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Paper: Financial Management

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Chapter-12
Dividend Decisions

Once a company has been formed and continues in operation, it should have earnings to retain or to distribute to the owners. This disposition of these earnings is a fundamental problem of financial management. In organisations, which are closely held, the problem is not there because the shareholders run the organisation themselves and can dictate the terms. In large organisations, however, the situation is different. Here the policy concerning the distribution of earnings is normally delegated to the directors of the company by the shareholders. However, they retain the final approval authority and the dividend is paid only after final approval of the shareholders in the Annual General Meeting. Once it is approved in the AGM, the dividend cheque is sent to the shareholders within a month and is normally payable in the city of residence of the shareholder so as to expedite the payment to him.

The management of an enterprise has an important financial decision to decide about the disposition of income left after meeting all business expenses. Generally, of the total business profits, a portion is retained for reinvestment in the business and rest is distributed to shareholders as dividend.

Organisations finance a large portion of their needs internally, that is, from retained earnings and from non-cash charges, such as depreciation, to the extent that they are covered by earnings. To the extent that the organisations are dependent on internal funds to meet their capital and other requirements, there could be a concern that the funds retained may not be used as productively as they might be elsewhere. In a small concern (especially proprietership/ partnership) the owners are very likely to compare the return to be gained from retained earnings in the business and the return that they might make from some other investment of equivalent risk. Because they do not participate directly in formulating dividend policy, shareholders in large companies do not have the chance to make this direct comparison. Thus earnings that are retained in many companies have not met a "market test" and therefore we may not be sure that they should have been retained.

The objective of the dividend policies should be to divert funds from the less productive operations to more productive ones. But it is very difficult for the directors and the management to accept the fate of a declining company and to allow the gradual liquidation of their company, as would be suggested by economic thought. If the management

finds itself in a declining industry, they want to retain more funds for the business operations and pay out less so as to conserve the funds. Something that is not beneficial for the shareholders. They also try to retain more to fund other more profitable investments so the continuity of the corporation can be maintained.

The important issue is to decide the portion of profit to declare for dividend pay out and for retaining in business. The dividend policy decision involves two questions:

- What fraction of earnings should be paid out, on average, over time? and
- Should the firm maintain a steady, stable dividend growth rate?

Before we try and answer these questions, let us look at the theories related to dividend decisions. After that we will look at the empirical evidence of the same.

Theories of Dividends

Traditional Position: MM Model

Dividend Irrelevance: Miller and Modigliani

Miller and Modigliani developed the dividend irrelevance theory, which holds that a firm's dividend policy has no effect either on the value of the firm or on its cost of capital (Do you remember the capital structure theories?). MM used the same five assumptions as they used in the debt policy:

1. There are no personal or corporate income taxes.
2. There are no share floatation or transaction costs.
3. Investors are indifferent between a rupee of dividends and a rupee of capital gains.
4. The firm's capital investment policy is independent of its dividend policy.
5. Investors and managers have the same set of information (symmetric information) regarding future investment opportunities.

The above assumptions that give us MM1 actually yield a far more powerful result than just the irrelevancy of debt policy. They imply that the entire financial policy followed by the organisation is irrelevant for its valuation; all that matters is the organisation's portfolio of investment projects. Hence, capital structure, dividend policy and risk management activities (among other things) are all ineffectual in altering organisation's value.

Consider a firm that has fixed its investment policy. In each period, it is left with a net cash flow, which is simply the difference between operating income and investment costs. A straightforward corporate dividend policy would just be to pay out this net

cash flow to the holders of the equity. However, consider a firm that desires to pay a dividend in excess its cash flow. In order to do this, the firm can raise funds by issuing new equity. Alternatively, the firm could borrow money, which assuming perfect capital markets is a transaction with the NPV of zero. Conversely, a firm wishing to pay a smaller dividend might spend the balance of its net cash flow on repurchasing equity. The key idea here is that a firm can choose whatever pay-out policy it desires, funding the policy through share issues/ repurchases; hence; dividend policy is irrelevant.

In other words, they reasoned that the value of a firm is determined by its basic earning power and its risk class, and, therefore, that a firm's value depends on its asset investment policy rather than on how earnings are split between dividends and retained earnings. MM demonstrated, under the light of above mentioned assumptions, that if a firm pays higher dividends, then it must sell more shares to new investors, and the value of the shares given to the new investors is exactly equal to the dividends paid out.

From the individual investor's point of view we can show that the dividend policy is irrelevant too. To do this we can use a similar argument to that employed when we said that shareholders are indifferent to capital structure changes; shareholders are indifferent to dividend policy as, through appropriate purchases or sales of shares, they can replicate any dividend policy they wish. Hence, investors will not value a firm paying a particular dividend policy different to any other firm such that firm value does not depend on dividends.

The MM assumptions are not realistic, and they obviously do not hold precisely. Firms and investors do pay income taxes, firms do incur floatation costs, and investors do incur transaction costs. Further, managers often have better information than outside investors. Thus, MM's theoretical conclusions on dividend irrelevance may not be valid under real-world conditions.

Radical Models

Bird-in-the-hand Theory: Gordon and Lintner

Gordon and Lintner argue that the cost of equity increases as the dividend payout is reduced, because investors can be more sure of receiving dividends than the capital gains that are expected to result from retained earnings. Therefore, the theory holds that the value of the firm will be maximised by a high dividend payout ratio, because investors regard actual dividends as being less risky than potential capital gains.

This means that this theory is in direct contrast with MM theory of dividend irrelevance.

Tax Preference Theory: Litzenberger and Ramaswamy

If a firm retains its earnings then the share gains in value in the market which results in capital gains for the shareholder. If the company pays out dividend the share value does not increase but the shareholder gains cash. In case of getting dividends the shareholder has effectively paid only 10% tax while in the case of capital gains he would be in the 20% tax bracket. This means that he would prefer to get dividends rather than get capital gains but if the capital gains are disproportionate he would prefer capital gains rather than dividends.

The tax preference theory holds that the value of the firm will be maximised by a low dividend payout, because investors pay lower effective taxes on capital gains than on dividends internationally. In India the situation is different and the shareholder would prefer dividends rather than capital gains.

The above analysis suggests that there is a preference for current dividends - that, in fact, there is a direct relationship between the dividend policy of a firm and market value. The argument goes on the lines that investors are generally risk averse and therefore attach less risk to current as opposed to future dividends or capital gains. In the words of John E. Kirshmann "Of two stocks with identical earnings, records and prospects but the one paying a larger dividend than the other, the former will undoubtedly command a higher price merely because shareholder's prefer present to future values. Myopic vision plays a part in the price-making process. Stockholders often act upon the principle that a bird in hand is work two in the bush and for this reason are willing to pay a premium for the stock with the higher dividend rate, just as they discount the one with the lower dividend rate."

Benjamin Graham and David L. Todd, authors of the well-known security valuation book 'Security Analysis' also say that "The typical investor would most certainly prefer to have his dividend today and let tomorrow take care of itself. No instances are on record in which the withholding of dividends for the sake of future profits has been hailed with such enthusiasm as to advance the price of the stock. The direct opposite has invariably been true. Given two companies in the same general position and with the same earnings power, the one paying the larger dividend will always sell at the higher prices."

These observations are supported by the share valuation models that have been developed using the dividend payouts. Walter's model (which is actually an adaptation of the Gordon's model) are given below.

Walter's Model

Walter's model is one of the earliest dividend models is adapted from the Gordon's model for valuation of an equity share.

Gordon's model gives us the cost of internally generated common equity, ks

$$ks = \frac{\text{dividend in yea r 1}}{\text{market price}} + \begin{pmatrix}\text{annual growth}\\ \text{in dividends}\end{pmatrix}$$

$$ks = \frac{D_1}{P_o} + g$$

which can also be written as:

$$P_0 = \frac{D_1}{K_s - g}$$

Hence the dividend growth rate can be subtracted from the cost of equity capital to get the present value of the share price which should be the market price according to the formula.

Walter adjusted the above formula to reflect the earnings retention and rewrote the equation as:

$$P_0 = \frac{D_1}{K_s - rb}$$

Here, b is the percentage of earnings retained, and r is the expected rate of profitability from the retained earnings.

It follows from the formula that if the earnings retained gives you a higher return than the cost of capital, you would get a positive return and the share price would go up and otherwise the share price would come down because of the higher earnings retained.

Walter's formula highlights the return on retained earnings relative to the average market rate of return on investment (market capitalisation rate) as the critical determinant of dividend policy. A high rate of return on retained earnings indicates a low payout ratio, whereas a low rate relative to the market average indicates the desirability of a high payout ratio to increase the price of the equity shares.

Therefore to increase the share valuation a company may go in for a higher payout in the form of a dividend. But this reduces the growth rate of the dividends (keeping all other things constant) bringing it back to square one.

Also a high dividend policy may force the firm to go to the capital markets more often. In practice, most firms try to follow a policy of paying a steadily increasing dividend. This policy provides investors with stable, dependable income, and if the signalling theory is correct, it also gives investors information about management's expectations for earnings growth.

Most firms use the residual dividend model to set a long run target payout ratio which permits the firm to satisfy its equity requirements with retained earnings.

Factors Affecting Dividend Policies

Fund Requirements: Generally, the firms that have substantial investment opportunities and consequently considerable funding needs to keep their payout ratio rather low to conserve resources for growth. On the other hand, firms which have rather limited investment avenues usually pursue a more generous payout policy.

Bond indentures: Debt contracts often restrict dividend payments to earnings generated after the loan was granted. Also, debt contracts frequently stipulate that no dividends can be paid unless the current ratio, the interest coverage ratio, and other safety ratios exceed stated minimum values.

Preference share restrictions: Typically, equity dividends cannot be paid if the company has omitted (not paid) dividend on its preference shares. The preference dividends arrears must be paid before equity dividends can be resumed.

Availability of cash: Cash dividends can only be paid with cash. Thus, a shortage of cash in the bank can restrict dividend payments. However, unused borrowing capacity can offset this factor.

Control: If the management is concerned about maintaining control, it may be reluctant to sell new shares, hence it may retain more earnings than it otherwise would. This factor is especially important for small, closely held firms.

Differences in the cost of External equity and Retained Earnings: Cost of external equity is obviously more than the cost of retained earnings due to the floatation costs of raising the former. Therefore, if the company has some expansion plans which involves capital expenditure it is very likely that it would prefer a low dividend payout ratio.

Signalling: As we have noted earlier, managers can and do use dividends to signal the firm's situation. For example, if management thinks that investors do not fully understand how well the firm is doing, and how good its prospects are, it may increase the dividend by more than that was anticipated in an effort to boost the stock price.

Shareholder Preference: When equity shareholders have greater interest in current dividend vis-a-vis capital gains, the firm may be inclined to follow a liberal dividend payout policy. While the preference of equity shareholders has some influence over the dividend policy of the firm, the dividend policy may have a greater impact on the kind of shareholders who are attracted towards it. Each firm is likely to draw itself a "clientele" which finds its payout policy attractive.

As mentioned above certain formal and casual empirical observations point in the opposite direction. Perhaps the most famous set of results on actual dividend policy was compiled and presented by John Lintner. Lintner interviewed the management of a sample of US corporations in order to determine what lay behind their dividend-setting decisions. His research led to the four following stylised facts:

- Managers seem to have a target dividend pay-out level.
- This pay-out level is determined as a proportion of long run (i.e. sutainable) earnings of the firm.
- Managers are more concerned with changes in dividends rather than the actual level of dividends.
- Managers prefer not to make dividend changes that might need to be reversed (e.g. cutting dividends after having raised them in the previous period).

As the second fact implies, it is not current but long-run earnings that matter in setting dividends such that dividends can be seen to be smoothed relative to earnings.

There are three basic types of dividend policies that are used by the companies. They are

1. Stable dividends
2. Target Payout Ratio and
3. Regular and extra dividends

1. **Stable dividends:** A company following this type of a policy maintains a constant dividend rate irrespective of the actual earnings level and the company tries to maintain it even when during the recession the earnings go down below the actual dividends pay, trying to signal to the investor that this is a temporary phase and earnings will be back up when the economy revives.

   Companies expect that the investors will place a premium on the shares of a company which pays stable dividends and only increases its dividend payment when it believes that increase can be maintained. A stable dividend policy

irrespective of fluctuating earnings also is beneficial because many institutions take decisions based on the actual payout by the companies. Signalling effect of this type has already been mentioned above.

This is the most favoured type of dividend policies adopted by the companies the world over.

2. **Target Payout Ratio:** Although there is a reason to believe that stable dividends have a positive effect on a company's share price, many firms set a bench-mark target payout ratio (or range). They only deviate from this target to achieve relatively stable dividends or stable and occasionaly increasing ones. Lintner contents that companies seek to maintain a target dividend payout ratio over the long run, but only with a lag. For example, a company may decide that it will pay around 40 per cent of its earnings as dividends and only increase it when this ratio falls to 30 per cent of the earnings that the company is reasonably sure of. This is especially applicable in case of companies with stable earnings and earnings growth for only they can sustain a target payout ratio in the long run.

3. **Regular and extra dividends:** Especially when a company earns above average earnings because of any reason but which is non-recurring in nature, it proposes a extra dividend over and above the regular dividend it pays. This extra earnings could be due to divestment of a plant or business operations and the company has no possible utilisation of the same. In line with the recommendations that investors like to receive the money back from the company rather than the company utilising that money in non-business activities, the companies usually return the money back to the shareholders. This labelling of extra dividends or one-time dividends is given to help the investors appreciate the fact that extra dividends are non-recurring in nature and this is the only year this is being paid.

There are other ways of returning cash to shareholders and one of the biggest ones is gaining ground in India recently. This is share buyback.

Stock Dividends and Stock Splits

An integral part of dividend policy of a firm is the use of bonus shares and stock splits. Both involve issuing new shares on a pro rata basis to the current shareholders while the firm's assets, its earnings, the risk being assumed and the investors percentage ownership in the company remain unchanged. The only definite result from either a bonus share or share split is the increase in the number of shares outstanding. Table illustrates their effect on the capitalization of the firm. Part one of the table shows the equity of the balance sheet before the bonus issue and part two after the issue. The effect of share splits is shown in part three.

1.	Equity portion before the bonus issue:	
	Equity share capital (30,000 shares of Rs.100 each)	Rs. 30,00,000
	Share premium (@ Rs.25 per share)	7,50,000
	Retained earnings	62,50,000
	Total equity	**1,00,00,000**
2.	Equity portion after the bonus issue (1 : 2 ratio):	
	Equity share capital (45,000 shares of Rs.100 each)	45,00,000
	Share premium (45,000 shares X Rs.25)	11,25,000
	Retained earnings (Rs.62,50,000 – 15,000 shares × Rs.125)	43,75,000
	Total equity	**1,00,00,000**
3.	Equity portion before the share splits (10 : 1 ratio):	
	Equity share capital (3,00,000 shares of Rs.10 each)	30,00,000
	Share premium	7,50,000
	Retained earnings	62,50,000
	Total equity	**1,00,00,000**

TABLE Effect of Bonus Shares and Shares Splits

From Table it is clear that a share split is similar to bonus issue from the economic point of view though there are some difference from the accounting point of view. In the equity portion of the firm, a bonus issue reduces the retained earnings and correspondingly increases paid-up equity and share premium, if any, whereas stock/share split has no such effect. The economic effect of both is to increase the number of equity shares outstanding.

