash-surplus companies on the scene which were all set to take on to the new developments.

What has really happened is that the traditional matrix has got expanded and partitioned into two matrices. The second matrix is given in Exhibit 2. It starts with cumulative cash gap and moves on to current account balance, short-term borrowings from banks and the market, drawing power from banks, and, investment in money market instruments or other short-term quick assets coming under the purview of money manager. They include management of cash collections and payments and float to improve the bottom line and parking of idle funds to earn money on money.

It appears, in future, the focus in the area of financing the working capital in India would not only be on current assets, current liabilities, net working capital, and the current ratio. There will also be another major area of focus: the bottom-line and the portfolio of investment in quick assets. This would make quick ratio not only relevant but also important for a large number of companies, and, that is what makes the situation formally bifocal.

Towards New Scenario

During the second half of the 80s, the national policies in India were modified with a view to liberalising regulations and to activate capital and money markets. Trends towards greater financialisation of savings and greater securitisation of financial assets have already started. With the activation of the capital market, larger volume of funds are being raised through debentures, and many debenture issues are being made, specifically to make more funds available for financing working capital. Many public sector units also raised funds through bonds. The corporate sector, in general, has been more active in raising, funds through public deposits as well. The current regulations restrict the amount of funds that can be raised by a company by way of public deposits. As it has already been argued earlier, a part of the investment in working capital assets is always of long-term nature. Recent attempts to raise funds for financing working capital through public deposits and through bonds and debentures in the capital market although relatively few in number, are in the right direction because they strengthen the net working capital position and, therefore, improve creditworthiness of the concerned companies and also bring down the over-all cost of funds. As it happens, interest rates on short term borrowings in India are still higher compared to the rates prevalent for long-term borrowings.

Recent changes in the short-term money market are more significant for raising the working capital finance. With passage of time, most of these recent developments are likely to assume great significance during the 90s. The way things are developing, it appears that the exclusive dependence of the Indian companies on commercial banks for financing their working capital will, in large number of cases, no longer be necessary.

There is a healthy trend towards better management of cash movements and money manages position is gradually being involved. Although, only a few companies have got themselves involved thus far, serious attempts have been started to decentralise cash collection and to speed up collection with the help of services provided by some of the banks in the country. This is meant to reduce the float and improve the bottom-line of the cash flows. Further, attempts are also being made to streamline the working capital management and to reduce the need for working capital finance. Focus: the first matrix. But what is more important is the growing active interest in generating cash surpluses and parking them in short-term investments as and when they are available. These attempts lead to faster recycling of funds, reduction in need for borrowing and lowering of the interest burden. Focus: the second matrix, demanding policy and operational decisions on all rows.

With a view to activating the money market, the banking system in India has introduced two new instruments. Treasury bills and commercial bills are already available. To these certificates of deposits issued by commercial banks and commercial paper issued by the corporate bodies have been specifically for use by the corporate sector. The certificates of deposit provide an opportunity to the corporate manager to raise short-term funds in the money market. The Reserve Bank has issued guidelines for issuing the two new money market instruments. These guidelines are highly restrictive in character because the eligibility criteria have been set too high. There have been some subsequent liberalisation too. It is expected that as the experiment succeeds, the eligibility criteria will be further liberalised to permit larger number of companies to use CDs and CPs. It is also expected that the variety and range of instruments would also widen, and the secondary market would get itself established.

In this connection, it is relevant to point out that the basic idea underlying the introduction of new money market instruments and supportive new financial services, is to enable the corporate sector to raise funds more easily, to use funds already available
more effectively and to reduce the interest burden. An active money market is meant to provide short-term funds at rates of interest much lower than long-term rates of interest. Treasury bills are, to some extent, used but only by the banks. They themselves also accept term deposits for short periods. In these cases, the rates of interest have fluctuated around 8 to 10 per cent. It is expected that under ideal conditions these should be the rates around which short-term money market in India should fluctuate. A prime rate would emerge and the CDs and CPs would also get related to it.

