COMMERCIAL BILLS

In the early part of the nineteenth century bills were widely used in the United Kingdom as a method of obtaining credit, primarily in the financing of domestic trade, and discounting bills was the chief method of bank lending. In the second half of the century the relative importance of bill finance in internal trade declined as that of the bank overdraft grew, but the decline coincided with a substantial increase in international trade, in particular the overseas trade of the United Kingdom, which was to a large extent financed through bills.

The historical importance of bills partly explains the structure and growth of some important types of financial institution for which commercial bills may now provide only a small proportion of business. For instance, the growth and organisation of the discount houses and accepting houses can only be properly appreciated in relation to their long association with bill finance. Although the relative importance of commercial bills in the London market has diminished during this century, the canons of financial practice associated with the bill on London underlie the attitudes of many who are closely concerned with the provision of finance.

The drawing and discounting of commercial bills is still a significant means of raising finance in the British capital market. In 1959 the total of commercial bills outstanding is estimated to have been some £700 million of which about half consisted of bills accepted by banks (bank bills) and half of bills accepted by traders (trade bills). Bank bills appear to be held almost entirely within the banking system[(a)] and can be compared with advances as a means by which banks lend. Although some trade bills are held by the banking system, it appears that for the most part they are held outside it and are a means of borrowing and lending between firms, to be compared, therefore, with trade credit.

This note gives a brief account of the main features of commercial bills, chiefly from the point of view of the market. It then goes on to outline the Bank of England's policy and practices with regard to bank bills.

Main types of bill

A bill is a written instruction by the person drawing it (the drawer) to another person (the drawee) to pay a particular sum either to the bearer of the bill or to the order of a specified person (the payee).[(b)] A bill may be drawn so as to be payable either on presentation to the drawee (a sight bill) or payable at a later date (a usance bill). When a usance bill is presented to him, the drawee marks it " Accepted " and signs and dates it, thereby signifying his acceptance of the liability to pay the bill on maturity. A drawee who has accepted a bill is known as the acceptor.

A bill is a negotiable instrument and once accepted may be sold (discounted) by the owner in order to secure funds in advance of the bill's maturity date. A bill may be resold (rediscounted) a number of times before maturity, each seller as a rule endorsing it. When a bill becomes due for payment it is presented to the acceptor by, or on behalf of, the person then owning it; should the acceptor not meet his obligation the owner may have recourse to the endorsers and to the drawer. For this reason the financial standing of the acceptor, the drawer and any endorsers are of the greatest importance to a purchaser of a bill, affecting both his willingness to buy it at all and the rate of discount at which he will do so. A buyer may also take into account the purpose for which credit is being raised by a bill, as it may influence his assess-

(a) In this note the term " banking system " comprises the institutions whose holdings of commercial bills are identified in the table on page 31.

(b) The Bills of Exchange Act, 1882, defines a bill of exchange as " an unconditional order in writing, addressed by one person to another, signed by the person giving it, requiring the person to whom it is addressed to pay on demand or at a fixed or determinable future time a sum certain in money to or to the order of a specified person, or to bearer ".

ment of the risk of the bill not being paid on maturity.

A bill financing the movement of goods into the hands of the person who has bought them is known as a " self-liquidating " bill, because the buyer of the goods will have had the opportunity to re-sell them or re-finance them and so be in a position to meet the bill at maturity. Bills which do not have an underlying transaction of this sort are known as finance bills; those used, for example, for financing stocks of materials already in the hands of the user or for financing hire purchase sales come into this category.

A bill drawn on and accepted by a U.K. bank or accepting house with an unquestioned financial standing is known as a " prime bank bill ". Prime bank bills are readily saleable in the London market and command a rate almost as fine as that on U.K. Treasury Bills. The banks buy them as first-class liquid assets, and will accept them as security against their loans to discount houses; the discount houses are willing to hold them for the same reasons and because in case of need such bills can be rediscounted with, or used as security for a loan from, the Bank of England.

Most prime bank bills which come into the market are sold to the discount houses; the rate at which the discount houses buy them (the prime or fine rate) is currently $5\frac{5}{8}\%$[a] and the rate at which they re-sell them is about $5\frac{1}{2}\%$. The latter is about $\frac{1}{8}\%$ above the rate at which the discount houses are currently selling comparably dated Treasury Bills. This is because the standing of even the most highly regarded names on a bill does not match that of H.M. Government, and because compared with Treasury Bills, commercial bills are relatively expensive to check and record.

Some bills accepted by London banks are only discountable at rates of $\frac{1}{16}\%$ per annum or more above the prime rate. This is normally because the acceptor has a lower financial standing. The discount houses, clearing banks and Scottish banks will usually buy these bills but will restrict their total holdings of those of any one acceptor in order to limit their risk.

