NON-FUND BASED CREDIT FACILITIES

CCP CHAPTER 14C PART 2

📌 **Bills Purchase/Discounting Under LC** 🏦

🔍 What is Bill Discounting/Purchasing?

✓ **Bill Discounting** is a financial arrangement where a bank **purchases trade bills (bills of exchange) before their maturity** at a discount & provides immediate cash to the seller/exporter.

✓ It **helps businesses manage their cash flow** by converting receivables into liquid funds.

✓ The **buyer/importer** pays the full amount on the due date, and the bank collects the payment.

📌 🌟 Benefits of Bill Discounting

Benefit ☑	**Description** 🔍
1 Faster Cash Flow 💰	Businesses can receive cash before the bill's due date, improving liquidity.

2 Reduces Credit Risk 🏦	The bank takes on the risk (except in "with recourse" cases), reducing exposure for the seller.
3 Enhances Trade Relations 🤝	Ensures smooth business transactions between buyers & sellers.
4 Self-Liquidating Credit 🔄	Bills are settled automatically upon maturity, reducing risk for banks.
5 Can be Rediscounted 🔄	Banks can **rediscount** bills in the market, improving liquidity management.

📌 🔎 Guidelines for Banks on Bill Discounting

☑ Do's (Permitted Practices)

✔ **Only Genuine Trade Transactions** – Banks must ensure the bills represent **actual trade transactions** (not fictitious).

✔ **Regular Credit Facility Required** – The seller (beneficiary) must have **sanctioned credit limits** with the bank.

✔ **Restricted LCs** – If a letter of credit (LC) specifies a **particular bank**, only that bank can negotiate the bill.

✔ **LC Issuing Bank Can Discount Bills** – If the seller has regular credit facilities with another bank, discounting can be permitted.

✓ **LC Issuing & Discounting Bank Same?** – If both banks are the same, exposure is taken **on the buyer (importer)**, not the LC issuing bank.

✓ **Proper KYC & Verification** – Banks must verify trade documents before discounting to prevent fraud.

🚫 Don’ts (Restricted Practices)

❌ **No Accommodation Bills** – Bills must be linked to actual trade; fictitious or “accommodation bills” should not be discounted.

❌ **No “Without Recourse” Discounting** – Banks should avoid buying bills with a "without recourse" clause (except in specific cases).

❌ **No Non-Constituent Borrowers** – Bills financing should not be extended to customers without existing banking relationships.

❌ **Avoid Front Finance Companies** – Banks should be cautious when discounting bills of **subsidiaries of large business groups** dealing with related companies.

📌 🔎 Types of Risk in Bill Discounting

Risk Type ⚠️	Description 🔍
1 Credit Risk 💳	Risk of default by the buyer/importer.
2 Fraud Risk 🚨	Fake trade transactions or duplicate financing.
3 Legal Risk ⚖️	Incorrect documentation or regulatory non-compliance.
4 Liquidity Risk 💧	Difficulty in rediscounting bills when needed.
5 Country Risk 🌍	Political/economic instability in the buyer's country.

📌 Non-Fund Based Facility to Non-Constituent Borrowers of Bank 🏦

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📌 🔎 Key Guidelines for Non-Fund Based Facilities to Non-Constituents

Requirement ☑️	Details 📌
1 Board Approved Policy 📜	Banks must have a **Board-approved policy** for granting NFB facilities to non-constituent borrowers.
2 Verification of Borrower Credentials 🏦	Borrower must **declare all existing non-fund based credit facilities** with other banks.
3 Credit Appraisal & Due Diligence 🏛️	Banks must conduct the **same level of credit appraisal as for fund-based loans** before sanctioning NFB limits.
4 Compliance with KYC/AML/CFT Norms 🛡️	Strict **Know Your Customer (KYC), Anti-Money Laundering (AML), and Counter-Terrorism Financing (CFT) checks** must be performed.
5 Reporting to Credit Information Companies (CICs) 📊	Banks **must report** all sanctioned NFB limits to CICs (such as CIBIL, Experian)

	under **Credit Information Companies (Regulation) Act, 2005**.
6 Adherence to Exposure Norms 📈	Banks must **follow RBI's exposure norms** while granting these facilities.

📌 🔎 Special RBI Restrictions & Clarifications

✓ **No Negotiation of Unrestricted LCs of non-constituents** 🚫

- As per **RBI's Master Circular**, banks **cannot negotiate** LCs of non-constituents unless specifically restricted to a particular bank.
- If a bill is drawn under an LC and the seller **is not a bank's customer**, the bank **can negotiate the LC** only if the proceeds are **remitted to the seller's regular banker**.