It is no doubt true that the Reserve Bank is overcautious. It is also not yet ready to exercise control over the monetary system if new developments pick up fast. All its control instruments and policies were developed in the past to meet the then prevailing conditions. It will have to review its own working and devise new control measures. This is what in the new environment, is called re-regulation. With more freedom available to banks, as well as players on the other side of the market it will be necessary to change regulations so that non-fund and off the balance sheet business of banks and all other financial institutions can be regulated to achieve the national objectives.

For this purpose, some of the old ideas may have to be drastically revised. For example, it is not necessary to look at new money market instruments in the Tandon Committee perspective. It is no doubt true that more active use of CDs and CPs would drastically alter the nature of other current assets and current liabilities on corporate balance-sheets. That would demand a major reconsideration of the present system. But it is not wise to link operations relating to new money market instruments to maximum permissible bank finance or not to permit revolving underwriting arrangements and instead, permit only standby agreements within the credit limit sanctioned by the banks. In other words, it will have to be understood that if new developments are to be encouraged in the 90s, one cannot restrict them by the wisdom of the 70s.

There is the other side of the picture; it is also necessary to take note of the developments beyond the official market. What has really been happening in the unofficial market in the last few years is somewhat dysfunctional. The first major development in the market was the emergence of the financial service called portfolio management. Since the Reserve Bank regulations did not permit it, it emerged as a sort of bypass banking. It was not prohibited either. Some banks started offering interest rates around 12 per cent to the corporate sector for their cash surpluses. The money was invested in either UTI units or public sector bonds and the banks made some profit for themselves. To ensure absolute liquidity, the banks signed buyback agreements with their corporate clients. This meant reward without risk and also a more than normally expected reward on short-term deposits in India. The RBI prohibited portfolio management for periods shorter than a year.

Another most important development has been the removal of the ceiling of 10 per cent interest rate for the call market. Therefore, the call rates have on many occasions risen too high touching sometimes even 50 per cent and more. It is expected that the rates would somewhat stabilise in the near future, as the banks get used to the new game. There are, however, some banks and also some corporate money managers and private matchmakers who believe that in a country like India, demand and supply position of money is likely to keep the rates in the call market often times as high as 30 or 40 per cent. They are gearing themselves up for business opportunities under such conditions. In recent months, things have gone to the extent that some corporate money managers have availed credit facilities from some commercial banks at 16 per cent and through matchmakers lent them back through commercial banks at 30 or 40 per cent to other commercial banks. The matchmakers have also been busy in arranging inter-corporate short-term borrowings and lendings at rates above 20 per cent. In such transactions, commercial banks have also been involved. On the other hand, discounting of commercial bills which carry interest rates lower than 15 percent has not been so popular because the rediscount rates have not been higher.

These two parallel developments described above are apparently contradictory. On the other hand, the authorities at the national level have been trying to deregulate, to activate money and capital markets, to introduce new money market instruments in the expectation that money market would offer opportunities to the corporate money managers and banks to do more business and earn reasonable profit and, at the national level, to raise more funds in the market at reasonable cost of funds. On the other hand, the matchmakers in the market are using the new freedom to arrange inter-corporate borrowing and lending, lending surplus funds to banks to meet their cash reserve requirements and to continue the short-term portfolio management service by replacing buyback arrangements with forward purchases. There have been several occasions in the recent past when liquidity in the market was tight and several companies have been made fabulous profits through such transactions, and, these profits have been earned through totally risk-free transactions. They cannot be considered functional.

The situation is, therefore, paradoxical. There is the hope that gradually things will, in due course, settle down and both the banks and the corporate money managers will start using available instruments and play the game within the guidelines and the policies of the Reserve Bank and help in achieving the national objectives. There is also the fear that the new environment might promote more of bypass banking, and ultimately, the experiment in freeing the call market rate may have to be considered a failure.

As against this, it might be noted that many Indian companies with the help of commercial banks have been gaining access to foreign funds raised in international money markets through the issue of commercial paper at fairly low rate of interest. This not only makes cheaper funds available to the Indian industry but also helps in bridging the foreign exchange gap.