Bills drawn on and accepted by the London offices of many foreign banks may be discountable in the market at the prime rate, even though uncertainties over a country's exchange position or political stability may at times make the discount houses and banks reluctant to hold a large amount of bills drawn on the London offices of the banks of that country. There is always the feeling that such bills might, at a difficult moment, prove to be less easily rediscounted than prime bank bills; and as they are not eligible for discount with the Bank of England the discount houses have not the same certainty that they can be turned into cash in case of need. There is also the possibility that should such a bill not be met on maturity, payment might not be obtainable through action in a U.K. court because the U.K. assets of the acceptor might be insufficient to meet all claims in full. These possibilities are in many cases too remote to be reflected in a higher rate of discount, but on occasion such fears may rise to the point at which acceptances of the London offices of some foreign banks may no longer command the fine rate, and can be discounted in only very limited amounts. Even with no specific political or other uncertainties, a marked rise in the volume of such acceptances coming into the market from a particular bank or group of banks can provoke concern and cause the rate on these bills to rise above the fine rate and limit the amounts which any bank will take.

Acceptors of trade bills vary between, at the one extreme, established international companies and, at the other, small individual traders. For this reason the rates of discount at which it is possible to sell trade bills vary widely. Rates for fine trade bills are currently quoted at about $1\frac{1}{8}\%$ to $1\frac{7}{8}\%$ per annum over the rates for comparably dated prime bank bills; other trade bills may sell at a rate up to $2\frac{3}{8}\%$ above the prime bank bill rate. Some banks discount trade bills, but they are seldom willing to hold large amounts. For this reason and because banks do not generally regard trade bills as providing acceptable security for call money, the discount houses are usually reluctant to buy large amounts of them. In consequence, these bills are mainly held outside the banking system. Trade bills are sometimes lodged by the owner as security for a

[a] The prime rate is closely linked to the Treasury Bill tender rate and ranges between $\frac{1}{8}\%$ and $\frac{7}{8}\%$ below Bank Rate. This article was written in mid-November 1961, and all rates quoted relate to that time.

bank advance, but in this case they do not form part of a bank's assets.

Cost of bank bill finance The extent to which commercial bills are used as a means of financing will depend upon the convenience, availability and cost of bill finance relative to other forms of credit, as well as upon the financing habits of users and the extent to which the various forms of finance are actively promoted by the providers. Relative cost is the only one of these factors which is open to any direct measurement, and it appears that, so far as bank bills are concerned, there is usually no very significant difference between the cost of bill finance and a bank advance. The cost of bank bill finance is composed of the acceptance commission charged by the acceptor and the rate of discount at which the bills can be sold. The acceptance commission can vary widely and depends primarily upon the acceptor's assessment of the credit standing of the party responsible for putting him in funds to meet the bill at maturity. For a commercial borrower of high standing, the acceptance commission may at present be taken as being about 1¼% per annum. The rate of discount on three months' prime bank bills is currently 5⅝% per annum, the equivalent of a rate of interest of about 6% per annum. The cost of bank bill finance in such a case is therefore, about 7¼% per annum. (Prior to August 1961 Stamp Duty was a significant factor. This was levied at a rate of 1*s*. per £100 on most usance bills, the equivalent of nearly ¼% per annum. It was abolished in the Finance Act, 1961, and replaced by a flat duty of 2*d*. per bill, bringing it into line with the duty payable on sight bills and cheques.)

The present advances rate for most bank customers is 1% over Bank Rate with a minimum of 5%. Currently therefore, most bank advances cost 7% and the difference between this and the cost of bank bill finance to commercial borrowers of high standing is about ¼%. Since the rate at which the discount houses buy prime bank bills may vary between ⅛% and ⅞% below Bank Rate, the cost advantage can at times be on either side. When Bank Rate is below 4%, and so long as the standard minimum rate on bank advances is 5%, bill finance will normally be the cheaper of the two.

Bank of England policy The Bank of England's general policy regarding commercial bills has two main aims. These are:

(i) to maintain the standards of quality long associated with the London prime bank bill and hence its reputation as a liquid asset of undoubted security; and

(ii) to allow reasonable development of bills of all classes as being useful financial instruments some of which, incidentally, bring in modest net earnings of foreign exchange.

Although the accepting houses account for only about one-third of all bills accepted by banks in London, they account for a much higher proportion of the bills sold in London since the bulk of accepting houses' acceptances come on to the market, while a large proportion of the bills accepted by other banks under confirmed credits is retained by them. The Bank have some influence over the acceptance business of the accepting houses and use this to favour business which gives rise to self-liquidating bills rather than finance bills. This influence is exercised in a number of ways.