✓ **LCs & BGs for Co-operative Bank Clients** 🏦

- **Scheduled Commercial Banks** can **issue BGs & LCs** for clients of **cooperative banks**, but only **against a counter guarantee from the cooperative bank**.

- Banks must **verify that the cooperative bank has sound credit appraisal & monitoring systems** before issuing the facility.

✓ **Additional KYC Checks for Co-op Bank Clients** 🔍

- Before issuing a **BG/LC for a co-op bank customer**, commercial banks **must ensure KYC checks** are done properly.

📌 🔎 Why Was This Change Made?

✓ Earlier, many businesses that **only needed LCs/BGs** but **did not require fund-based loans** struggled to get NFB facilities.

✓ RBI recognized that **credit information systems have improved**, making it easier to track borrower liabilities.

✓ **Now, businesses without a fund-based loan can access LCs/BGs**, boosting **ease of doing business**.

📌 Understanding Bank Guarantees (BGs) in Banking 🏦

🔍 What is a Bank Guarantee (BG)?

✔ A **Bank Guarantee (BG)** is a financial commitment issued by a bank on behalf of a customer (applicant) to a **beneficiary** assuring payment in case the customer fails to meet their obligation.

✔ It is a **non-fund-based facility** but can become a **fund-based liability** if invoked.

✔ BGs provide financial security and enhance trust between parties in trade and contracts.

✔ They are widely used in **construction, manufacturing, import/export, business transactions, and government contracts**.

📌 🎭 Parties Involved in a Bank Guarantee

Party 🤝	Role 📌
1 Applicant 🏢	The borrower/customer who requests the guarantee.

2 Beneficiary 🎯	The person/entity in whose favor the BG is issued (e.g., contractor, supplier, government authority).
3 Guarantor (Bank) 🏦	The bank that guarantees payment in case of default by the applicant.

📌 🔎 Types of Bank Guarantees

1 Performance Guarantees 🏗

✔ Issued when a customer (e.g., contractor, manufacturer) needs to **assure performance** under a contract.

✔ Used in **construction, tenders, supply contracts, and service agreements**.

✔ If the customer **fails to perform**, the bank pays the beneficiary.

✔ **Examples**:

- **Bid Bonds** (Earnest Money Deposit)
- **Advance Payment Guarantees** (Mobilization Advance)
- **Retention Money Guarantees**
- **Maintenance Bonds** (for post-project defects/warranty)

2 **Financial Guarantees** 💰

✔ A **direct credit substitute**, where the bank guarantees repayment of a financial obligation.

✔ It **substitutes the borrower's credit risk with that of the bank**.

✔ **Examples**:

- **Guarantees for Customs Duty, Taxes & Levies**
- **Guarantees for Credit Facilities**
- **Deferred Payment Guarantees (DPG)** for equipment financing

3 **Deferred Payment Guarantees** 🏭

✔ Used when a **supplier sells goods (e.g., machinery, capital equipment) on deferred payment terms**.

✔ The bank guarantees that the buyer will make **installment payments on due dates**.

✔ If the buyer defaults, the **bank makes the payment**.

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📌 🔎 Financial vs. Performance Guarantee 🏦

Feature 🔍	Financial Guarantee 💰	Performance Guarantee 🏗
Purpose 🎯	Guarantees **financial repayment**.	Guarantees **completion of a contractual obligation**.
Risk 📉	Similar to **direct credit risk**.	Risk depends on **project execution**.
Example 📌	Guarantee for **loan repayment, taxes, customs duty**.	**Bid bond, advance payment, retention money guarantee**.

📌 🚨 Key RBI Guidelines for Issuing Bank Guarantees 🛑

✔ **No BG should exceed 10 years** unless approved by the bank's Board.

✔ **Proper credit appraisal must be done** before issuing a BG.

✔ **Banks must assess financial strength & past performance** of applicants before issuing BGs.

✓ **BGs should be backed by collateral or margin money** to reduce risk.

✓ **Risk-based pricing should be applied** for different types of guarantees.

📌 🚀 Importance of Bank Guarantees in Business

✓ **Enhances trust between parties** – Beneficiary is assured of payment if the applicant defaults.

✓ **Encourages trade and business** – Businesses can enter contracts confidently.

✓ **Helps SMEs and contractors** – Provides financial backing to **secure projects & contracts**.

✓ **Reduces default risk** – Banks evaluate **creditworthiness** before issuing guarantees.