As pointed out earlier, no major economic benefit results from bonus shares and share splits. Yes, certain advantages are associated with them. In the first place, the issue of bonus shares / share splits would have the effect of bringing the market price of shares within more popular range as a result of larger number of shares outstanding. The larger number of outstanding shares will also promote more active trading in the shares due to availability of floating stock. Yet another advantage might relate to the informational content of bonus/split announcement. The announcement is perceived as favourable news by the investors in that with growing earnings, the company has bright prospects and the investors can reasonably look for increase in future dividends. Moreover, it enables the conservation of corporate cash. If the bonus share is an effort to conserve cash for profitable investment opportunities, the share prices will tend to rise and the shareholders benefit. However, if the move to conserve cash relates to financial difficulties within the firm, the market price will most likely react adversely. Finally, bonus / split announcements improve the prospect of raising additional funds particularly through the issue of convertible debentures.

Repurchase of Stock

As an alternative to paying cash dividends, a company may distribute income to its

shareholders by repurchasing its own shares. Assuming that the repurchase does not adversely affect the firm's earnings, the earnings per share on the remaining shares will increase, resulting in a higher market price per share, which means that the capital gains will have been substituted for dividends.

A repurchase that is part of capital restructuring is different from a regular repurchase mentioned above. In a capital restructuring repurchase plan asset sales and issuance of debt are used to bring in additional capital and then this capital is distributed to shareholders through a major, one-time share repurchase.

Disadvantages/ Advantages of Share Repurchases

1. Repurchase announcements are viewed as positive signals by investors because the repurchase is often motivated by management's belief that the firm's shares are undervalued.
2. The shareholders have a choice to sell or not to sell in share repurchase situation. So those who prefer capital appreciation can get the same and those who prefer cash can sell the shares.
3. Repurchase can help reduce the supply of shares in the market, thereby increasing the value of the share.
4. Management dislikes increasing cash dividend as it sends positive signals about future profitability and if the company cannot maintain the same in the future it may result in a sharp fall in the share price. Therefore, if the earnings increase is only temporary then the management may prefer to make the distribution in the form of a share repurchase.
5. It can help in drastically changing the capital structure of the company, which is otherwise very difficult.

There are certain disadvantages too:

1. The shareholder may benefit more from cash dividends than share repurchase if the market discounts the earnings more than a given level.
2. The selling shareholder may lose because of the share repurchase plan as he would get the long term benefit of share repurchase.
3. The company may pay too high a price for share repurchase, resulting in a reduction in value for existing shareholders.

All this means that share repurchases on a systematic, dependable basis is probably not a good idea. However, it can be given careful consideration if the market is not discounting the share in a proper manner and the company has extra cash that it can utilise for the same. Repurchases can be especially valuable to a firm that wants to make a large shift in its capital structure within a short period of time.

Procedural and Legal Aspects of Dividends

The amount of dividend that can be legally distributed is governed by company law, judicial pronouncements in leading cases, and contractual restrictions. The important provisions of company law pertaining to dividends are described below.

1. Companies can pay only cash dividends (with the exception of bonus shares). Apart from cash, dividend may also be remitted by cheque or by warrant. The same may also be transmitted electronically to shareholders after obtaining their consent in this regard to the bank account number specified by them. The step has been proposed by the Department of Company Affairs to avoid delay in the remittance of dividend.

2. Dividends can be paid only out of the profits earned during the financial year after providing for depreciation and after transferring to reserves such percentage of profits as prescribed by law. The Companies (Transfer to Reserve) Rules, 1975, provide that before dividend declaration, a percentage of profit as specified below should be transferred to the reserves of the company.

   a. Where the dividend proposed is up to 10 per cent of the paid up capital, no amount of the current profits need to be transferred.

   b. Where the dividend proposed exceeds 10 per cent but not 12.5 per cent of the paid-up capital, the amount to be transferred to the reserves should not be less than 2.5 per cent of the current profits.

   c. Where the dividend proposed exceeds 12.5 per cent but not 15 per cent, the amount to be transferred to reserves should not be less than 5 per cent of the current profits.

   d. Where the dividend proposed exceeds 15 per cent but not 20 per cent, the amount to be transferred to reserves should not be less than 7.5 per cent of the current profits.

   e. Where the dividend proposed exceeds 20 per cent, the amount to be transferred to reserve should not be less 10 per cent.

   f. A company may voluntarily transfer a percentage higher than 10 per cent of the current profits to reserves in any financial year provided the following conditions are satisfied:

      (i) It ensures that the dividend declared in that financial year is sufficient to maintain average rate of dividend declared by it over three years immediately preceding the financial year.

      (ii) In case, it has issued bonus shares in the year in which dividend is declared or in the three years immediately preceding the financial year, it maintains the amount of dividend equal to the average amount of

dividend declared over the three years immediately preceding the financial year.

However, maintenance of such minimum rate or quantum of dividend is not necessary if the net profits after tax in a financial years are lower by 20 per cent or more than the average profits after tax of the two immediately preceding financial years.

g. A newly incorporated company is prohibited from transferring more than then percent of its profits to reserves. The 'current profit' for the purpose of transfer to reserves will be profits after providing for statutory transfer to the Development Rebate Reserve and arrears of depreciation if any.

3. Due to inadequacy or absence of profits in any year, dividend may be paid out of the accumulated profits of previous years. In this context, the following conditions, as stipulated by the companies (Declaration of Dividend out of Reserves) Rules, 1975, have to be satisfied.

   a. The rate of the declared dividend should not exceed the average of the rates at which dividend was declare by the company in 5 years immediately preceding that year or 10 per cent of its paid-up capital, whichever is less.

   b. The total amount to be drawn from the accumulated profits earned in previous years and transferred to the reserves should not exceed an amount equal to one-tenth of the sum of its paid-up capital and free reserves and the amount so drawn should first be utilized to set off the losses incurred in the financial year before any dividend in respect of preference or equity shares is declared.

   c. The balance of reserves after such drawal should not fall below 10 per cent of its paid-up capital.

4. Dividends cannot be declared for past years for which accounts have been adopted by the shareholders in the annual general meeting.

5. Dividend declared, interim or final, should be deposited in separate bank account within 5 days from the date of declaration and dividend will be paid within 30 days from such a date.

6. Dividend including interim dividend once declared becomes a debt. While the payment of interim dividend cannot be revoked, the payment of final dividend can be revoked with the consent of the shareholders.

Procedural Aspects

The important events and dates in the dividend payment procedure are:

1. **Board Resolution:** The dividend decision is the prerogative of the board of

directors. Hence, the board of directors should in a formal meeting resolve to pay the dividend.

2. **Shareholder Approval:** The resolution of the board of directors to pay the dividend has to be approved by the shareholders in the annual general meeting. However, their approval is not required in the case of declaration of interim dividend. Further, it should be noted that the shareholders in the annual general meeting have neither the power to declare the dividends (if the Board of Directors do not recommend it) nor to increase the amount or dividend. However, they can reduce the amount of the proposed dividend.

3. **Record Date:** The dividend is payable to shareholders whose names appear in the register of members as on the record date.

4. **Dividend Payment:** Once a dividend declaration has been made, dividend warrant must be posted within 30 days. Within a period of 7 days, after the expiry of 30 days, unpaid dividends must be transferred to a special account opened with a scheduled bank.

   In case the company fails to transfer the unpaid dividend to the 'unpaid dividend account' within 37 days of the declaration of dividend, an interest of 12 per cent per annum on the unpaid amount is to be paid by the company. The interest so accruing is to be paid to the shareholders in the proportion of the dividend amount remaining unpaid to them.

   The dividend will be paid to the registered shareholder or to his order or to his banker or in case a share warrant has been issued to the bearer of such a share warrant. In the case of joint-holders, the dividends should be paid to the first joint-holder.

   Further, as per the notification issued by the Department of Company Affairs, the payment of dividend to the shareholders involving the fraction of 50 paise and above be rounded off to the rupee and the fraction of less than 50 paise may be ignored.

   In the case of dematerialized shares (i.e., the shares held in electronic form), the corporate firms are required to collect the list of members holdings shares in the depository and pay them the dividend.

5. **Unpaid dividend:** If the money transferred to the 'unpaid dividend account' in the scheduled bank remains unpaid / unclaimed for a period of 7 years from the date of such transfer, the company is required to transfer the same to the 'Investor, Education and Protection Fund' established for the purpose.

Dividend Policies in Practice

To learn about the dividend policies of business firms, the author asked the chief finance executives of 20 large-sized business undertakings, representing a wide cross-section of industries, the following question: What is your dividend policy? The responses obtained are reproduced below (the lengthier ones have been paraphrased).

Nature of Industry	Response
Electrical	"We try to maintain a ten per cent dividend rate. That is what the government expects from us."
Chemicals	"Dividend policy is concerned primarily with the welfare of shareholders. When earnings position permits we declare good dividends. Otherwise, we don't. We don't think of accumulating surplus and declaring bonus shares."
Tea	"In the last ten years the parent company has not been insisting on any dividend rate. Whatever has been paid out is accepted. Our payout has been 30 to 50 per cent."
Fertiliser	"Though we are a joint sector project, our dividend policy is governed by commercial considerations. Of course, we are a bit conservative."
Toothpaste	"We believe in rewarding shareholders generously - both in dividends and bonus shares. Our payout has been very high.
Aluminium	'We pay dividend whenever we can afford it. When performance or liquidity unsatisfactory we skip dividend to preserve strength our financial strength."
Chemical	"Our dividend policy is to pay a fixed rate of dividend and issue bonus shares when we are eligible to. The purpose is to ensure that shareholders retain shares to enjoy capital gains."
Automobile	"We like to maintain a dividend rate of 15 per cent. This seems to be a fair return to investors."
Shipping	"In the past when the going was good, we paid good dividends and issued bonus shares periodically. The last few years were rough. We had to suspend dividend for some time. We are now recovering. We will try to follow the past policies, provided business conditions are good."
Leasing	"We would like to declare as high a dividend as we can. If share prices rise due to that, we can raise relatively easily more funds by issuing convertible debentures."

Diversified	"We regard shareholders as partners. They deserve handsome returns. We give good dividends and periodic bonus issues."
Diversfied	"We have a very conservative dividend policy. Our dividend rate which used to be 10 per cent four years ago has now been raised to 15 per cent. We won't probably consider a change for the next few years.
Truck	"The company follows a conservative dividend policy which aims at protecting the interests of the shareholders and the company by (a) providing a consistent and reasonable return to the (b) shareholders, and (c) ploughing back profits to take care of contingencies and to improve the equity base.
Pharmaceuticals	"We distribute about 30 per cent of our earnings. We maintain our dividend around 18 per cent. When the reserves position permits and the earnings potential justifies, we issue bonus shares."
Diversified	"We don't have a specific dividend policy. When the profits are good and liquidity satisfactory we give 12 per cent to 15 per cent as dividends.
Textiles	"Due to drop in profits we have skipped dividends. We will try to restore it-when I don't know."
Storage	"We have been paying steadily about 20 per cent as dividends." "Of course, our bonus record is poor. In the foreseeable future there may be very little change."
Diversified	"The investor is the king. Unless he is rewarded, we can't get the funds for our growth. So, we try to benefit him by dividends, bonus issues, and rights issue."
Consumer Electronics	"We paid good dividends a profits were high. We will try to maintain the same. Of course, profitability will be the key factor."
Diversified	"We have, if you permit me to say, an obsession with 20 per cent dividend rate. We don't want to raise it to 25 or 30 per cent as this connotes super profits--but we would like to declare bonus shares. Our planning revolves around this compelling goal-dominant

Some Types

On the basis of the above responses we find that most of the firms pursue three types of policies:

Generous Dividend and Bonus Policy Firms which follow this policy reward shareholders generously by stepping up total dividend payment over time. Typically, these firms maintain the dividend rate at a certain level (15 to 25 per cent) and issue bonus shares when the reserves position and earnings potential permit. Such firms naturally have a strong share holder orientation.

More or Less Fixed Dividend Policy Some firms have a target dividend rate which is usually in the range 10 per cent to 20 per cent which they consider as a reasonable compensation to equity shareholders. Such firms normally do not issue bonus shares frequently, may be once in few years, the dividend rate may be raised slightly to provide somewhat higher compensation to equity shareholders to match the higher returns from other forms of investment.

Erratic Dividend Policy Firms which follow this dividend policy seem to be indifferent to the welfare of equity shareholders. Dividends are paid erratically whenever the management believes that it will not strain its resources.

Tax Aspects

With effect from financial year 2003-4, dividend income from domestic companies and mutual funds is exempt from tax in the hands of the shareholders / investors / unit-holders. However, the domestic companies will be liable to pay dividend distribution tax at the rate of 12.5 per cent (plus surcharge) on dividends paid after April 1, 2003.

Chapter-13
Working Capital Financing

Accruals, trade credit, commercial Banks advances, public deposits, Inter Corporate Deposits, Short Term Loans from Financial Institutions, Debentures for working capital, Commercial Paper, Factoring, Regulation of Bank Finance – Recommendation of Latest Committee.

This chapter discusses sources of financing. By convention all sources of financing that must be repaid within one year are considered to be short–term, those that must be repaid in one to five years are intermediate term, and all sources with maturities longer than five years are classified long–term.

Two major issues are involved in managing the firm's use of short-term financing:

(1) How much short-term financing should the firm use? and (2) What specific sources of short-term financing should be selected? The earlier chapter used the bedging principle of working–capital management to answer the first of these two questions. Basically, that involved an attempt to match temporary needs for funds with short-term sources of financing and permanent needs with long–term sources.[1] The objective of this chapter will be to answer the second of the above questions:

How should the financial manager select a source of short-term credit?

In general, three basic factors should be considered in selecting a source of short-term credit: (1) the effective cost of credit, (2) the availability of credit in the amount needed and for the period of time when financing is required, and (3) the influence of the use of a particular credit source on the cost and availability of other sources. We discuss the problem of estimating the cost of short-term credit before.

Introducing the various sources of credit, as the procedure used is the same for all. The second and third factors listed above are each discussed as they pertain to the individual sources of short-term credit.

Estimating the Cost of Short-Term Credit

[1] Temporary needs for funds arise in response to a temporary need for current assets. These include current assets that the firm does not plan to hold throughout the indefinite future. Permanent needs for funds arise in conjunction with a permanent need for certain assets. These assets consist of fixed assets plus the firm's minimum level of investment in current assets. Thus, when discussing working-capital management we abandoned the current-fixed assets classification in favour of the more useful concept of temporary and permanent assets.

Approximate Cost-of-Credit Formula

The procedure used in estimating the cost of short-term credit is a very simple one and relies on the basic interest equation.

(8-1) Interest = principle × rate × time

Where interest is the amount of interest on a principal that is borrowed at some annual rate for a fraction of a year (represented by time). For example, a six-month loan for Rs 1000 at 8 per cent interest would require interest payments of Rs 40:

Interest = Rs 1000 × .08 × 1/2 = Rs 40.

The problem faced in assessing the cost of a source of short-term financing, generally involves estimating the annual effective rate (RATE) where the interest amount, the principal sum, and the time for which financing will be needed are known.