All innovations in financial world get popularised with passage of time. As attempts in India are being made to broaden the range of options available to corporate managers to finance their working capital through more deregulation, disintermediation, securitisation, institutionalisation, and internationalisation, it should be recognised that to begin with only a few companies and a few banks would be involved. As
these developments proliferate, with passage of time, the number of players and the variety of instruments will increase. This hope will materialise only if the introduction of instruments like CDs and CPs becomes popular both in the banking and in the corporate world. If they are pushed aside by somewhat clandestine and bypass banking in which the name of the game will only be making money on money, the bus will be missed. Much would depend upon whether the money game is played as chess or poker.

Bill Discounting - An Avenue for Retail Investors too

Bill discounting is a short tenure financing instrument for companies willing to discount their purchase / sales bills to get funds for the short run and as for the investors in them, it is a good instrument to park their spare funds for a very short duration.

A lot of people believe that bills discounting falls in the purview of banks and financial institutions. While this may be correct to a large extent, it is also true that most of the smaller value bills of big corporates and smaller, but sound, companies is undertaken by retail investors, who have funds to spare for a certain period.

Bills discounting is of two types

1. Purchase bills discounting and
2. Sales bill discounting.

A purchase bill discounting means that the investor discounts the purchase bill of the company and pays the company, who in turn pay their supplier. The investor gets his money back from the company at the end of the discounting period.

A sales bills discounting means the investor discounts the sales bill of the company and pays directly to the company. The investor gets his return from the company at the end of the discounting period.

Funds The funds generally required for this type of transaction start from Rs300,000 to upto Rs2mn. The tenure, generally, ranges from 60 days to upto 180 days.

Procedure The procedure is that a broker will contact you with proposals to discount bills of different companies at different rates of discounting. The better companies command discounting rates of 13% to 15%, while the lesser known, by size and by safety, have to pay discounting rates of 17% to as high as 28%.

It is later explained what factors determine the discount rates. When an investor and the company agree to a particular bill discounting transaction, the following is what the company gives to the investor:

The original copies of bills to be discounted;
A hundi / promissory note; Post dated cheque.

The investor simply has to issue a cheque. The amount of cheque is arrived at after deducting the discount rate. The post-dated cheque that the company gives is of the full amount of the transaction. This can be better explained with an example as follows.

Company A wants to discount its purchase bill of Rs200,000 for a period of three months. Investor P agrees to do so at a discount rate of 21%. The deal is mutually agreed. Now, the investor will issue a cheque of Rs189,500. This figure is arrived at as follows:

\[ 200,000 \times 21\% \times \frac{3}{12} \]

Thus the investor gets his/her interest before the end of the period on discounting. The company on its part will issue a post-dated cheque of Rs200,000 for three months period.

Here we see that the investor benefits in two ways:

He gets the interest element at the first day of issuing the cheque. i.e. he does not include that part in his cheque amount. Thus he can earn interest on this interest for a three-month period. Even a simple bank fixed deposit on it will earn @ 5% p.a. By investing Rs189,500 for three months, the investor earns Rs10,500 on it. A return of 22.16%.

Discount Rates The rates depend on the following factors:

The Broker: The broker has a good influence on the rates offered by companies. His relations with the company and the investor do make a difference of a couple of percentage point in discounting rates.

Market Liquidity: Liquidity crunch in the market tends to hike up the rates even in the best of the companies. Since this instrument is a short tenure one, short-term changes in the market liquidity greatly affect the discount rates.

Volume/Value of Discounting: When the volume/ value of discounting done by the investor is high, he is looking at security more than returns. The company on its part is looking at savings by way of reduced legal paperwork and a higher amount of dedicated funds for a said period and hence on the whole reduced costs to the company.

Frequency: An investor who is regular billscontador for the company may get upto 1% to 1.5% points higher interest rates than a new investor. As for the investor he is trying it out with a new company and will agree to a lesser rate to ensure safety.

Company’s finance resources: This is one of the biggest factors that decide the discount rates. A Public limited company generally tends to have a cheaper source of finance as against any other form of company. Working capital financing of companies to a large extent manipulates the rates the companies are willing to discount their bills at.

Caveat The following points need to be remembered when dealing in this instrument.

One must have a thorough knowledge of the company whose bills are discounted. Their industry, competition, people at the helm and their reputation in the market. This is necessary as it is going to be the company that is going to pay you from its earnings.