📌 Assessment of Bank Guarantee (BG) Limits 🏦

🔍 What is a Bank Guarantee (BG) Limit?

✓ **A Bank Guarantee Limit** is a pre-approved amount within which a borrower can request multiple BGs as required.

✓ It functions **similar to a Cash Credit (CC) or Overdraft (OD) limit**, where the borrower can issue BGs **up to the sanctioned limit**.

✓ The **limit is subject to annual review** based on the borrower's financial health, past utilization, and repayment history.

✓ The BG limit depends on **the type of guarantees needed**, **the borrower's industry**, and **the expected volume of business transactions**.

📌 🔎 Key Factors in Assessing BG Limits

✓ **Nature of Business Activity**:

- Manufacturing, construction, trade, or services sector?
- Regular business operations or one-time projects?

✓ **Types of Guarantees Required**:

- **Financial Guarantees** (e.g., tax/customs liabilities, credit enhancements)
- **Performance Guarantees** (e.g., contract execution, bid bonds, advance payment guarantees)

✓ **Guarantee Duration**:

- Short-term guarantees (e.g., bid bonds) may **expire soon**.
- Long-term guarantees (e.g., security deposits) may remain **outstanding for years**.

✓ **Guarantees Required for Ongoing Operations**:

- **Examples**: Electricity deposit guarantees, excise/tax authorities, project tenders, government contracts.

✓ **Contingent Guarantees**:

- **Example**: BGs for advance payments, disputed liabilities, or project-specific needs.
- **These are temporary and fluctuate** based on business needs.

✓ **Financial Standing of the Borrower**:

- **Debt-Equity Ratio**
- **Net Worth & Liquidity**

- **Past utilization of BGs** and history of **invocation cases**.

✓ **Ability to Execute Contracts**:

- If a **Bid Bond Guarantee** is issued, the borrower may need a **Performance Guarantee** if they win the bid.
- The bank must **assess technical & financial capability** before issuing bid-related guarantees.

📌 🔎 Computation of BG Limit 📊

A practical approach followed by banks:

S.No	Particulars	Amount (₹ in Lakhs)
A	Outstanding BGs	**500**
B	Cancellations expected	**(-300)**
C	Regular Operational Requirements	**600**
D	Contingent Guarantees (Bid Bonds, Disputed Liabilities)	**100**
E	**Total Required BG Limit [(A - B) + C + D]**	**900**

✓ **This method ensures a balance between ongoing needs and contingent exposures.**

✓ The bank ensures that **fund-based and non-fund-based borrowings together remain within reasonable debt-equity limits**.

📌 🚨 **Precautions Before Issuing BGs** 🛑

✓ **Assess Borrower's Creditworthiness**:

- Like **fund-based loans, banks should evaluate financial strength** before issuing BGs.

✓ **Monitor Utilization**:

- If a contractor **abandons a project**, a **Performance Guarantee may get invoked**, leading to **bank liability**.

✓ **Ceiling on Total Borrowings**:

- A combined **cap for fund-based + non-fund-based limits** must be set based on debt-equity norms.

✓ **Avoid Over-exposure in Risky Sectors**:

- Construction projects, disputed tax liabilities, and government tenders should be **carefully appraised**.

✓ **Consider Collateral/Margin Requirements**:

- Higher **margins for high-risk projects** to safeguard the bank’s exposure.

📌 **Bank Guarantees: Security, Expiry, and Claim Period Management** 🏦

🔍 14.9.2 Security for Bank Guarantees (BGs)

✔ **BGs are typically secured** by a charge on the borrower's assets (current or fixed) or third-party guarantees.

✔ **Collateral security** is often required, especially in cases of performance guarantees related to **construction and large contracts.**

✔ **Banks should monitor** project progress through site visits and financial statements (inflow/outflow tracking).

✔ **Unsecured guarantees should be limited** and require higher scrutiny, as per RBI guidelines.

Key RBI Guidelines on BG Security:

- **Avoid large unsecured guarantees** for long-term projects.
- **Ensure diversification** to prevent over-exposure to a particular group/sector.

- **Unsecured guarantees should be a reasonable proportion** of the borrower's equity.

📌 **Period of Bank Guarantees**

✓ **All BGs must have a fixed expiry date** to limit bank liability.

✓ **A disclaimer clause is included** in every BG:

"Notwithstanding anything contained herein:"

- **(a)** Our liability under this Bank Guarantee shall not exceed ₹_______.
- **(b)** This Bank Guarantee shall be valid up to (date).
- **(c)** We are liable to pay the guaranteed amount only if a written claim is served before (expiry date).