Thus, solving the basic interest equation for RATE produces

(8-2) $$\text{Rate} = \frac{\text{Interest}}{\text{Principal} \times \text{Time}}$$

or $$\text{Rate} = \frac{\text{Interest}}{\text{Principal}} \times \frac{1}{\text{Time}}$$

Example: The SKC Corporation plans to borrow Rs 1000 for a 90-day period. At maturity the firm will repay the Rs 1000 principal amount plus Rs 30 interest. The effective annual rate of interest for the loan can be estimated using the RATE equation as follows:

$$\text{Rate} = \frac{\text{Rs } 30}{\text{Rs } 1000} \times \frac{1}{90/360}$$

$$= .03 \times \frac{360}{90} = .12, \text{ or } 12 \text{ per cent}$$

The effective annual cost of funds provided by the loan is therefore 12 per cent.

The Annual Percentage Rate Formula

Compound interest was not considered in the simple RATE calculation. To consider

the influence of compounding we can use the following equation:

(3-3) APR = (1 + r/m)m – 1

Where APR is the annual percentage rate, r is the nominal rate of interest per year (12 per cent in the above example) and m is the number of compounding periods within a year (m = 1/TIME = 1/(90/360) = 4 in the example above. Thus, the effective rate of interest on the example problem, considering compounding, is

APR = (1 + .12 / 4) 4 – 1= .126, or 12.6 per cent

The effect of compounding is to raise the effective cost of short-term credit. Since the differences between the two methods for periods less than one year are usually small, the simple interest version of RATE discussed above will be used.

Sources of Short-Term Credit

Short-term credit sources can be classified into two basic groups: unsecured and secured. Unsecured loans include all those sources that have as their security only the lender's faith in the ability of the borrower to repay the funds when due. There are three major sources of unsecured short-term credit: trade credit, unsecured bank loans, and commercial paper. Secured loans involve the pledge of specific assets as collateral in the event the borrower defaults in payment of principal or interest. The principal suppliers of secured credit include commercial banks, finance companies, and factors. The primary sources of collateral include accounts receivable and inventories.

Accruals

Internal accruals is one of the major sources of funds for most companies and is derived from the retained earnings. Profits left after paying dividends are primarily used for working capital financing.

Trade credit

In any normal business practice, buyers are not generally required to pay cash on delivery for the goods and services they order. Instead, the sellers "invoice", or bill the buyers on delivery according to the terms of the particular 'trade' or line of business. That is, sellers extend credit to buyers, and this extension of credit provides a temporary source of funds to the buyer in the form of accounts payable. Because suppliers are generally more liberal in extending credit than banks are, trade credit has become the most important source of short-term business funds in terms of total volume of credit supplied.

Forms of Trade Credit

There are three avenues of trade credit extension: (1) the open account, which is by far the most common; (2) the promissory note; (3) the trade acceptance.

Open-account credit is ordinarily extended only after the seller conducts a fairly extensible investigation of the buyer's credit standing and reputation. The open account derives its name from the fact that the buyer does not sign a formal debt instrument evidencing the amount he owes the seller, as would be the case if he applied for and obtained bank credit. The only evidence the seller has that credit has been extended is the buyer's purchase order, a copy of the invoice showing that merchandise was shipped,

and an entry in his accounts receivable ledger. It is indicative of the extent to which a "credit economy" has developed in this country that, when most trade credit is arranged, this is all that is done and all that is required to be done to establish legal evidence of indebtedness.

In some situations, however, a promissory note may be used in the transaction. A promissory note is written promise by one person to another to pay on demand or at a fixed or determinable future time a certain sum of money to order of bearer. The promissory note is generally an interest-bearing instrument. Buyers are required to sign such notes most often in cases where their open accounts have become delinquent and the seller wishes to obtain a formal acknowledgement of the debt, a definite maturity date, and, at times, a return in the form of interest on the funds thus committed. Promissory notes appear on the seller's balance sheet as "notes receivable" of course.

In some lines of business, trade acceptances are used in place of the open account. A trade acceptance is generated when a seller, after receiving a purchase order from a customer, draws a time draft on that customer in the amount of the order. A time draft is an unconditional order to pay a certain sum of money at a fixed or determinable future time. The seller then sends the draft through his own bank, together with an order bill of lading from the carrier by which the goods are shipped, for presentation to and acceptance by the customer. An order bill of lading must be presented to the carrier to secure the release of the goods shipped at their destination. The seller's bank forwards the draft and bill of lading to its correspondent bank in the city in which the customer is located; and this bank presents the draft to him for acceptance. The customer accepts the draft simply by signing, dating, and writing the word "accepted" across the face of the draft.

After accepting the draft, the customer receives the order bill of lading from the bank and is able to secure his shipment of goods from the issuing carrier. The accepted draft, now a trade acceptance, is then returned to the seller's bank and then to the seller, he may either hold it to maturity or ask his bank to discount it for him, since as a trade acceptance it is a full fledged negotiable instrument. In either event, it will be presented to the buyer for payment on its due date.

Terms of Trade Credit

Promissory notes and trade acceptances are both used rather sparingly in commercial transactions; therefore, the more relevant terms of trade credit are those pertaining to open accounts. Three aspects of this form of credit warrant discussion:

(1) the size of the cash discount, if any, from the net invoice price which is given for making cash payment within a specified period;

(2) the period within which payment must be made if the cash discount is to be allowed; and

(3) the maximum period that can elapse before payment of the net invoice price is required if the cash discounts is not taken.

It is important to distinguish a cash discount — from both a quantity discount and a functional discount. A quantity discount generally expressed as a percentage reduction form a list price-is given for purchasing certain minimum amounts of a particular item. Functional discounts are differential discounts given to different types of customers — a wholesaler, for example, may be given a larger discount than a retailer.

Terms of trade credit, which vary from industry to industry, are specified on each invoice and may be categorised according to both the net period within which payment is expected and the terms of the cash discounts allowed. In general, cash discounts could be set as high as 10 % but the average is closer to 2 to 6 percent; the discount periods are usually fairly short, in most cases 10 or 20 days.

CBD And COD

"Cash before delivery (CBD)" and "Cash on delivery (COD)" are two common forms of payment. Under CBD, as buyer must pay for the goods before the supplier will ship them, when a supplier imposes these terms, he either knows nothing at all about the buyer's creditworthiness or, more frequently, he knows "too much" about the customer's unreliability in managing his business affairs. In the latter circumstances, to eliminate the risk of non-payment completely, he may even wait for the customer's check to clear even before shipping the order. Under COD, supplier will ship the goods ordered, but the buyer must pay for them before taking possession. The only risk involved with COD is that the customer may refuse the shipment and the seller will have to pay shipping costs both ways. Transactions completed under either CBD or COD terms are considered cash transactions since suppliers are required to extend no credit at all.

Net-terms, no cash discount

When net terms are quoted, the supplier specifies the period permitted for payment in full payment. For example, "net 30" means that the amount of net invoice must be paid in full within 30 days. If the seller bills on a monthly basis, he may stipulate such terms as "net 15 EOM," meaning that all goods shipped before the end of the month must be paid for in full by the fifteenth of the following month. Sometimes, "bill-to bill" terms are specified, that is, the bill for a previous delivery is collected at the time a new delivery is made.

Cash discount terms

In addition to extending credit on net terms, suppliers may offer a cash discount for payment more prompt than the net terms require. The terms' "2/10, net 30," for example, indicate that the buyer is offered a 2 per cent discount for payment within 10 days of the date of the invoice. If this discount is not taken, the full amount is due within 30 days. When the buyer is far removed from the seller, or the method of shipping the goods is slow, terms may be "2/10, net 30 AOG". That arrangement affords the buyer the opportunity of inspecting the goods before paying for them. More important, it provides all buyers with an equal opportunity to earn the cash discount, regardless of the transit time required for the goods to reach them.

Rationale for trade credit terms

The variation in trade credit terms described above have a rationale. First; the period of time for which credit is granted is related to the nature of the commodity sold. High-style items or perishable merchandise are generally sold on fairly short credit terms because of the high turnover of the items.

Second, the estimated degree of credit risk is generally reflected in the terms of sale. Retail shops in the apparel trades are characterised by a rather high rate of failure and if not failure a exceptionally long credit period (six months on an average), for example. This may explain the rather large cash discounts usually allowed to such retailers - the size of the discount reflecting supplier's desires to be paid as quickly as possible.

Third, the nature and extent of competition among suppliers is expressed in credit terms as well as in prices and service. When a product is new, or if a supplier is soliciting business from a new account, granting more liberal credit terms than are customary may be one way of generating additional sales.

Fourth, a supplier short of working capital may offer rather large cash discounts to his customers to induce them to settle their accounts quickly. In this way, the supplier reduces his collection period and thus reduces his total working capital requirements. A thinly capitalised supplier may find that the cost of offering large cash discounts is less than the cost of borrowing or raising additional equity capital to meet his working capital needs.

Finally, the financial strength of the supplier relative to that of his customers is also a determinant of credit terms. Although it might appear that a financially strong supplier could dictate stringent terms, by doing so he may succeed only in losing some customers and possibly even putting others out of business.

In reality, in many lines of business, smaller companies are "carried" by their suppliers.

Trade credit as a source of funds

Since buyers generally do not pay for goods until some time after they are delivered, trade credit is a short-term source of business funds. If a firm "automatically" pays all its bills a certain number of days after the invoice date becomes a built-in source of financing that varies with the production cycle. As the firm increases its level of production, and thus its purchases, accounts payable increase commensurately providing some of the funds needed to finance the increase in production. Similarly, as production decreases, purchases, and thus account payable, decrease.

Although change in the size of a firm's account payable may not be able to move with inventory adjustments, there will ordinarily be a strong degree of correspondence between the two. If a firm adheres strictly to the practice of always paying its bills a certain number of days after invoice date, trade credit cannot be considered a discretionary source of financing.

Instead, it becomes determinate insofar as it is dependent on the purchasing plan of the firm which, as we discussed earlier, is dictated largely by its production cycle. Although prompt payment of such obligations is generally to be commended, certain advantages may be gained from using trade credit as a discretionary source of short-term financing.

When the company gets the trade credit, it would like to pay back as late as possible, because these are the funds that require no interest payments and are free of cost. Right. Wrong, these funds are not free of cost because the sale price of these already includes the cost of the time for which the credit is given.

Cost of Trade Credit

For purposes of measuring the true cost, or the effective annual rate of interest associated with use of trade credit as a discretionary source of short-term business funds, it is necessary to consider the effects of its use both when :

(1) a company fails to take its cash discounts but nevertheless pays within the net period, and

(2) a company fails to take its discounts and allows its payable to become overdue.

These two situations are the only ones that involve an actual cost to the debtor. If no cash discount is offered, then there is no cost for the use of credit during the "net" period, however long it may be. By the same token, if a discount is available and the buyer takes it, there is also no cost for the use of credit during the discount period. However, if a cash discount is offered and is not taken, there is an explicit opportunity cost for the use of third credit.

For example, the Road Company purchases it raw materials on terms of 2/10 net 30. It thus has the option of using the funds for 20 days after the discount period if it "passes" the discount but pays on the final day of the net period. Road Co., however, must pay 2 % of the privilege of using the funds for 20 days. It is given by the equation:

$$R = \frac{C(365\ D)}{D\ (100-C)}$$

where

C = the cash discount

D = the number of extra days Road has the use of the supplier's funds

R = the annual interest rate for the use of these funds

In our example, C = 2 percent, D = 20: the effective annual interest rate for the company would be

$$R = \frac{2\ (365)}{20\ (100-2)} \quad 37.24 \text{ per cent}$$

Thus, we see that passed discounts can transform trade credit from a normally easy sources of funds into a very expensive form of short-term financing. Therefore, if other financing is available even though with high interest rates, say 20 or 24%, Road's financial administrator would be well advised to borrow in sufficient time so that it can take advantage of any cash discounts offered by its suppliers.

Sometimes companies that are short of cash and lack reserve borrowing power may be forced to not only pass up cash discounts but also postpone payment beyond the net period. This practice is referred to as "stretching" accounts payable or "riding" trade creditors.

There are two types of costs incurred by a company that stretches its accounts payable

(1) the explicit cost of discounts foregone, as outlined above, and

(2) the implicit cost of permitting its trade credit rating to deteriorate.

If a company rides its creditors excessively, so that its trade payable become noticeably delinquent, its credit rating among all suppliers in the trade will surely suffer. They will view the company as increasingly risky to sell to and may quickly begin to impose rather strict terms of sale, upto and including COD or CBD.

Proper Use of Trade Credit

As compared with other kinds of short-term business credit — bank loans, for example- trade credit is almost automatic. And because it may be much more readily acquired,

business companies must exercise continuing care to avoid falling into the habit of using trade credit to excess.

Because suppliers regard the extension of trade credit as a part of their overall sales promotion programs, they often extend trade credit to many marginally creditworthy companies-small, new companies and old, declining companies-that do not qualify for and consequently cannot obtain credit from other sources of short-term funds. It is also quite easy to get into debt through the use of trade credit.

A company needs only to order additional goods from its suppliers; and if it is occasionally late in making payment, the sales promotion aspect of trade credit extension may prompt suppliers to "look the other way," so that the company's credit reputation may suffer no immediate harm.

Finally, trade credit is exceedingly useful and valuable precisely because business companies can usually obtain it when, as, and to the extent that it is needed. When inventory should be increased to anticipate the seasonal expansion of sales, for example trade credit will automatically finance a part of the increase. Then, as the seasonal sales convert into cash through collections, the company may use the funds to reduce trade payable. For this reason, trade credit is often termed a "spontaneous" source of funds.

Thus, a company's financial officer while assuring that his company benefits from the availability of trade credit in every legitimate way, should always maintain the business liquidity required to pay all his company's bills as they come due. Beyond this, even considering the extremely high cost of passing discounts, he should certainly plan to pay all of his company's trade bills within the discount period. Doing so will have favourable results, not only on the company's credit reputation in the trade but, more important, on its current and long-run profitability as well.

In a negative but equally significant sense, doing so will automatically avoid the possible financial over extension of the company that could result from its succumbing to the temptation to use trade credit excessively "because it is there".

Commercial Banks advances

Bank credit is the most basic and the most widely used method of short term finance (apart from trade credit) because of the availability of funds and relatively permanent source of funds as compared to the trade credit. We will discuss the requirements of the banks which they take into consideration before accepting the corporate as a client, then we take a look at RBI Guidelines governing the same including the methods of calculating the amount that the bank is going to finance and lastly we take a look at some of the recent issues concerning bank finance.

A business firm may have diverse credit needs and may require either (1) a revolving credit arrangement, (2) a seasonal line of credit, (3) funding on a transaction basis, or (4) get its bills discounted. Banks will take care that it meets the kind of requirements that the company has and not push their own systems of financing. Banks do participate even in financing some of the money market instruments (like CPs) but the basic funding remains through the working capital loans only.

A line of credit is simply a formal or informal agreement between a commercial bank and a borrowing customer regarding the maximum amount of credit the bank is willing to extend to that customer over a given number of months usually a quarter. These limits are usually rollable from year to year after reassessment of the requirements.

Seasonal business borrowers commonly request seasonal lines of credit. By preparing and analysing cash budget reflecting his firm's operations over some period, the financial administrator estimates the patterns of his seasonal financing needs and arranges a line of credit with the firm's bank, the upper limit of which equals the firm's forecasted peak requirements, as shown in his cash budget.

The seasonal build up of inventories, accounts receivable, or both create needs for funds, the firm simply signs promissory notes for the amounts required at the times they are required, and the bank credits the firm's account in the proper amounts. Subsequently, the post seasonal shrinkage in working capital needs permits the firm to repay the advances with funds generated from the sale of inventories and the collection of accounts receivable. (for example in sugar industry where demand for WC builds up for six months and comes down in the rest six months).