One way is through some prior consultation between the accepting houses and the Bank especially over the larger acceptance credits, which gives the Bank the opportunity to discourage finance bill business.

Another way is through the policy followed by the Bank in their purchases of commercial bills in the market. The Bank's policy of maintaining a portfolio of commercial bills dates from the period before the commercial bill had been displaced by the Treasury Bill as the main short-term security traded in the London market. Nowadays the value of the portfolio as an investment is very much a secondary consideration and the Bank make their purchases chiefly to sample the prime bank bills changing hands in the market. This portfolio is maintained by purchases on the Bank's initiative of parcels of bills on most days from members of the London Discount Market Association, the general aim being that the Bank's portfolio should represent a fairly stable proportion of the total of prime bank bills in the London market. Bills are bought at the rates ruling in the market; the Bank make no attempt to influence these rates by their day to day buying.

The Bank will take only a limited proportion of finance bills in their purchases, and this tends to restrict the market's willingness to take up finance bills. In addition, the prime status accorded by the Bank to the acceptances of the accepting houses depends upon the readiness of the latter to make their balance sheets available to the Bank and to answer any enquiry that the Bank might wish to make as a result of their sampling of the bills coming on to the market, or for any other reason. This provides a further means of influencing the quality of bills in the market.

In addition to the direct influence exercised through their purchases of bills there is also some indirect influence. The Bank's policy inevitably becomes known in the market and some other banks follow the Bank's lead in regard to the bills they purchase for their own portfolios.

Another channel of influence, though now of very minor importance, is through the rediscount facilities which the twelve members of the London Discount Market Association have at the Bank. They may, as of right, rediscount approved commercial bills or borrow money against the security of such bills. The Bank's approval of certain types of bills for these purposes could be expected to have some influence, though in practice these facilities in respect of commercial bills have only been used on rare occasions during the last ten years—mainly because Treasury Bills and short-dated gilt-edged stocks are more convenient instruments for the discount houses to use for these purposes.

Currently the Bank require that the bills they buy from the market or take as security for a loan to a discount house should bear two good British names, one of which must be the acceptor. (The other name will in practice be that of the discount house which will have endorsed the bill on selling it to the Bank.) The Bank are prepared to buy a limited amount of finance bills drawn to provide working capital for firms in the United Kingdom, though not bills drawn to provide working capital for overseas firms. Because of their preference for self-liquidating bills, the Bank view with disfavour the appearance in the market of many bills drawn for periods in excess of 90 days, since this period is now in most cases sufficient to cover the time the underlying goods are in transit. The Bank are not prepared to discount bills accepted by the London offices of foreign banks, nor do they discount bills accepted abroad but made payable at a bank in London.

The Bank are the arbiters of the type of bill they will purchase or take as security, and retain the right to vary their practice at any time. The Bank, therefore, are never committed in advance to the purchase of any particular bill. For instance, when Exchange Control restrictions imposed in order to limit overseas borrowing in London have been relaxed, the fact that a bill has been drawn under a credit consequently authorised by the Exchange Control has not meant that the Bank have been in any way committed to purchase such a bill. The Exchange Control is concerned with limiting strains on the balance of payments while the Bank, when buying bills, have in mind the purposes previously described.

The Bank have not always made use of their influence over the quality of bills, although they have always preferred to see self-liquidating bills circulating in the market rather than finance bills. Before the 1914-18 War there was a considerable volume of finance bills in the market and although in those days the Bank did not discriminate against them, it is clear from their evidence given in 1910 to the National Monetary Commission in the United States that even then they did not regard finance bills with much favour. In 1919 it was thought desirable to apply some curb to the use of finance bills and the Governor told the discount market that, except in special cases, only bills covering the movement of goods would be entitled to fine rates of discount at the Bank. From that time until 1930, despite increasing pressure from those wishing to use this form of borrowing and lending, the Bank used their influence to restrict the growth of finance bills. In the 1930's the Bank began to discount a small proportion of finance bills drawn by British companies. The main reasons for this change in policy were the growth of hire purchase finance, which was then being encouraged, and a shortage of Treasury Bills and of self-liquidating commercial bills.

During the Second World War the Bank's attitude to finance bills was further relaxed but since 1950 they have again sought to restrict their use. In that year the Bank reverted to their earlier and stricter standards of what constituted a good bill. They were influenced partly by the relaxation of Exchange Control regulations relating to the granting of credits abroad, which made some further growth in bill finance likely, and also by the feeling that this was appropriate to more normal peace-time conditions. The Bank therefore refused, when buying bills in the market, to take more than a limited proportion of finance bills.