✓ **Post-expiry Liability Management:**

- Banks should **extinguish expired guarantees** to avoid unnecessary capital allocation.
- If the **original BG is not returned**, a **formal notice should be sent to the beneficiary** stating that the guarantee is no longer valid.

📌 **Claim Period of Bank Guarantees**

✔ The **Claim Period** of a **Bank Guarantee (BG)** is the **additional timeframe** given to the beneficiary **after the expiry of the guarantee** to invoke (claim) it in case of default by the applicant.

✔ **Banks must ensure BGs contain an appropriate claim period** to protect against extended liability.

📌 **Key Guidelines on Bank Guarantees (BGs) and Rights of Beneficiaries**

🛑 **Right to Claim Under Bank Guarantee Agreement**

✔ **(i) Demand Period:**

- The demand for payment under the BG must be made **during the validity period** of the guarantee.
- No claims can be raised after the validity period expires.

✔ **(ii) Disputes & Legal Actions:**

- If a demand is made during the validity period but payment is delayed or denied, disputes or legal suits **must be filed within the claim period**.

- The claim period is meant for **legal recourse** and not for making fresh demands.

✓ **(iii) No Recourse After Claim Period:**

- Once the claim period ends, no further legal action or financial liability remains on the bank.

📌 14.9.6 Bank's Liability & Payment Obligations

✓ **Absolute Liability of Banks:**

- A bank's obligation under a BG is **independent and unconditional**.
- Upon invocation, payment **must be made without delay or dispute**, as long as it complies with the guarantee terms.
- The bank **cannot** refuse payment citing any underlying disputes between the applicant and beneficiary.

✓ **When Can Payment Be Withheld?**

- Only **a court order (injunction/restraint)** can prevent payment.

- If a case is pending in court, the bank's liability continues, **even if the BG validity has expired**, until the case is resolved.

📌 **Due Diligence Before Granting Credit Based on Third-Party Bank Guarantees**

When a borrower seeks credit based on a BG issued by another bank, the following checks must be performed:

✓ **(a) Credit Proposal Scrutiny:**

- Conduct **full due diligence** and risk assessment as per standard procedures.

✓ **(b) Verify Why the Original Bank is Not Lending:**

- Investigate why the **guaranteeing bank** is not offering direct credit itself.
- Ensure that the arrangement **is not a risk transfer mechanism** to shift liabilities.

✓ **(c) Check Authority of Issuing Bank Officials:**

- Confirm whether the officials issuing the BG **have the required authorization**.

- Ensure the **Power of Attorney is registered with the bank**.

✓ **(d) Purpose of Guarantee:**

- Verify that the BG is issued for the **usual and regular business activity** of the borrower.

✓ **(e) Redemption of Expired Guarantees:**

- Ensure expired guarantees are **closed immediately** to reduce unnecessary exposures.

📌 **RBI Guidelines on Funded Exposure for Banks Issuing BGs**

✓ **(f) Funded Exposure Requirement:**

- The bank issuing the BG must take at least **10% of the exposure** as a **funded exposure** (i.e., direct credit facility).

✓ **(g) Project Financing Exposure:**

- If a BG is issued for a project, the bank **must participate in at least 5% of the project cost** as direct lending.

✓ **(h) Prudential Compliance of Issuing Bank:**

- Ensure the guaranteeing bank has a **good compliance record** on capital adequacy, asset classification, provisioning, and credit exposure norms.

✓ **(i) BGs Only for Bank's Own Borrower Constituents:**

- BGs should **only be issued for existing borrowers** to help them avail additional credit from other lenders.

✓ **(j) Restrictions on Overseas Guarantees:**

- **Banks cannot issue BGs or Letters of Comfort (LoC) in favor of foreign lenders** unless permitted by FEMA regulations.

✓ **(k) Risk Weight on Guarantees:**

- The exposure taken by the issuing bank is treated as a **credit exposure on the borrowing entity** and **must be risk-weighted accordingly**.

✓ **(l) Risk Weight on Counter Guarantees:**

- If a BG is backed by another bank's counter-guarantee, the **risk is considered on the counter-guaranteeing bank** rather than the borrower.

✓ **(m) Inter-Bank Exposure Limits:**

- BG-backed exposures **should be included in the inter-bank exposure limits** to control overall risk.

- **Board-approved sub-limits** should be set for **long-term exposures**, as they carry higher risk than short-term money market transactions.

📌 ☑ Key Takeaways & Best Practices

✔ **Strictly monitor demand periods**—invocation must be **within the BG validity period**.