Banks usually access the peak seasonal demand and off-season demand separately and sanction credit on this basis.

Revolving Credit Agreements

Earlier the whole working capital loan was revolving credit in the sense that the company could repay whatever part of the loan it wanted to.

Revolving lines typically were continuous and were negotiated as formal commitments to lend by the bank, and a commitment fee was charged on any portion of the line that lied unused. The main problem was that the bank had to keep aside a huge portion of funds, which, in the case of corporates not utilising them, were not earning any return except the return from the call money markets (which were very low as compared to the returns from the loans).

To rectify this problem the banks divided the working capital loans into two parts, demand loan and cash credit in a ratio of 80:20. Demand loan became the fixed portion of the bank working capital financing and only the cash credit was allowed to be kept fluctuating.

Transaction Basis

When a firm borrows only occasionally, for specific purposes that may differ from time to time, it will generally negotiate each loan with the bank as a separate transaction.

Bill Discounting

Under this a borrower can obtain the bank credit through the bank's purchase of (or discount of) its bills. The amount covered under this agreement is covered within the overall working capital limits. Before purchasing or discounting the bills the bank satisfies itself with the creditworthiness of the drawer. In practice, the banks hold the bills as security against the credit it gives to the company.

Cost of Bank Credit

Interest rates on bank loans to business are determined through negotiation between borrower and lender. The rate charged tends to vary directly with the credit quality, or the credit-worthiness, of the borrower. The largest, soundest companies possessing the highest credit quality are able to borrow at the prime rate, the lowest rate charged on business loans at any point in time.

The prime rate is the one at which the nation's largest banks lend to their biggest and best business-borrowing customers. It is the connecting link between a commercial bank's loan rates and short- term, open-market money rates. The prime rate measures, in effect, the opportunity cost to banks of lending rather than investing in short-term, open market instruments. Since the latter are virtually risk less, it follows that prime-rate borrowers must possess credit qualities of the very highest order to qualify for the lowest bank loan rate.

This rate is usually used for the working capital financing, while for extending short-term credit (especially in commercial paper) this rate is almost never used as the benchmark and banks frequently lend below this rate.

Example: M&M Beverage Company has a Rs 300,000 line of credit which requires a compensating balance equal to 10 per cent of the loan amount. The rate paid on the loan is 12 per cent per annum, Rs 200,000 is borrowed for a six-month period, and the firm does not, at present, have a deposit with the lending bank. The cost of the loan includes the interest expense and, in addition, the opportunity cost of maintaining an idle

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2 Although technically incorrect, the same answer could have been obtained by assuming a total loan of Rs 200,000 of which only 90 per cent of Rs 180,000 was available for use by the firm; that is,

$$\text{RATE} = \frac{\text{Rs}\,12{,}000}{\text{Rs}\,180{,}000} \times \frac{1}{18/360} = 13.33\ \text{per cent}$$

Interest is now calculated on the Rs 200,000 loan amount (Rs 12,000 = Rs 200,000 × .12 × ½).

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cash balance equal to the 10 per cent compensating balance. To accommodate the cost of the compensating balance requirement, assume that the added funds will have to be borrowed and simply left idle in the firm's checking account. Thus, (a) the amount actually borrowed (b) will be larger than the needed Rs 200,000. In fact, the needed Rs 200,000 will comprise 90 per cent of the total borrowed funds due to the 10 per cent compensating balance requirement, hence 90B =Rs 200,000, such that B =Rs 222,222. Thus, interest is paid on a Rs 222,222 loan Rs 222,222 × .12 × ½ = Rs 13,333.32), of which only Rs 200,000 is available for use by the firm.[2] The effective annual cost of credit therefore is

$$\text{RATE} = \frac{\text{Rs } 13{,}333.32}{\text{Rs } 200{,}000} \times \frac{1}{18/360} = 13.33 \text{ per cent}$$

If the firm normally maintains at least Rs 200,000 (or 10 per cent of the needed funds) in a demand deposit with the leading bank, then the cost of the credit is,

$$\text{RATE} = \frac{\text{Rs } 12{,}000}{\text{Rs } 200{,}000} \times \frac{1}{18/360} = 12 \text{ per cent}$$

In the M&M Beverage Company example the loan required the payment of principal Rs 222,222) plus interest Rs 13,333.32) at the end of the six-month loan period. Frequently, bank loans will be made on a discount basis. That is, the loan interest will be deducted from the loan amount before the funds are transferred to the borrower, extending the M&M Beverage company example to consider discounted interest involves reducing the loan proceeds (Rs 200,000) in the previous example by the amount of interest for the full six months (Rs 13,333.32). The effective rate of interest on the loan is now:

$$\text{RATE} = \frac{\text{Rs } 13{,}333.32}{\text{Rs } 200{,}000 - \text{Rs } 13{,}333{,}32} \times \frac{1}{18/360} = .1429, \text{ or } 14.29 \text{ per cent}$$

The effect of discounting interest was to raise the cost of the loan from 13.33 per cent to 14.29 per cent. This results from the fact that the firm pays interest on the same amount of funds as before Rs 222,222); however, this time they get the use of Rs 13,333.32 less, or Rs 200,000 – Rs 13,333.32 = Rs 186,666.68.[3]

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3 If M&M needs the use of a full Rs 200,000, then they will have to borrow more than Rs 222,222 to cover both the compensating balance requirement and the discounted interest. In fact, the firm will have to borrow some amount B such that

$$B - .10\,B - (.12 \times ½)\,B = \text{Rs } 200{,}000$$
$$.84\,B = \text{Rs } 200{,}000$$
$$B = \frac{\text{Rs } 200{,}000}{.84} = \text{Rs } 238{,}095$$

The cost of credit remains the same at 14.29 per cent, as we see below:

$$\text{RATE} = \frac{\text{Rs } 14{,}285{,}70}{\text{Rs } 238{,}095 - \text{Rs } 23{,}810 - \text{Rs } 14{,}285.70} \times \frac{1}{18/360} = .1429, \text{ or } 14.29 \text{ per cent}$$

Compensating Balances

Banks require client firms with a line of credit or a revolving credit arrangement to maintain a current account or demand deposit balance that is related either to the credit limit or to the amount borrowed. The required balances are called compensating balances and under some circumstances have the effect of raising the interest rate on the loan. The usual practice is for banks to require that 10 to 20 per cent of the borrowed on a line of credit be kept as a demand deposit balance.

Assume that a firm borrows Rs 2 crore on a line of credit and the lending bank requires a 15 per cent credit balance; 15 per cent of this Rs 2 crore loan, or Rs 30,00,000, will have to be kept in the firm's current account at the bank to meet the compensating balance requirement. Whether this compensating balance raises the interest rate on the loan is dependent on whether the firm has a need to maintain a cash balance of Rs 300,000. Assume that the interest rate on the loan is 8 per cent. The firm wants to maintain a minimum balance of Rs 37,00,000 in its unit account. In this case meeting the compensating balance requirement does not increase the interest rate on the credit line.

Next, assume that the firm has no need to maintain any unit account balance at the lending bank. By maintaining a compensating balance of 15 per cent of the loan, it is effectively getting to use only 100 – 15 = 85 per cent of the loan. However, the interest rate is applicable on 100 per cent of the loan. Therefore, the effective interest is higher than 8 per cent and is given by effective interest rate

= stated interest rate / 1 – compensating balance fraction

= 8 % / 1 – 0.15 = 9.4 %

The effective interest rate is 9.4 per cent.

Firms borrowing on a line of credit can try to reduce the effective interest rate by shifting some of their cash maintenance needs to the bank where they have their line of credit. The effective interest rate can also be lowered by securing a line of credit at the bank where the firm conducts the majority of its cash receipts and disbursements transactions.

Interest Rates on Unsecured Loans

Interest rates on unsecured loans are negotiated between the bank and the client firm. In general, though, the interest rate is related to the client's credit worthiness. The most creditworthy clients pay the *prime rate*. The prime rate is the lowest rate applicable to business loans. The lower the credit worthiness of the firm, the higher the interest rate the bank is going to charge on unsecured loans. The interest rates applicable to a firm's are determined by the bank's risk classes and loan pricing matrix.

Risk Classes. Bank typically classify credit applicants into a series of risk classes. The balances may also use Credit Rating Agencies ratings to sulestatide than credit worthiness. Selected risk categories which may be maintenance as follows:

Class 1. Highest rated. Long-term debt is AAA or AA rated. Stable cash flows, interest coverage.

Class 2. High quality. Long-term debt is rated A. Good interest coverage.

Class 3. Upper-medium quality. Debt is rated A. Interest coverage, though good, may be impaired under adverse economic conditions.

Class 4. Medium quality. Debt is rated BBB. Adequate interest coverage. Access to alternative financial markets limited except during favourable economic periods.

Class 5. Lower-medium quality with debt rated at BB or B. Interest coverage is acceptable but is subject to severe fluctuations.

Class 9. Collections of loans is questionable. Not enough collateral to cover existing debt.

Class 10. Debt is not collectible.

Loan Pricing Matrix. Once a credit applicant has been assigned a risk class, the interest rate applicable will be established from using a loan-pricing matrix. The loan-pricing matrix of a bank is shown in Table 3. According to this loan pricing matrix, a firm in risk class 3 that borrows on a line of credit would be paying the prime rate plus 0.7 per cent as interest rate on its loan. A firm in risk class 4, seeking an unsecured transaction loan for 60 days, would incur an interest rate of prime plus 1.5 per cent.

The assignment to risk classes is based strictly on conservative financial considerations. On occasions the bank may feel that the need to develop the market for the bank's commercial lending practices requires that marketing considerations be given precedence over financial considerations. A risk class 2 firm may find that a bank, eager to land its borrowing business, is willing to assign the firm to risk class 1. However, very rarely if ever will a bank be willing to treat a risk class 9 or 10 firm as a risk class 5 firm.

Type of Loan Rick Class

Type of Loan	Rick Class				
	1	2	3	4	5
Unsecured for up to 90 days	P	P	P + 1.50	P + 1.50	P + 2.25
Secured, for up to 90 days	P	P	P + 1.00	P + 1.00	P + 1.50
Unsecured, for 90 days to 1 year	P	P + 0.25	P + 1.75	P + 1.75	P + 2.50
Secured, for 90 days to 1 year	P	P + 0.25	P + 1.50	P + 1.50	P + 2.25

[a] P stands for the lending rate at the time loan is issued. Interest rate are in per cent.

Concept of Credit Quality

The credit quality of a prospective business borrower is revealed to the lending banker through inquiries made of the company's trade creditors; through reports requested of credit-rating agencies; through analysis of the company's financial statements; and by "trade comparison" - comparisons of the prospective borrower's financial situation with that of other similarly sized firms in the same general line of business activity.

Required Security

There are four basic types of securities the bank can ask for:

1. **Hypothecation:** A charge that is made against movable property (like inventory) for an amount of debt where neither the ownership nor possession is passed to the creditor. Banks generally grant hypothecation on the basis of it's satisfying itself with the quality of the assets.

2. **ledge:** Under this arrangement the borrower is required to transfer the physical possession of the property offered as a security to the bank to obtain credit. The bank retains the right to sell off the property to recover its dues its loans are not paid on time.

3. **Mortgage:** It is the transfer of legal or equitable interest in a specific immovable property for the payment of debt. In case of mortgage, the physical possession of the property may remain with the borrower with the lender getting the full legal title.

4. **Lien:** Lien means right of the lender to retain property belonging to the borrower until he repays credit. It can be a particular lien in which the right is retained until the claim associated with the property is fully paid. General lien, on the other hand, is applicable till all dues of the lender are paid. Banks usually enjoy the facilities of general lien so as to more securely safeguard their interests.

A combination of 1 and 4 above is used in India.

Public deposits

Public deposits, also known as fixed deposits, had been an important source of raising money for working capital. But because of many scams of the finance companies, the term fixed deposits earned so much bad publicity that it is now only used by companies with good credit standing. However, the market is quite small now compared to the one that existed earlier.

Inter Corporate Deposits

One of the most utilised money market instruments, ICDs are the hallmark of lending and borrowing between companies and high-networth individuals. Usually backed by a security, (typical security being shares) ICD is normally for three months, but higher and shorter periods are also prevalent depending upon the needs. Normally the maximum time frame of an ICD is six months. But ICDs are rollable (turned over from one period to another) and can extent to any period with the mutual consent of the lender and the borrower.

It is one of the instruments which many cash rich corporates like to park their funds in as the security is good and the interest rate is much higher than what they would get from banks for the same time period. Risks of default are also much higher and it is normally not possible to offload the securities in the market, as the market may not be able to absorb the same.

Importance of personal contacts cannot be denied as this market operates from word of mouth and no advertising is done because it could harm the reputation of the corporate borrowing through ICDs. One of the top criteria for getting ICDs is the credibility of the company in the market, the lessor the credibility the lower the chances of getting the ICDs and the higher the interest rate the company may have to pay.

Short Term Loans from Financial Institutions

Although Bank Finance is one of the most important source of working capital funds, money market is no less important. Money market is useful when the company does not require a continuous source of working capital and is need of funds for only some time. For this short term needs, which are over and above its normal needs of working capital, going to banks is infeasible because either the limits with the banks have already been exhausted or the process is so long that by the time the bank sanctions, the situation for which the funds were required may already be gone.

Short term loans can be raised using highly liquid debt securities that have short terms until they mature. They are known as money market instruments. All money market instruments are debts that mature within 364 days or less.

Money market securities normally pay fixed rate of interest that is above the rate paid by them for normal working capital financing. This is because the need is for shorter duration and the risk of default is higher.

Money market instruments can pay interest, to their investors, as a discount from their face (or maturity) values or on the maturity return both the principal and the interest together.

A short-term loan is one having a maturity of less than one year. Loans maturing within 1 to 10 years are considered to be intermediate-term or *term loans*. Sources for term loans are banks, insurance companies, and pension funds. Some of the more important characteristics of term loans are discussed in the following paragraphs.

Characteristics of Term Loans

Term loans are different from other types of loans in a variety of ways including maturity, repayment schedule, collateral, costs, and provisions.

Maturity. As stated previously, the maturity for a term loan varies from 1 to 10 years. The 10-year limit is somewhat arbitrary in classifying a loan as a term loan. However, in recent years financial institutions are becoming less reluctant to issue term loans with maturities up to 10 years. The classification of loans with maturities of up to 10 years as term loans is becoming very common. The maturity of a term loan is dependent upon the financial institution lending the funds. Banks are generally reluctant to issue term loans with maturities in excess of 5 to 6 years. On the other hand, insurance companies and pension funds frequently underwrite term loans with maturities of 10 years.

*Repayment Schedule***.** Short-term loans are generally repaid as the firm generates excess cash flows. Long-term loans are generally repaid in full at maturity. Term loans are typically repaid according to a specified schedule. The most typical situation requires fixed payments, which include both principal and interest, on a monthly, semiannual, quarterly, or annual basis. The size of the periodic payment is such that when the last payment is made, the loan is fully paid and the lender is provided his required return. The repayment of term loans is discussed in the following section.

The particular procedure of making equal payments periodically to repay a loan is called loan amortisation. For example, a company borrows Rs 800,000 for 10 years and makes year-end equal payments of Rs 124,655.25 every year for 10 years. At the end of the tenth year the loan will have been fully repaid and will have provided the lender a 9 per cent interest rate. On rare occasions the loan amortisation is such that only a portion of the loan is repaid, leaving a large or "balloon" final payment. For example, the lender and borrower by mutual agreement may amortise only Rs 600,000 of the Rs 800,000 loan. In this case the 10 annual payments would be Rs 111,491.44 each. The borrower would also have to repay the unamortised Rs 200,000 portion of the loan at the end of the tenth year. Both of these examples are explained in the next section.