There is no legal fall back option in case of default by the company. The company does sign a promissory note, but legal respite using this will take years to happen. The investor is not a secured creditor for the company nor does he get any preference on winding up of the company.

Brokers need to be people who are well known to you. Since most of the deals happen through them, you should know the broker well enough to trust him and his deals. Spurious brokers are plenty out there in the market and a watchful eye must be kept. Even after investing in the company a regular
watch on the company’s fortune and a constant touch with the broker would be warranted.

**RBI Tightens Norms for Bills Discounting**

THE Reserve Bank of India has permitted banks to sanction limit for bills discounting to borrowers in accordance with the loan policy as approved by their board of directors.

In its guidelines on discounting and rediscounting of bills by banks, based on the recommendations of the working group on discounting of bills by banks, the RBI has said banks should lay down a bills discounting policy approved by their board of directors and consistent with their policy of sanctioning of working capital limits.

In a circular issued to all scheduled commercial banks, the apex bank has said the procedure for board approval should include banks’ core operating process from the time the bills are tendered till these are realised.

Banks should open letters of credit (LCs) and purchase, discount, negotiate bills under LCs only in respect of genuine commercial and trade transactions of their borrower constituents who have been sanctioned regular credit facilities by the banks.

Therefore, banks should not extend fund-based (including bills financing) or non-fund-based facilities like opening of LCs, providing guarantees and acceptances to non-constituent borrower or a non-constituent member of a consortium, multiple banking arrangement.

While purchasing, discounting, negotiating bills under LCs or otherwise, banks have been asked to establish genuineness of underlying transaction documents.

Accommodation bills should not be purchased, discounted or negotiated by banks.

Banks should be circumspect while discounting bills drawn by front finance companies set up by large industrial groups on other group companies.

Bills rediscounts should be restricted to usancebills held by other banks. Banks should not rediscount bills earlier discounted by non-banking financial companies (NBFCs) except in respect of bills arising from sale of light commercial vehicles and two-/three-wheelers.

Banks may exercise their commercial judgment in discounting of bills of services sector.

In order to promote payment discipline which would to a certain extent encourage acceptance of bills, all corporates and other constituent borrowers having turnover above threshold level as fixed by the bank’s board of directors should be mandated to disclose ‘aging schedule’ of their overdue payables in their periodical returns submitted to banks.

Banks should not enter into repo transactions using bills discounted/rediscounted as collateral.

Banks should follow the above instructions strictly and any violation of these instructions will be viewed seriously and invite penal action from the RBI.

**Banking : Tightening the noose**

HISTORY has shown that banking crisis are followed by reforms. Bankers expect history to repeat itself in the forthcoming monetary policy.

Investigations into the Madhavpura Co-operative Bank episode have shown that stock brokers have misused the Ahmedabad-based cooperative bank’s funds to the extent of Rs 1000 crore. This includes the Rs 800 crore lent to stock broker Ketan Parekh and Rs 200 crore to Mukeshbabu by Madhavpura Cooperative Bank.

A fallout of this is expected to be RBI measures aimed at curbing such violation of norms. But it is unlikely that any dramatic changes on bank’s capital markets exposure would be announced in this policy.

The central banks has always debated major policy changes with senior bankers before implementing them. A draft report on bank’s exposure in the capital market was circulated last week and comments from banks are expected only in May.

But in the short run, RBI is expected to announce fine turning of some of the existing prudential norms. Some bankers feel that the central bank will tighten norms in respect of the maximum counter-party exposure in inter-bank deals.

It is also likely that the RBI will take the first step towards introducing risk based supervision In the last two credit policy, RBI has expressed its intentions to move towards RBS.

RBS would imply monitoring banks by allocating supervisory attention according to the risk profile of each institutions. It would be done by upgrading the supervisory tools like on-site and off-site inspections and putting in place market intelligence mechanism.

Besides this, several other draft reports which have been circulated and largely debated could be notified in the forthcoming policy.

These include a draft guideline credit exposure limits which suggest broadening the definition of net worth and thereby permitting higher loan exposure limits to individual and group accounts.

There are draft norms on strengthening the bills discounting mechanism and extending it scope to service sector, a paper on pre-empt corrective action which will enable RBI to pre-empt any deterioration in the banking system.