✔ **Claim periods only allow legal recourse**, not fresh demands.

✔ **Payments under BGs are absolute**—banks cannot withhold payment unless a court order exists.

✔ **Ensure the issuing bank has adequate exposure** (10% in normal cases, 5% in project financing).

✔ **Avoid issuing BGs for non-borrowers** or unknown entities.

✔ **Monitor expired BGs and get them formally closed** to prevent excess risk allocation.

✔ **Inter-bank BG-backed exposures must be managed under the overall exposure cap.**

CO-ACCEPTANCE FACILITY: A Key Tool for Deferred Payments

💡 What is Co-Acceptance Facility?

When a **borrower purchases goods or machinery** on **deferred credit**, the seller usually demands a **Deferred Payment Guarantee** or the **co-acceptance of usance Bills of Exchange** from the buyer's bank.

✔ This provides assurance to the seller that payment will be made on the due date.

✔ If the buyer defaults, the **co-accepting bank must make the payment**.

✔ This is similar to a **Bank Guarantee or Letter of Credit facility**, and hence requires **thorough scrutiny** before approval.

RBI Guidelines on Co-Acceptance of Bills

The Reserve Bank of India (RBI) has issued strict **guidelines** for co-acceptance of commercial usance bills:

✓ (a) Co-Acceptance Only for Genuine Trade Bills

- Co-acceptance is allowed **only for genuine trade bills** related to actual purchases of goods.
- The bank must **verify stock records** to ensure goods **are received and recorded** in the buyer's books.

✓ (b) No Over-Valuation of Stocks

- The bank should verify the **invoice values** to **prevent over-inflated stock** purchases.

✓ (c) No Co-Acceptance for House Bills/Accommodation Bills

- Banks **must not** co-accept bills drawn by **group concerns** on one another.

✓ (d) Co-Acceptance Restrictions on Certain Credit Schemes

- Banks **should not co-accept** bills under **Buyers Line of Credit Schemes** introduced by **IDBI Bank, SIDBI, PFC, etc.**
- Banks **should not** co-accept bills drawn by **NBFCs** on behalf of their borrowers under the SIDBI scheme.

✓ (e) Permitted Co-Acceptance for Seller's Line of Credit Schemes

- Banks **are allowed** to co-accept bills drawn under the **Seller's Line of Credit Scheme** (now called **Direct Discounting Scheme**) operated by **IDBI, SIDBI, and PFC**.
- **No limit on co-acceptance**, but must comply with **borrower exposure norms**.

✓ **(f) Co-Acceptance of Bills Under LC (Letter of Credit)**

- If a bank **co-accepts** a bill drawn under its own **LC**, it **defeats the purpose** of an LC.
- The co-accepted bill becomes an **independent obligation** under the **Negotiable Instruments Act**, instead of following LC rules under **UCPDC**.

Co-Acceptance of Bills for Raw Material Purchases

Banks must **exercise caution** while allowing co-acceptance for **raw material purchases**:

✓ **(a) Part of Working Capital Facilities**

- The co-accepted bill must be **counted as part of the borrower's working capital limit**.

✓ **(b) Goods Must be Hypothecated**

- Goods purchased under co-accepted bills **must be hypothecated to the bank**.
- **No double financing** should occur by providing additional advances against these goods.

✓ **(c) Bills Must Be Honored from Own Sources**

- The borrower must repay the bills from **internal cash flows or existing credit lines**.

✓ **(d) No In-House Bills**

- Bills issued between **group entities or related parties** should **not** be co-accepted.

✓ **(e) Timely Repayment Monitoring**

- Due dates of the co-accepted bills should be **tracked and diarized** to ensure **prompt payment**.

📌 Co-Acceptance for Machinery Purchases (Deferred Payment Guarantee)

When a **buyer purchases machinery** on a **deferred payment basis**, the bank must conduct a **risk assessment** similar to a **Term Loan approval**:

✓ **(a) Due Diligence Similar to Term Loan Processing**

- The bank must analyze the **viability of the project** and **assess repayment capacity**.

✓ **(b) Risk Evaluation & Cash Flow Analysis**

- Banks should evaluate whether the new **machinery purchase will generate enough revenue** to support **timely repayment**.

✓ **(c) Collateral Security May Be Required**

- Additional collateral (such as **other fixed assets**) may be **required**, depending on **risk appetite**.

✓ **(d) Short-Duration Usance Bills Need Strong Justification**

- If the co-acceptance is for a **short-term usance period (90-180 days)**, it should be **justified based on operational requirements**.