Collateral. Financial institutions underwriting term loans generally require collateral on the loans. Since these loans are used for specific purposes such as purchase of computers

machinery, and so forth, the loans can be readily secured by the new equipment being purchased. Occasionally, stocks bonds, real estate, and other assets are also used as collateral for term loans.

Costs. The interest rate on a term loan is usually higher than the interest rate on short-term loans. Term loans rates also reflect the credit worthiness of the borrower and the liquidity and marketability of the collateral used to secure the loan. For a financially sound borrower, the term loan rate will be about 0.5 per cent higher than the prime lending rate.

Interest rates on term loans can either remain fixed for the duration of the loan or vary with changes in the prime rate. If the term loan has a variable interest rate, then the loan agreement may also specify the "floor" and "ceiling" rates. For example, a term loan agreement may provide that the interest on the unamortised portion of the loan will be at a prime plus 0.5 per cent rate but in no case will be higher than 10 per cent or lower than 7 per cent. In this case the 7 and 10 per cent rates are the floor and ceiling rates, respectively.

In addition to interest expense, term loans may entail other costs. The lending institution may charge a moderate loan commitment fee. Occasionally, the lending institution may require that warrants or options to buy common stock at specified prices be provided by the borrower. This allows the lender to participate in the anticipated growth of the borrower's business. Insurance companies providing term loans prefer to use this device to gain additional returns.

Provisions. Financial institutions making term loans need to assure them–selves that the borrower continues to have the potential to make interest and principal payments at the scheduled intervals. This need to secure their financial position leads term lenders to incorporate a variety of provisions in the lending agreement. These provisions are designed to provide the lender with timely financial information about the borrower and to impose certain restrictions on the borrower. For example, the lending arrangement may require the borrower to maintain a *minimum current ratio*. If the borrower's current ratio falls below the minimum level, then, at its option, the lender may require immediate payment of the unamortised portion of the term loan.

Another provision regulates the amount of new long-term debt that the borrower can acquire. This provision typically requires that the borrower must secure the lender's approval before the borrower can issue any new long-term debt or sign leases. This provision allows the lender to exercise control over the borrower's indebtedness and to keep the borrower from becoming too indebted.

Another common term loan provision requires the borrower to provide the lender with

periodic sheets, income statements, cash budgets and sources, and uses of funds statements. This allows the lender to monitor the borrower's financial condition and to take or suggest corrective actions when needed.

Finally, the term loan agreement may also require the borrower to not make changes in its executive ranks without the lender's permission. The lender may also require sufficient life insurance on the borrower's key managerial personnel. These provisions are designed to protect the lender from losses resulting from unforeseen changes in the borrower's important personnel.

Repaying Term Loans

Term loans are generally repaid on a periodic, systematic basis. Term lenders prefer this procedure because it enhances the borrower's capability to repay the loan. A large lump-sum loan repayment at maturity may place a heavy financial burden on the borrower, whereas with small periodic payments the borrower is not unduly financially burdened. A second reason for amortising loans has to do with the use of funds from the loans. Term loans are usually obtained for purchasing equipment. Loan amortisations are more desirable because loan repayments can be geared to the cash flows being generated by the equipment.

In this section two different loan amortisation procedures will be considered full amortisation and one that results in a balloon payment.

Full Amortisation. Under full amortisation, the borrower makes periodic payments until the loan and interest is fully paid. To explain the example cited previously, assume that Central Manufacturing Corporation borrows Rs 800,000 for 10 years at an interest rate of 9 per cent. The interest rate is the effective interest rate on the remaining balance. In addition, the bank making this term loan requires that the loan be repaid in 10 equal installments which would include interest as well as payment on the principal.

The annual payment required to repay this loan can be determined by using Equation. 8, which we renumber 1 for convenience.

$$P_O = P \times IFAP_{n/i} \qquad (1)$$

where P_0 is the present value of an annuity of P rupees receive every year for N years and discounted at one per cent. In the term loan situation the annual payment is P rupees and is found by

$$P = P_O \times IFA_{n/i} \qquad (2)$$

In the example cited, P_O is Rs 800,000. The annuity factor, rounded off to four decimal places, for Re 1 received every year for 10 years and discounted at 9 per cent is shown as 6,4177 in Appendix B. Then P is

P = Rs 800,000 / 6,4177 = Rs 124,655.25.

After Central has made 10 annual payments of Rs 124,655,25, it will have fully repaid the term loan and the bank will have been provided with its 9 per cent interest rate.

Table 4 shows how this annual payment is divided between interest and payment on principal. At the time of loan, or at time O, the beginning balance is Rs 800,000. At the end of the first year an annual payment of Rs 124,655.25 is made. This amount includes interest of Rs 800,000 × 0.09% = Rs 72,000. The remaining payment, Rs 124,655.25 – Rs 72,000 = Rs 52,655.25 is applied to the beginning balance to pay off a portion of the loan. The first-year ending balance is Rs 800,000 – Rs 52,655.25 = Rs 747,344.75. The first-year ending balance becomes the second-year beginning balance. Interest on this is computed at 9 per cent. The difference between the second-year payment and interest is used to reduce the second-year beginning balance. This process continues until the final payment is made at the end of the tenth year and the loan is completely repaid.

1	2	3	4=2×0.09	5=3–4	6=2–5
End of Year	Beginning Balance	Annual Payment	Interest at 9 %	Loan Repayment	Ending Balance
0	Rs 800,000.00	Rs –	Rs –	Rs –Rs	800,000,00
1	800,000.00	124,655.25	72,000.00	52,655.25	747,344.75
2	747,344.75	124,655.25	67,261.03	57,394.22	689,950.53
3	689,950.53	124,655.25	62,095.55	62,559.70	627,390,83
4	627,390.83	124,655.25	56,465.17	38,190.08	559,200.75
5	559,200.75	124,655.25	50,328.07	74,327.18	484,873.57
6	484,873.57	124,655.25	43,638.62	81,016.63	403,856.94
7	403,856.94	124,655.25	36,347.12	88,308.13	315,548.81
8	315,548.81	124,655.25	28,399.39	96,255.86	219,292.95
9	219,292.95	124,655.25	19,736.37	104,918.88	114,374.07
10	114,374.07	124,655.25	10,281.18[a]	114,374.07	—

[a] For the tenth year only, interest is the difference between annual payment balance. This rounding-off error exists because only four decimals were utilised in the annuity factor used in computing the annual payment.

One word of caution related to Table 4 has to do with the rounding-off error. We used a rounded-off annuity factor of 6.4177 from Appendix B. the actual annuity factor is 6.4176550. Rounding off the annuity factor changes the annual payment slightly. The net cumulative result is that when one calculate the interest for the last year, it becomes Rs 114,374.07 × 0.09% = Rs 10,293.67. It should be recognised that minor errors are caused by rounding-off annuity and discount factors. This error is remedied by either using more significant decimals or by treating interest expense in the last year as a

residual item–the difference between the annual payment and the tenth-year beginning balance.

Balloon Payment Amortisation. On occasion firms prefer to amortise less than the full amount of the loan. Amortising only a portion of the term loan results in the firm's making a relatively large or "balloon" payment when the loan matures. One reason for doing this may be that the unamortised portion of the loan on maturity may equal the anticipated salvage value of the equipment to be purchased with the term loan. Another reason is that with a balloon payment the firm's annual payments are smaller, except of course for the last payment, which includes the unamortised loan. A firm may choose a balloon payment with the idea of refinancing the unamortised loan at maturity.

Assume that Central Manufacturing and the lending bank agree to amortise Rs 600,000 of the Rs 800,000, with the unamortised portion or Rs 200,000 due at the end of the tenth year. One way to evaluate this term loan is to view it as two separate loans-one for Rs 600,000 and one for Rs 200,000. The annual payment for Rs 600,000 portion is determined by using Equation 2;

P = Rs 600,000 / 6.4177 = Rs 93,491.44

The Rs 200,000 portion is not repaid until the last year. Interest due every year for 10 years on this amount is Rs 200,000 × 0.09% = 18,000. Total annual payment for the first 9 years on this loan is Rs 93,491.44 + Rs 18,000 = Rs 111,491.44. The tenth and final payment would include the unamortised portion of the loan also and would equal Rs 111,491.44 + Rs 200,000 = Rs 311,491.44.

In this section we have considered two alternative, term loan repayment procedures. Variations would include situations in which the applicable interest rate is not fixed or the annual payment amount is not fixed. The technique for amortising term loans of these types is similar to the procedure outlined in Table 4.

Advantages and Disadvantages of Term Loans

As with any financing procedure, term loans are not without their advantages and disadvantages.

Advantages. The relationship between borrower and lender is one-to-one, and it is easy for them to negotiate loans terms that meet the special need of the borrower. Repayment schedules, annual payments, and maturity date can be negotiated to meet the borrower's needs. The borrower also finds it easy to negotiate with one lender and does not have to go through a Securities and Exchange Commission registration as is the case with typical bond financing. The lending institution also may not seek certain financial information that the firm may be hesitant to divulge. Term loans can be arranged

more quickly than long-term loans. The firm or borrower is assured to funds for a number of years, which is not the case with borrowing on a credit line. Finally, smaller firms with limited access to capital markets find term loans very convenient.

Disadvantages. The borrower may feel that, at times, term loan provisions are too restrictive. The limitations on issuing new debt may hinder the firm's ability to finance future growth. Another disadvantage of term loans is that at times the cost may be high. If the loans involve issuance of options on warrants that are exercised, then the affective cost of the loan to the borrower increases. Despite these disadvantages, term loans are a major source of financing.

Debentures for working capital

Debentures have been traditionally used for long term funding the capital projects, but they can also be used for funding short term requirements of working capital and become the part of long sources used for funding working capital requirements. Funding is used by corporates for a medium time frame and hence are a stable source of funds.

Commercial Paper

CP refers to the short-term promissory notes issued by "blue-chip" corporations - large, old, safe, well known companies like TISCO, ONGC, SAIL, etc. The maturities normally vary from 90 to 180 days as compared to US where the maturity period ranges from 5 days to 270 days, and the denominations are for a minimum of Rs 10 lac or more - usually more. These notes are backed only by the high credit ratings (normally P1+ the highest grade available) of the issuing corporations which means that there is no security given by the company when issuing CP.

CPs are normally issued at a discount to its face value and are redeemed at the face value.

Credit Terms

The maturity of this credit source is generally six months or less, although some issues carry 270-days maturities. The interest rate on commercial paper is generally slightly lower (one-half to one per cent) than the prime rate on commercial bank loans. Also, interest is usually discounted, although commercial paper is available at times that is interest bearing.

New issues of commercial paper are either directly placed (sold by the issuing firm directly to the investing public) or dealer placed. Dealer placement involves the use of a commercial paper dealer, who sells the issue for the issuing firm. Many of the major finance companies place their commercial paper directly. The volume of direct versus

dealer placements is roughly four to one in favour of direct placements. Dealers are used primarily by industrial firms that make only infrequent use of the commercial paper market or that, owing to their small size, would have difficulty placing the issue without the help of a dealer.

Commercial Paper as a Source of Short-term Credit

A number of advantages accrue to the user of commercial paper:

Using commercial paper for short-term financing, however, involves a very important risk. That is, the commercial paper market is highly impersonal and denies even the most creditworthy borrower any flexibility in terms of repayment. When bank credit is used, the borrower has someone with whom he can work out any temporary difficulties he might encounter in meeting a loan deadline. This flexibility simply dose not exist for the user of commercial paper.

Estimating the Cost of Commercial Paper

The cost of commercial paper can be estimated using the simple effective cost of credit equation (RATE). The key points to remember are that commercial paper interest is usually discounted and that if a dealer is used to place the issue a fee must be paid. Even if a dealer is not used, the issuing firm will incur costs associated with preparing and placing the issue, which also must be considered in estimating the cost of credit.

Example: The EPG Mfg. Company uses commercial paper regularly to support its needs for short-term financing. The firm plans to sell Rs 100 crore in 270-day-maturity paper on which it expects to have to pay discounted interest at an annual rate of 12 per cent per annum. In addition, EPG expects to incur a cost of approximately dealer placement fees and other expenses of issuing the paper. The effective cost of credit to EPG can be calculated as follows:

$$\text{RATE} = \frac{\text{Rs 9 crores}}{\text{Rs 100 crores - Rs 100,000 - Rs 9 crore}} \times \frac{1}{270/360} = .1320, \text{or } 13.20 \text{ per cent}$$

Where the interest cost is calculated as Rs 100 crore × .12 × 270/360 = Rs 9. Thus, the effective cost of credit to EPG is 13.2 per cent.

CPs have to be credit rated in India. The highest credit rating holder corporates are issuing CPs at around 8-12 % at this moment, which is much lower than the interest rate they would have paid if they had gone through either the ICD market or the bank finance route. Still CPs are not utilised to their maximum possible extent as the banks do not like to fund through them because they lose on the interest they could have charged if the corporates went through bank finance instead.

Pledging Accounts Receivable

After cash and marketable securities, accounts receivable are considered to be the most liquid assets on a firm's balance sheet. A financial institution such as a bank or finance company will readily make a loan secured by accounts receivable. The lender will evaluate the quality of the receivable to be pledge and the average size of account pledged. Once these have been established, the pledging procedure can be implemented. These steps are explained in the following paragraphs.

Quality of Receivables Pledged. The lending institution is gone to evaluate thoroughly the quality of the receivables the borrower wants to pledge. If, on the average, the receivables appear to be of very high quality with almost a 100 per cent probability of payment, the lender may loan up to 90 per cent of the face amount of the receivables pledged. If the receivables appear to be of relatively low quality, the lender may be willing to lend only 25 per cent of the face value of the receivables. The higher the receivable quality, the higher their loan value.

Although a lender may be willing to lend anywhere from 25 to 90 per cent of the face value of the receivables pledged, he retains the right to reject any receivable that he does not wish to accept as a pledge. In addition, the lender holds the borrower liable for any accounts that become delinquent or default after they have been pledged.

Size of Accounts. Pledging receivables involves a considerable amount of record keeping for the lender. These record-keeping costs remain relatively constant irrespective of the rupee amount of the account being pledged. Smaller-size accounts cost more per rupee of loan than larger-size accounts. A firm with a lot of small-size accounts receivable will find it difficult to raise funds by pledging receivable at a reasonable cost. A firm may be able to negotiate a "floating lien" loan with a lending institution. With a floating lien the lender does not maintain records on individual accounts. Rather, a general lien is assigned to all receivables. Since the lender is not tracking individual accounts under a floating lien the chances of fraud by the borrower are higher than with specific pledging of accounts. As a precaution against exposing itself to undue risk, a lender will rarely lend more than 25 per cent of the face amount of receivables subject to a floating lien.

Pledging Procedure. Once the loan value of receivables has been established, the borrower sends to the lender a list of accounts, billing dates, and amounts involved. Assume that the lender has agreed to lend 80 per cent of the face value of receivables pledged. The borrower sends to the lender a schedule of accounts totalling Rs 1 crore. The borrower is now eligible to borrow any amount up to 80 per cent of Rs 1 crore, or Rs 80,00,000, upon signing a promissory note.