The Bank's influence over the quality of the bills in the London Market is important for the development of bill finance, because the accepting houses, which are most affected by the Bank's views, provide the greater part of the general acceptance facilities as opposed to bankers' confirmed credits. The latter also give rise to the drawing and acceptance of bills, but as noted above, a high proportion of these bills is retained in the portfolio of the accepting bank. While held in this way such bills are effectively 'one-name' paper and more in the nature of security for advances, although they could in most cases be sold in the market should the bank wish to do so. For this reason practice varies between banks over their treatment for balance sheet purposes.

The fact that commercial bills accepted by one bank and held by another are rightly regarded by the latter as liquid assets gives the Bank a further interest in the development of commercial bill finance. The banking system can be induced to exercise restraint in the provision of credit by means of pressure on its liquidity. Accordingly, a switch in financing methods from bank advances to the use of acceptance credits, or a change in the policy of banks other than the accepting houses towards selling their own acceptances under confirmed credits in the market rather than holding them, could hamper efforts to restrict the supply of credit; for it would enable the banks collectively to maintain or improve their liquidity by substituting bills for bank advances. The influence that the Bank exercise through the channels described above could not be expected to deal with such a change, but the Bank have on occasion made known to the London banks their concern that credit restraint should not be weakened by such means.

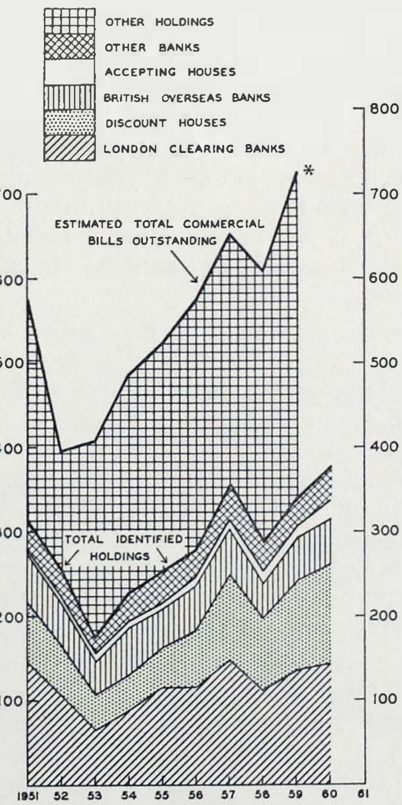
The bill continues to perform a useful function in a limited field, in particular the provision of finance for the importing of a number of commodities such as petroleum, sugar and timber and for exports. The Bank's policy is to continue to facilitate its use to the extent that this is compatible with any necessary degree of credit restraint and to use their influence to maintain the standards of quality associated with the London prime bank bill.

DIVISION OF COMMERCIAL BILLS BY HOLDER

£ millions	1951	1952	1953	1954	1955	1956	1957	1958	1959	1960
Identified Holdings:										
London Clearing Banks	145	105	63	87	114	114	148	110	134	142
Discount houses ...	72	61	43	43	48	68	100	88	107	119
British overseas banks	55	47	41	55	46	53	54	40	51	54
Accepting houses ...	6	9	8	9	8	11	11	14	14	23
Other banks[(a)]	35	35	18	33	36	34	42	36	34	40
Total identified holdings	313	257	173	227	252	280	355	288	340	378
Estimated Total Commercial Bills Outstanding	575	395	407	488	524	577	653	609	726	..
therefore estimated other holdings ...	262	138	234	261	272	297	298	321	386	..

(a) Comprising Scottish banks, Northern Irish banks, American banks, and " other foreign banks " as defined for Table 11C of the Statistical Annex.

DIVISION OF COMMERCIAL BILLS BY HOLDER



* 1960 NOT YET AVAILABLE

NOTES TO THE GRAPH AND TABLE

1. Estimated Total Commercial Bills Outstanding

Figures are from estimates by Jessel, Toynbee & Co. Limited. The compilers of the estimates took the figures for the total stamp duty received in each financial year from all bills of exchange and promissory notes (published in the Annual Reports of the Commissioners of Inland Revenue) and assumed that each instrument attracted duty at the standard rate (1*s.* per £100 until the 1st August 1961) and had an average life of three months.

The figures are no more than estimates, because the Inland Revenue statistics include indistinguishably:

(*a*) Bills paying less than the standard rate, that is
- (i) Bills payable on demand or at sight (other than cheques) which paid a fixed rate of 2*d.*;
- (ii) Bills both drawn and payable abroad (but negotiated in the United Kingdom).

(*b*) Bills having a usance of other than three months.

(*c*) Promissory notes.

2. Identified Holdings

Figures for the London Clearing Banks are averages of monthly totals. Other figures are annual averages of all available figures.