Pledging of receivables can be either on a notification or non-notification basis. On a *notification* basis the borrower notifies its accounts that payments on the receivables are to be made directly to the lender. On *a non-notification* basis the account is not informed of the financial arrangements between borrower and lender. The account remits payments to the borrower, who forwards is to the lender. The lender then checks the payment against the schedule provided by the borrower and reduces the borrower's loan balance by a corresponding amount. When pledging receivables is on a non-notification basis, the lender relies on the borrower to forward account payments to him. Should the borrower keep the checks, the lender would be ultimately holding "receivables" that have been paid. To prevent fraud of this natures, non-notification pledging allows the lender to randomly audit the borrower's books to see that payments on all pledged accounts are being forwarded to the lender.

The lender will also adjust the rupee value of accounts pledged for any discrepancies between the amount invoiced and the amount paid. These discrepancies are caused by the account taking a cash discount for early payment, taking credit for merchandise returned or adjusting for other invoice errors.

Interest Rates. Interest rates with pledged receivables financing are 2 to 4 per cent higher than the prime-lending rate. The lending institution may also charge a processing fee, which may equal 1 to 3 per cent of the average annual loan. Commercial finance companies charge rates that are higher than the rates charged by banks. The total effective interest with this type of receivables financing will vary from 10 to 20 per cent. This high interest rate does not imply that secured loans are more expensive than unsecured loans. The rates are high because the borrower is risky and does not have access to normal sources of unsecured loans.

Factoring

Factoring is an arrangement between the company and the factor (another company providing factoring services) in which the factor agrees to buy the bills receivable of the company for a commission and an interest for the period for which he is expected to keep the bills before receiving payments from the parties on whom the bill is drawn.

Factoring can be on recourse basis (in which the risk of default is borne by the company) or without recourse (in which the risk of default is borne by the factor himself). The biggest benefit of factoring is that the receivables can be converted into cash and redeployed into the business. The most negative aspect is that the interest rate is higher than most other short-term debt instruments because it depends upon the quality of the parties on which the bills are drawn (except ICDs where it is equivalent). Hence company going in for factoring is looked down upon considering the fact that the company was

not able to mobilise the required funds from the normal short-term sources.

While the book debt purchasing is fundamental to the functioning of factoring, the factor can provide three other basic services to the companies:

- Sales ledger administration and credit management
- Credit collection and protection against default and bad debt losses
- Financial accommodation against the assigned book debts

In developed countries like the US the factors provide various other services in addition to the basic services mentioned above. They include:

i. Providing information on the prospective buyers

ii. Credit risk management

iii. Financial counselling

There are seven different types of factoring services available abroad. The brief comparison of them is tabulated below:

Types of Factoring	Types of Services				
	Availability of Finance	Protection against bad debts	Notification to debtors	Sales ledger administration	Collection
1. Full non-recourse factoring	Y	Y	Y	Y	Y
2. Recourse factoring	Y	N	Y	Y	Y
3. Bulk factoring	Y	N	Y	N	N
4. Maturity factoring	N	Y	Y	Y	Y
5. Agency factoring	Y	S	Y	S	N
6. Invoice discounting	Y	N	N	N	N
7. Undisclosed factoring	Y	S	N	N	N

Y = Provided, N = Not Provided, S = Sometimes Provided

Factoring is different from bill discounting in the aspect that bill discounting is just providing a credit on the bills without any onus on the company providing the credit to collect or manage the receipts. Bill discounting is termed as Invoice discounting in the above table and you can yourself see that apart from providing finance it offers no other service which full non-recourse factoring provides.

Still the biggest benefit of going for factoring to a specialist organisation is that the

company gets specialised service in credit management which helps it save costs in credit administration as also helps the company concentrate on other areas of operations.

Inventory Loans

Inventory loans provide a second source of security for short-term secured credit. The amount of the loan that can be obtained depends on both the marketability and perishability of the inventory. Some items, such as raw materials (geains, oil, lumber, and chemicals), serve as excellent sources of collateral, since they can easily be liquidated. Other items, such as work-in-process inventories, provide very poor collateral, owing to their lack of marketability.

There are several methods by which inventory can be used to secure short-term financing. These include a floating or blanket lien, chattel mortgage, field warehouse receipt, and terminal warehouse receipt.

Floating Lien Agreement

Under a floating lien agreement the borrower gives the lender a lien against all his inventories. This provides the simplest but least secure form of inventory collateral. The borrowing firm maintains full control of the inventories and continues to sell and replace them as it sees fit. Obviously, this total lack of control over the collateral greatly dilutes the value of this type of security to the lender. Correspondingly, loans made with floating liens on inventory as collateral are generally limited to a relatively modest fraction of the value of the inventories covered by the lien. In addition, floating liens usually include future as well as existing inventories.

Chattee Mortgage Agreements

The lender can increase his security interest by having specific items of inventory identified (by serial number or otherwise) in the security agreement. Such an arrangement is provided by a chattel mortgage. The borrower retains title of the inventory but cannot sell the items without the lender's consent. This type of agreement is very costly to implement, as specific items of inventory must be identified; thus, it is used only for major items of inventory such as machine tools or other capital asset.

Field Warehouse Financing Agreements

Increased lender control over inventories used as loan collateral can be obtained through the use of a field warehouse agreement. Here the inventories used as collateral are physically separated from the firm's other inventories and placed under the control of a third-party field warehousing firm. Note that the inventories are not removed from the borrower's premises, but they are placed under the control of a third party who is

responsible for protecting the security interests of the lender. This arrangement is particularly useful where large bulky items are used as collateral. For example, a refinery might use a part of its inventory of fuel oil to secure a short-term bank loan. Under a warehousing agreement the oil reserves would be set aside in specific tanks or storage vessels, which would be controlled (monitored) by a field warehousing concern.

The warehousing concern, upon receipt of the inventory, takes full control of the collateral. This means that the borrower is no longer allowed to use or sell the inventory items without the consent of the lender. The warehousing firm issues a warehouse receipt for the merchandise, which carries title to the goods, represented therein. The receipt may be negotiable, in which case title can be transferred through sale of the receipt, or nonnegotiable, whereby title remains with the lender. With a negotiable receipt arrangement the warehouse concern will release the goods to whoever holds the receipt, whereas with a nonnegotiable receipt the goods may be released only on the written consent of the lender.

The cost of such a loan can be quite high, since the services of the field warehouse company must be paid for by the borrower.

Example: The M.M. Company follows a practice of obtaining short-term credit based on its seasonal finished goods inventory. The firm builds up its inventories of outdoor furniture throughout the winter months for sale in spring the summer. Thus, for the two-month period ended March 31, it uses its fall and winter production of furniture as collateral for a short-term bank loan. The bank lends the company up to 70 per cent of the value of the inventory at 14 per cent interest plus a fixed fee of Rs 2000 to cover the costs of a field warehousing arrangement. During this period the firm usually has about Rs 200,000 in inventories, which it borrows against. The annual effective cost of the short-term credit is therefore.

$$\text{RATE} = \frac{\text{Rs } 3267 + \text{Rs } 2000}{\text{Rs } 140.000} \times \frac{1}{60/360} = 22.57 \text{ per cent}$$

where the financing cost consists of two month's interest Rs 140,000×.14× 60/360 = Rs 3267) plus the field warehousing fee of Rs 2000.

Terminal Warehouse Agreements

The terminal warehouse agreement differs from the field warehouse agreement just discussed in only one respect. Here the inventories pledged as collateral are transported to a public warehouse that is physically removed from the borrower's premises. An added degree of safety or security is provided to the lender, as the inventory is totally removed from the borrower's control. Once again the cost of this type of arrangement

is increased by the necessity for paying the warehouse concern; in addition, the inventory must be transported to and eventually from the public warehouse.

The same warehouse receipt procedure described earlier for field warehouse loans is used. Again, the cost of this type of financing can be quite high.

Lease Financing

Firms are generally interested in acquiring the use of equipment. One way to acquire use is to buy the equipment. The same result can also be achieved by leasing the equipment. A lease is a contractually established obligation by the lessee to pay the lessor a series of payments for the use of certain assets. In this section we shell consider types of leases, lease capitalisation's, and the advantages and disadvantages of leasing.

Type of Leases

There are two major types of leases–operating and financial.

Operating Lease. An operating or service lease is one that allows the lessee at his convenience. Telephone service is an example of an operating lease. The telephone user can, at his or her convenience, discontinue telephone service. Another example of a service lease is leasing copying equipment from companies such as Xerox Corporation and A. B. Dick Corporation. These companies typically lease their equipment on a 30 day cancellation notice basis. If a lessee cancels a service lease, the equipment is leased to another lessee. The lessor expected to recover the costs plus profits over the economic life of the equipment. Operating lease payments usually include charges for servicing and maintaining the leased equipment.

Financial Lease. A financial lease is a non-cancelablle, contractual obligation of the lessee to pay the lessor a fixed amount for a specified time period for the use of certain assets. A financial lease includes the following features:

1. The lease is non-cancelable. The lessee cannot "walk away" from the lease without becoming liable for the remaining lease payment.

2. The lease is fully amortised. A fully amortised lease is one that returns to the lessor all his costs plus a reasonable return.

3. A financial lease does not include repair and maintenance services. A variation of the financial lease in which the lessor pays the maintenance and insurance costs is called a maintenance lease.

A special type of financial lease is a sale and leaseback arrangement. In a sale and leaseback a firm sells an asset to another fir, who leases the asset back to the first firm. Special features of a sale and leaseback arrangement are as follows:

1. Assets involved can be either old or new. A firm could sell an old fully depreciated plant and then lease it back. Another firm could buy a new IBM computer, sell it to a finance company, and then lease it right back.

2. Assets are sold at or close to appraised market value.

3. The leaseback arrangement calls for lease payments that return all costs plus a fair return to the lessor. That it, the lease is fully amortised.

Sale and leaseback arrangements and financial leases are identical. The practical distinction is that financial leases involve assets new to the firm whereas sale and leasebacks typically involve assets that the firm is already using.

Internal Revenue Service Lease Requirements

The total amount of a lease payment is tax deductible, provided that the lease qualifies as a bonfire lease. Without this IRS safeguard some firms would have a tendency to call an installment sale a lease, say an equipment has a useful life of 20 years and is being purchased on a 10-year installment loan plan. The company conceivably could write up the sale as a lease with the installment loan payments being called lease payments. When the installment loan is fully paid–that is, when the "lease" obligations are met–the buyer could buy the residual rights to the equipment for a nominal amount of Re. 1. If the IRS were to let this installment sale qualify as a lease, it would put other firms at a competitive disadvantage. The reason is that while other firms are writing off the asset over 20 years, this firm by expensing the "lease" payments would be depreciating the asset over 10 veers. It would be underpaying its taxes and increasing its net cash flows. To prevent this type of abuse, the IRS requires that the following criteria be met before a "lease" qualifies as a lease and not an installment loan:

1. Lease obligation must be for less than 30 years.

2. The lease must provide a fair return to the lessor.

3. Any lease renewal option granted to the lessee must not be different than one that would be provided to a third party.

4. Any purchase option granted to the lessee must not be different than one that would be provided to a firm not a party to the lease.

If these criteria are not met, the lease does not qualify as a bonfire lease and the lease payments are not fully tax deductible. A leasing arrangement that does not meet IRS criteria for a lease is treated as a purchase financed through an installment loan. The tax deductions are the same as for any other equipment purchase, that is, depreciation, interest expanse, and so forth.

Lease Capitalisation's

Financial leases call for the lessee to make periodic payments to meet contractual obligations. As such it is not conceptually different from a loan. Lease capitalisation involves capitalising the lease payments at an appropriate capitalisation rate and showing the capitalised amount as a liability. An entry equal to the capitalised lease obligations is shown on the assets side of the balance sheet.

The capitalisation rate is generally equal to the lessee's marginal cost of borrowing. For example, a corporation leases a computer system for 6 years. Lease payments are to be made in six annual payments of Rs 340,000 each. The first payment is made on the day that the computer is installed. The second payment is due 2 years from today, and so on. Payments three through six are capitalised at the firm's marginal borrowing rate of 9 per cent. The capitalised value of payments 3 through 6 is Rs 340,000(0.84168 + 0.77218 +0.70843 + 0.64993) = Rs 1,010,555. The balance sheet entry for this leasing transaction would be

Assets		Liabilities	
Net leased assets	Rs 1,350,555	Current liabilities	
		Lease obligation	Rs 340,000
		Long-term liabilities	
		Lease capitalisation	Rs 1,010,555

These entries would be adjusted each year as the firm makes its lease payment.4 keep in mind that the net capitalised value of the lease of Rs 1,350,555 + Rs 340,000 = Rs 1,690,555.

Cost of Leasing

The typical situation in leasing involves a decision either to borrow and buy or to lease the equipment. The best alternative of buying or leasing is the one with the highest net present value. This situation is discussed in the last section of the chapter. Another situation could be when the item available is for lease only and cannot be purchased. Here the leasing analysis becomes intermingled with the capital budgeting decision itself. All leases, however, involve, a rate of return to the lessor. One way to conceptualise a before-tax cost of leasing is to view the lessor's cost of leasing. Consider the computer system lease example given previously. Assume that the computer system costs the lessor Rs 1.68 crore and that the investment tax credit is passed along to the lessee. Maintenance and service costs are also borne by the lessee. From the lessor's viewpoint, the lease involves an outflow of Rs 1.68 crore at t = 0 for the purchase, an inflow of Rs

340,000 at t = 0 from the first lease payment, another Rs 340,000 at t –1 for the second payment, and so on. The rate of return for the lessor is that discount rate which equates the sum of the present values of lease payments with Rs 1.68 crore. Or

$$\text{Rs } 1{,}680{,}000\text{s} = E^{5}_{t=0}\,\text{Rs } 340{,}000\,(1+r)^{-t} = \text{Rs } 340{,}000\,(E^{5}_{t=0}\,(1+r)^{-t}$$

$$= \text{Rs } 340{,}000\,(1+ E^{5}_{t=1}\,(1+r)^{-t} \qquad (3)$$

$$= \text{Rs } 340{,}000\,(1 + \text{IFA5/r})$$

Equation 3 can be restated in terms of the annuity factor IFA as

$$\text{IFA5/r} = (\text{Rs } 1{,}680{,}000/\text{Rs } 340{,}000 - 1 = 3.94118 \qquad (4)$$

From Appendix B IFA (5 year/8 per cent) IS 3.99271 and IFA (5year/9 per cent) is 3.88965. By interpolation r is found to be 8.5 per cent. A way of identifying the leasing cost is to consider this 8.5 per cent return to the lessor as the 4 lessee's cost of leasing. It should be recognised that in calculating the cost of leasing this way, we are ignoring tax effects and consequently depreciation as a tax shield. This method, however, does provide us with a reasonable perspective on leasing cost.

Equation 4 can be generalised to estimate the lessor's rate of return on any lease. If it is assumed that the first lease payment is made at the time the equipment is installed, then

$$\text{IFA}_{n-1/r} = C/L - 1 \qquad (5)$$

Where

n = length of lease

C = cost of equipment

L = annual lease payment

r = lessor's rate of return on the lease

The annuity factor can be used in conjunction with Appendix B to solve for r as shown in the example given previously.

One interesting factor to note is that the gross lease capitalised value does not necessarily have to equal the cost of the equipment being leased. The answer lies in the fact that the lessors' rate of return is generally different from the lessee's lease capitalisation rate.

Advantages and Disadvantages of Leasing

Leasing equipment possesses a variety of advantages and disadvantages for the lessee.

Advantages of Leasing. Lease financing is viewed to possess a number of advantages for the lessee. Perhaps one of the major advantages of leasing is that it provides for the use of equipment with 100 per cent debt financing. That is, a firm that is leasing equipment does not have to make a down payment. Such is not the case when a firm borrows to buy the same equipment. Very rarely will a lending institution provide a loan equal to the purchase price of the equipment. More typically, it will require the firm to take an equity position equal to 10 or 20 per cent of the equipment's purchase price. Some, however, argue that this advantage may be illusory, because 100 per cent financing provided by leasing uses up more of the firm's debt capacity than buying the equipment with an 80 per cent loan.

The current trend in financial reporting is toward full disclosure of financial obligations created by leasing arrangements. Once firms are required to capitalise lease obligations and to integrate lease capitalisation's fully into their financial statements, the advantage of 100 per cent financing in leasing will diminish significantly.

Another advantage of leasing is that it provides the lessee with flexibility in acquiring the use of specialised equipment that may become obsolete for the lessee but may be still a productive asset for another firm. Items such as lessee but may be still a productive asset for another firm. Items such as computers and copying machines fall in this category. A third generation IMB equipment may become obsolete as far as a large manufacture is concerned but may be readily utilised by a small manufacturer. A firm may prefer to lease a computer and then let the lessor handle the subsequent lease of the computer to another firm. The lessor has specialised skills in doing this and can do a better job of leasing the equipment again.

Another advantage of leasing is that the provisions typically associated with term loans are not present in lease financing. A firm that does not with to conform to minimum current ratio requirements, and so forth, may find the lack of these restrictions in lease financing to be a starring enough motive to prefer leasing to borrowing.

A final advantage in leasing is that the lessor and lessee can negotiate over who utilises the investment tax credit. A firm that is not able to fully utilise the tax credit may let the lessor retain the credit and settle for lower annual lease payments. This planning flexibility is not available with borrowing and buying when the tax credit goes to the buyer.

Disadvantages of Leasing. The major disadvantage of leasing is that the residual value of the leased asset at the termination of the lease belongs to the lessor. The typical leasing arrangement calls for a full amortisation of the cost of the equipment. One frequently encounters examples where the cost of leasing an automobile covers complete amortisation over 4 years of the automobile cost. If, after 4 years, the lessor

can sell the leased automobile for more than zero rupees, he or she gained at the expense of the lessee. Another example is full amortisation of costs in a sale and leaseback of a building and the land on which it is constructed. While the building will generally depreciate in value, very rarely will the land value decline to its eventual fully amortised cost of zero rupees.

Another disadvantage of leasing is that typically the lessor's rate of return is higher than the lessee's cost of borrowing.

This makes borrowing a more desirable alternative than leasing.

Regulation of Bank Finance – Recommendation of Latest Committee

Banks were tied by the guidelines issued by the Reserve Bank of India (RBI), which in turn has been influenced by various committees appointed by it from time to time. Now the RBI has considerably relaxed the rules, but the banks still stick to the guidelines to a high degree because shifting from protected to totally open environments is not easy and banks want to make the transition smoothly. We will first discuss the development of the guidelines through various committees.

The norms of working capital finance followed by banks since mid-70's were mainly based on the recommendations of the Tandon Committee. The Chore Committee made further recommendations to strengthen the procedures and norms for working capital finance by banks.

Chapter-14
Regulation of Bank Finance

Traditionally, industrial borrowers enjoyed a relatively easy access to bank finance for meet-ing their working capital needs. Further, the cash credit arrangement, the principal device through which such finance has been provided, is quite advantageous from the point of view of borrowers. Ready availability of finance in a fairly convenient form led to, in the opinion of many informed observers of the Indian banking scene, over-borrowing by indus-try and deprivation of other sectors.

Concerned about such a distortion in credit allocation, the Reserve Bank of India (RBI) has been trying, particularly from the mid-sixties onwards, to bring a measure of discipline among industrial borrowers and to redirect credit to the priority sectors of the economy. From time to time, the RBI has been issuing guidelines and directives to the banking sector toward this end. Important guidelines and directives have stemmed from the recommenda-tions of certain specially constituted groups entrusted with the task of examining various aspects of bank finance to industry. In particular, the following committees have signifi-cantly shaped the regulation of bank finance for working capital in India: the Dehejia Com-mittee, the Tandon Committee, the Chore Committee, and the Marathe Committee. The key elements of regulation are discussed below:

Norms for Inventory and Receivables

In the mid-seventies, the RBI accepted the norms for raw materials, stock-in-progress, fin-ished goods, and receivables that were suggested by the Tandon Committee for fifteen ma-jor industries. These norms were based, *inter alia*, on company finance studies made by the Reserve Bank of India, process periods in different industries, discussions with industry experts, and feedback received on the interim reports. These norms represented the maxi-mum levels for holding inventory and receivables in each period.

From the mid-1980s onwards, special committees were set up by the RBI to prescribe norms for several other industries and revise norms for some industries covered by the Tandon Committee. However, these norms are now regarded as indicative. Banks have a discretion to deviate from the norms. Still banks often look at them.

Maximum Permissible Bank Finance

The Tandon Committee had suggested three methods for determining the maximum per-missible bank finance (MPBF). To describe these methods, the following notation is used:

CA = current assets as per the norms laid down

CL = non-bank current liabilities like trade credit and provisions

CCA = core current assets—this represents the permanent component of working capital

The methods for determining the MPBF are described below:

Method 1 MPBF = 0.75 (CA - CL)

Method 2 MPBF = 0.75 (CA) - CL

Method 3 MPBF = 0.75 (CA - CCA) - CL

To illustrate the calculation of the MPBF under the three methods, consider the data for Ambex Company:

Current Assets1	**Rs (in millions)**
Raw material	18
Work-in-process	5
Finished goods	10
Receivables (including bills discounted)	15
Other current assets	2
Total	50
Current Liabilities	
Trade creditors	12
Other current liabilities	3
Bank borrowings (including bills discounted)	25
Total	40

The MPBF for Ambex Company as per the three methods is as follows:

Method 1 0.75 (CA - CL) = 0.75 (50 -15)

= Rs 26.25 million

Method 2 0.75 (CA) –CL = 0.75 (50) - 15

= Rs 22.5 million

Method 3 0.75 (CA - CCA) –CL = 0.75 (50 - 20^2) - 15

= Rs 7.5 million

The second method has been adopted. Note that under this method the minimum current ratio works, out to be 1.33. An example will illustrate this point. Suppose the current assets and current liabilities (excluding bank finance) for a firm are 100 and 50 respectively. The MPBF will be:

$$0.75 (CL) - CA = 0.75 (100) - 50 = 25$$

This means that the current liabilities including MPBF will be: 50 + 25 = 75. Hence, the current ratio works out to 100/75 = 1.33.

Forms of Assistance

Traditionally, bank credit to industry has been mainly in the form of cash credit which was introduced by the Scottish bankers. Under the cash credit system, the bank bears the respon-sibility of cash management because the borrowers have the freedom to determine their drawals within the cash credit limit provided by the bank.

With a view to bringing about a better discipline in the utilisation of bank credit, in 1995 a "loan" system for delivery of bank credit was introduced. Under the new dispensation, within the MPBF so arrived at in terms of the extant guidelines, banks/consortia/ syndicates are required to restrict sanction of cash credit limits to borrowers up to a certain portion (which is currently 25 per cent) of the MPBF. Where borrowers desire to avail of bank credit for the balance portion (which is currently 75 per cent) of the MPBF, or any part thereof, this will be considered on merit by banks/consortia/syndicates in the form of a short-term loan (or loans) repayable on demand for working capital purpose for a stipulated period. Banks/consortia /syndicates will have the discretion to stipulate repayment of the short-term loan for working capital purposes by a borrower in instalments or by way of a "bullet" or ''balloon" payment. In case the loan is repaid before the due date, it will be credited to the cash credit account.

Information and Reporting System

While banks can devise their own information and reporting system they largely follow the system recommended by the Chore Committee. Its key components are as follows:

1. ***Quarterly Information System—Form I*** This gives (i) the estimates of production and sales for the current year and the ensuing quarter, and (ii) the estimates of current assets and liabilities for the ensuing quarter.
2. ***Quarterly Information System—Form II*** This gives (i) the actual production and sales during the current year and for the latest completed year, and (ii) the actual current assets and liabilities for the latest completed quarter.
3. ***Half-yearly Operating Statements—Form III*** This gives the actual operating performance for the half-year ended against the estimates for the same.
4. ***Half-yearly Funds Flow Statement—Form IIIB*** This give the sources and uses of funds for the half-year ended against the estimates for the same.

The thrust of the information and reporting system is (i) to strengthen the partnership between the borrower and the banker, (ii) to give the banker a deeper insight into the opera-tions and funds requirements of the borrower, and (iii) to enable the banker to

monitor closely the performance and efficiency of the borrower.

Public Deposits

Many firms, large and small, have solicited unsecured deposits from the public in recent years, mainly to finance their working capital requirements.

Cost

The interest rate payable on public deposits was subject to a ceiling of till mid-1996. Just before the ceiling was withdrawn, it was 15 per cent. When the ceiling was withdrawn in 1996, companies started offering higher returns. Some of the NBFCs offered about 20 per cent. Due to unhealthy competition, RBI has re-imposed the ceiling of 15 per cent.

Regulation

The Companies (Acceptance of Deposits) Amendment Rules 1978 governs fixed deposits. The important features of this regulation are:

- Public deposits cannot exceed 25 per cent of share capital and free reserves.
- The maximum maturity period permitted for public deposits is 6 months and the maximum maturity period allowed is 3 years. For non-banking financial corporations (NBFCs) however, the maximum maturity period is 5 years. A minimum maturity period of 3 months, however, is allowed for deposits amounting to 10 per cent of share capital and free reserves.
- A company which has public deposits is required to set aside, as deposit or investment, by 30th April of each year, an amount equal to 10 per cent of the deposits maturing by 31st March of the following year. The amount so set aside can be used only for repaying such deposits.
- A company inviting deposits from the public is required to disclose certain facts about its financial performance and position.

Evaluation

Public deposits offer the following advantages to the company:

- The procedure for obtaining public deposits is fairly simple.
- No restrictive covenants are involved.
- No security is offered against public deposits. Hence the mortgageable assets of the firm are conserved.
- The post-tax cost is fairly reasonable.

The demerits of public deposits are:

- The quantum of funds that can be raised by way of public deposits is limited.

- The maturity period is relatively short.

Inter-Corporate Deposits

A deposit made by one company with another, normally for a period up to six months, is referred to as an inter-corporate deposit. Such deposits are usually of three types:

- ***Call Deposits*** In theory, a call deposit is withdrawable by the lender on giving a day's notice. In practice, however, the lender has to wait for at least three days. The interest rate on such deposits may be around 12 per cent annum.
- ***Three-months Deposits*** More popular in practice, these deposits are taken by borrowers to tide over a short-term cash inadequacy that may be caused by one or more of the following factors: disruption in production, excessive imports of raw material, taxpayment, delay in collection, dividend payment, and unplanned capital expenditure. The interest rate on such deposits is around 14 per cent annum.
- ***Six-months Deposits*** Normally, lending companies do not extend deposits beyond this time frame. Such deposits, usually made with first-class borrowers, carry an interest rate of around 16 per cent per annum.

Characteristics of the Inter-Corporate Deposit Market

It may be of interest to note the following characteristics of the inter-corporate deposit mar-ket.

- ***Lack of Regulation*** The lack of legal hassles and bureaucratic red tape makes an inter-corporate deposit transaction very convenient. In a business environment otherwise characterised by a plethora of rules and regulations, the evolution of the inter-corporate deposit market is an example of the ability of the corporate sector to organise itself in a reasonably orderly manner.
- ***Secrecy*** The inter-corporate deposit market is shrouded in secrecy. Brokers regard their lists of borrowers and lenders as guarded secrets. Tightlipped and circumspect, they are somewhat reluctant to talk about their business. Such disclosures, they apprehend, would result in unwelcome competition and undercutting of rates.
- ***Importance of Personal*** Contacts Brokers and lenders argue that they are guided by a reasonably objective analysis of the financial situation of the borrowers. However, the truth is that lending decisions in the inter-corporate deposit markets are based on personal contacts and market information which may lack reliability. Given the secrecy that shrouds this operation and the non-availability of hard data, can it be otherwise?

Short-term Loans from Financial Institutions

The Life Insurance Corporation of India, the General Insurance Corporation of India, and the Unit Trust of India provide short-term loans to manufacturing companies with an excel-lent track record.

Eligibility

A company to be eligible for such loans should satisfy the following conditions:

- It should have declared an annual dividend of not less than 6 per cent for the past five years. (In certain cases, however, this condition is relaxed provided the company has paid an annual dividend of at least 10 per cent over the last three years.)
- The debt-equity ratio of the company should not exceed 1:5:1.
- The current ratio of the company should be at least 1:33.
- The average of the interest cover ratios for the past three years should be at least 2:1.

Features

The short-term loans provided by financial institutions have the following features:

- They are totally unsecured and are given on the strength of a demand promissory note.
- The loan is given for a period of 1 year and can be renewed for two consecutive years, provided the original eligibility criteria are satisfied.
- After a loan is repaid, the company will have to wait for at least 6 months before availing of a fresh loan.
- The loans carry an interest rate of 18 per cent per annum with a quarterly rest, which works out to an effective rate of 19.29 per cent per annum. However, there is a rebate of 1 per cent for prompt payment, in which case the effective rate comes down accordingly.

Rights Debentures for Working Capital

Public limited companies can issue "rights" debentures to their shareholders with the object of augmenting the long-term resources of the company for working capital requirements. The key guidelines applicable to such debentures are as follows:

- The amount of the debenture issue should not exceed (a) 20 per cent of the gross current assets, loans, and advances minus the long-term funds presently available for financing working capital, or (b) 20 per cent of the paid-up share capital, including preference capital and free reserves, whichever is the lower of the two.

- The debt: equity ratio, including the proposed debenture issue, should not exceed 1:1.
- The debentures shall first be offered to the existing Indian resident shareholders of the company on a *pro rata* basis.

Commercial Papers

An emerging source of financing working capital requirements of corporate enterprises is Commercial Paper (CP). Commercial paper is a short-term money market instrument, consisting of unsecured promissory notes with a fixed maturity, usually between seven days and three months, issued in bearer form and on a discount basis. Issue may be made on an interval basis or more generally under revolving underwriting facility extended by banks, tailored to the needs of the cash flow requirements of the issuer. Thus, commercial paper is a Certificate evidencing an unsecured corporate debt of short maturity. It represents a promise by the borrowing company to repay loan at a specified date. In law, the CP comes closest to a "Promissory note."

Since CP represents unsecured, short-term promissory notes, only the highly reputed and creditworthy companies are able to take advantage of this source of funds.

Commercial paper can be sold directly by issuing company or through commercial paper dealers who either act as broker or purchase the paper outright for quick resale. Issuing companies tailor both the maturity and the amount of the notes to the needs of the investors. Thus. the maturities and amounts of the notes to the needs of the investors. Thus, the maturities and amounts of directly placed paper cover a wide range of combinations.

Commercial paper is different from banker's acceptance. Thus, in the former it is the obligation of the issuing company while in the case of the latter both the drawer and the accepting bank have obligations. Another major difference is that issues of commercial paper do not have to be tied to a specific transaction whereas in most of the circumstances banker's acceptances have to be tied to a specific transactions.

Genesis of Commercial Paper

The genesis of commercial paper is to enable highly rated Corporate borrowers to diversify their sources of short-term borrowings and also to provide an additional instrument to investors. A CP is not tied to any specific trade transaction.

It differs from other money market instruments like bankers' acceptances in the sense that it is an obligation of the issuer only, whereas acceptances are obligations of both the drawer and the accepting bank. A CP does not carry any underlying collateral security.

Basically, the issue of CPs is an important step in financial disintermediation bringing the borrower and the investor in touch with each other, without the intervention of the banking system as financial intermediary. However, to the extent CPs substitute the working capital loan, the banking system would lose its loan portfolio and probably would losts its deposits as well, if the funds were with the banking system before investment in CP. The banks end up losing both the asset and the liability through this disintemediation process and the profit margin earned on the march would vanquish. Theory suggests that the CPs would be predominantly funded by the short-term surplus of the corporate sector. This is unlikely to be true in India, especially when the market expands. The corporate sector will continue to the issue of CPs, intercorporate loans and portfolio management scheme for employing their surplus and in the long run, it is the money in the banks that will find its way to the CP market. Further CP facilitates securitisation of loans resulting in creation of a secondary market for the paper and efficient movement of money providing cash surpluses to cash deficit entities. In international context, securitisation of debt paves way to globalisation of loan assets.

Potentiality of Commercial Paper as a Source of Corporate Finance

Commercial paper serves as a very useful instrument for meeting working capital needs of firms. However, only large and well established business enterprises with a track record of high creditworthiness can make use of CP as a means of financing their short-term needs because CP is an unsecured promissory note and does not carry any tangible security. Basic reason for popularity of CP as a means of financing is that it is usually less expensive than short-term bank credit by about 1 to 2 per cent and cost differential increases in periods of easy money. Since no compensating balance requirements are associated with the issuing of CP, cost of its issue would further be lower than that of the bank credit. Another reason for the usefulness of CP as a source of financing is that by means of this instrument firms can raise large amount of funds which they cannot take from a single bank. CP provides sufficient flexibility in business financing in as much as issuing firm may decide the quantum of CP and its maturity on the basis of its future cash flows. Financially, use of CP adds to the prestige of the issuing company, it seems more likely that the prestige was there before the paper was sold.

A significant drawback of this source of financing is that it is less reliable source of credit than bank loans. Because of the impersonal nature of the market, a buyer of commercial paper feels no obligation "to see the borrower through" a period of hard times or tight money. Buyers of CP simply look for the best yield possible for a short-term investment at a minimum risk. Thus, alacrity with which buyers of CP will switch to more attractive investments leaves firms high and dry in hard days when money market condition becomes tight forcing the management to seek funds from banks. It is

generally noted that banks do not look favourably on credit requests only in periods of tight money. A firm relying too heavily on CP may, therefore, find itself shut off from an important source of capital in future periods of need. Therefore, a finance manager must be careful not to impair relations with its bank. He must maintain lines of credit of commercial banks in order to tide over money market conditions. Another limitation is that CP must be paid when due. There is no extension of maturity, as in the case of a short-term bank loan.

Growth of Commercial Paper Market

The roots of commercial paper can be traced back in the early 19th century when the firms in the U.S.A. began selling open market paper as a substitute for a bank loan needed for satisfying short-term financial require-ments. These firms facing great problem in getting loan from banks because of the existence of the unit-banking system were compelled to go to the market directly to raise resources from cities like New York.

During the first hundred years or so, the CPs were issued by non-financial business firms only. But subsequently, consumer financial companies also began issuing the paper, first through dealers and later directly with investors. By early 1950s, the U.S.A. had a large market for CPs. The commercial paper market in the U.S.A. is highly organised and sophisticated and the paper must be sold in denomination of $ 100,000. The issuing companies tailor both the maturity and the amount of the paper to the needs of the investors. Thus, the maturities and amounts of directly placed paper cover a wide range of combinations. Most U.S. papers are exempted from registration under the U.S. Securities Act, 1933. They have a maturity span of 270 days or less which is longer than the Indian paper. Under Section 3(a) (3), CPs are sold only to accredited investors to finance non-current transactions.

The U.S. marketed commercial paper worth $ 323 billion in 1986 accounting for over 90 per cent of the value of issues outstanding with all national CP markets is by far the largest in the world.

The U.K. CP market is modelled after the U.S. CP market. The Bank of England has prescribed that the issuer of the sterling CP must have net assets of at least U.K. Pound 50 million with shares listed in the Stock Exchange in London or be a wholly owned subsidiary guaranteed by a parent which fulfils this criteria. Further, only a public limited company can issue CP. The maturity period of CPs range between 7 and 364 days.

In Canada, the second most important and the oldest commercial paper market where CP was launched in the early fiftees, the CPs are generally issued for a term ranging from 7 to 364 days. CP issued by a Canadian company is generally secured by the pledge of assets.

In Japan Yen paper was issued in 1987. It carries maturities ranging from two weeks to nine months. Normally maturity period varies between 3 months and 4 months.

In Hongkong commercial paper market was opened in 1979 when MTRC (Mass Transit Railway Corporation) issued CPs. In Singapore CP was intro-duced for the first time in 1980 when the Singapore merchant bank, DBS Daiwa, issued a CP on behalf of C.I. to, a Japanese trading company.

Commercial paper in India came into existence in early 1990 following striking developments in Indian money market. In recent few years, there was unprecedented transformation in the money market from a highly regulated, narrow illiquid and shallow market to a highly liberalised, substantially deregulated vibrant market blessed with new money market instruments. The new monetary policy adopted by the Reserve Bank of India to update and upgrade the existing money market in India, gave birth to the 182 days treasury bills, Inter Bank participations, Certificates of Deposits and Commercial Papers. A highly specialised money market institution, 'Discount and Finance House of India Ltd.', was set-up. Ceiling on the rates in the call money market was removed. The new financial services market came into existence with a large number of banks permitted to set-up their subsidiaries for promoting merchant banking, investment banking, equipment leasing, venture capital finance, etc. It was in the wake of these developments that CP was launched in our country.

Since the inception of CPs scheme in India in January, 1990,23 companies issued CPs worth Rs. 419.4 crores (50 issues) till June 30,1991. There has been phenomenal progress in the CP market in recent years in as much as it rose from Rs. 4,000 crores in December, 1993 to Rs. 9,000 crores in June 1994. Although the maturity period of CPs issued by the companies varied from three to six months, the majority of CPs were issued with a maturity of six months. The effective interest rates were in the range of 11.7 to 18.50 per cent.

Regulatory Framework for Commercial Paper

Following the recommendation of the Vaghul Committee on the develop-ment of the money market in January, 1987, the RBI announced the broad scheme of CP in its Credit policy in March, 1989. In January, 1990 the RBI issued detailed guidelines for the issue of CP. These guidelines were modified in April, 1991.

The major features of these guidelines are:

(i) (a) An issuing company must have a tangible network of atleast Rs. 10 crores.

(b) The company must enjoy a fund-based Working Capital limit of Rs. 10 crores and above.

(c) Have a minimum Current ratio of 1.33:1.

(d) The Company must obtain a PI rating from Credit Rating and Information Services of India Ltd. which should not be more than 2 months old at the time of issue.

(e) The company must have Health Code No. 1 raising from the Company's brokers.

(f) The company must have got its shares listed on atleast one stock exchange.

(ii) Minimum size of a CP issue is Rs. 25 lakhs and the face value of each CP instrument should be Rs. 5 lakhs.

(iii) The maximum amount that can be issued by issue of CP will be 30% of the fund-based working capital limit. Once the issue is placed in the market, the fund-based working capital limit of the company will be correspondingly reduced.

(iv) The issuing company has to get the RBI permission every time it issues CP and the RBI will operate a queue system to regulate the CP market.

(v) CP may be issued to any person or corporate bodies registered or incorporated in India (including banks) as well as unincorporated bodies.

(vi) The issue of CP cannot be underwritten or coaccepted in any manner.

(vii) The paper being a usance promissory note, will be negotiable by endorsement and delivery'. The discount rate shall be determined by the free market.

Recently, RBI liberalised the terms of issue of CP to come into force retrospectively from May 30, 1991. According to the liberalised terms, proposals by eligible companies from the issue of CP would not require prior approval of the RBI. Such companies would have to submit the proposals to the financing banking company which provided working capital facility either as a sole banker or as a leader of the Consortium. The Bank on being satisfied of the compliance of then norms would take the proposal on record before the issue of CP.

In its attempt to boost up commercial paper market in the country the RBI further relaxed rules in June, 1992. Thus, the minimum working capital limit required by a company to issue CPs has been slashed to Rs. 5 crores from Rs. 10 crores. The minimum rating required from CRISIL has been lowered to P_2 from P_1 while the minimum rating needed from ICRA is now A_2 instead of A_1. Further the ceiling on the aggregate amount which can be raised through CP has been raised to 75% of the working capital from 30%. A closely held company has also been permitted to borrow CPs provided all the criteria are met.

According to the RBI's monetary policy for the second half of 1994-95, the stand-by facility for commercial paper (CP) has been abolished. As per the policy when CPs are issued, banks will have to effect a pro rata reduction in the cash credit limit and it will no

longer be necessary for banks to restore the cash credit limit to meet the liability on maturity of CPs. This will impart a measure of independence to CP as a money market instrument. The intrinsic strength of the issuing company will be reflected from the ratings of its CP.

Although CP has been delinked from working capital limits, the ceiling of 75 per cent of maximum permissible bank finance continues. Thus, with the revised guidelines an issuing company will have to approach the bank every time to have a higher cash credit limit, once it issues CP and its cash credit limit is brought down to that extent. Now, CP will not be a self-liquidating arrangement. Earlier, there was a virtual guarantee by the bankers to adjust the CP on maturity which definitely was an added advantage.

Future of Commercial Paper in India

Commercial paper as vibrant instrument of financing working capital needs has a very bright future in changing economic scenario in view of growing liberalisation and decontrol and widening openings for the private sector even in strategic sectors of the economy. Corporate enterprises requiring burgeoning funds to meet their expanding needs will find it easier and cheaper to raise funds from the market by issuing commercial paper. Furthermore, use of this instrument provides greater degree of flexibility in business finance to the issuing company in as much as it can decide the quantum of CP and its maturity on the basis of its future cash flows.

Fears are expressed in some quarters that popularity of CP will adversely affect the banks' business. However, the situation will not be as alarming as is made out. It must be noted that the use of CP is restricted only to highly creditworthy and large profitable organisations. Medium and small enterprises will, therefore, have no alternative but to resort to banks for their working capital needs. Demand for bank loans will certainly surge in future owing to massive expansion that it likely to take place in small sector in view of the current industrial policy of the Government. In the events of any loss of income the same may be effected by fees earned by the banks in their capacity as issuing and paying agents of the papers.

However, the popularity of CP as the most lucrative means of short-term finance will pass through the acid test in view of delinking of CPs from cash credit facilities. With the delinking, CP will not be a self-liquidating arrange-ment. In the changed situation, corporates will prefer the cash system of CP as against issuance of CPs which will result in better utilisation of cash credit limits. There can be two probable ways to increase the credit off take. One way of giving impetus to cash credit could be by offering a finer rate to the borrowers who on an average avail themselves of 70 per cent or above of cash credit limits.

As a corollary to this, a commitment fee of 1. 5 to 2 per cent on the utilised cash credit limits on the unutilised cash credit limits will be added to the cost of funds being raised through commercial papers offsetting, to some extent, the lowered interest rate on CP. Further, the issuing companies will now no longer have banks' funds as stand-by facility and they can no longer place reliance on the banks' working capital limits to meet the liability on maturity of CPs. Under the circumstances CPs will continue to be issued but will be restricted only to good companies with inherent strength.

Although CPs have made a good start, its future will depend on a number of factors. First such factor is conditionalities imposed on issue of CPs. Too many restrictions presently clamped on issuing companies are likely to kill the potentiality of CP as a source of corporate financing. For instance, companies in India do not have the discretion about the timing of CP issues and their roll overs. It is the RBI which decides in these matters. Further, the companies would find it impossible to roll over the CP issue in view of the queue system operated by RBI for CP issues. For instance, CP issue by a company is dated 1lth March, 1991. After six months, the instrument matures and the company has to get into the queue system for the next CP issue. The stipulation that only companies rated PI are eligible to issue CPs is much too harsher. There are some good companies with PI rating who have been deprived of opportunities to issue CP. The highly rigid liquidity norms do ensure impeccable quality standards but they suffocate the growth. For commercial paper market to grow, issuers must have option to offer CPs with attractive terms including maturity range, denominational range and interest rate range. Indian CP as such is not going to attract investors of varied notions and preferences. The minimum time limit of 3 months does not seem to be short enough and funds will unnecessarily be tied. It is felt that the inactivity period should be as less as 15 days. It would indeed be a milestone in corporate financing if a tax exempt commercial paper is introduced in the market. Such paper could be issued by public sector undertakings, mutual funds, all-India financial institutions etc. Further the short-term paper through regular roll overs can ensure regular supply of funds.

The RBI should explore the possibility of opening the door of the commercial paper market to international investors on the same lines as offshore mutual funds. Initially the profitable public sector undertakings may be allowed to issue foreign currency denominated paper only to international institutions, pension funds, provident funds and development banks.

In sum, commercial paper as an instrument of corporate finance has tremendous scope if structural rigidities are removed and only such regulatory measures are taken by the RBI as are justifiable to issuers, investors, dealers and other concerned parties to the paper.

Factoring

Backdrop

With growing industrialisation and consequential growth in the volume of industrial production and sales, timely collection and efficient management of receivables has assumed importance. In the buyer's market of today, it seems to go without observing that one should demand credit on one's purchases and give credit on sales. The system feeding on itself is self-perpetuating. Since sales always exceed purchases during a given period, a larger amount of credit is given than taken and if collections are delayed, liquidity of the firm is badly affected. The problem becomes more serious for smaller enterprises due to their relatively weak financial position and limited access to capital market.

To handle this problem and prompted debt collections, companies in the USA, UK and most European countries have resorted to factoring services in one form or the other as an alternative method of converting accounts receivable into cash. These services have recently been extended in some South American countries as well as countries in the south Eastern and Far Eastern parts of Asia. Factoring in these countries covers both domestic and international trade. The USA and European Countries account for nearly 90 per cent of global factoring turnover at present Is India need for introducing factoring is being keenly felt.

Concept of Factoring

Factoring is a method by which a businessman can obtain cash for invoices he sends to his customers in respect of supply of goods and services to them. Factoring is also termed as 'Invoice Discounting.' Factoring involves the sale of receivables to a financial institution such as an old line factor—a commercial financial company or one of a few commercial banks. The factor purchases accounts acceptable to him generally without recourse; if the customer does not pay, the factor takes the loss. The client no longer carries factored account receivable on his balance sheet, in effect having converted them into cash. Firms owing the accounts receivable to client firms are notified that the account has been sold to the factor and are asked to remit directly to the factor.

It is noteworthy that the factor seldom agrees to buy all of the accounts receivable of a client firm; instead, he retains the right to screen the accounts and selects those acceptable to him. The client firm can continue to sell to customers whose accounts are unacceptable to the factor, but it must carry them itself and assume all risks on them.

Factoring involves rendering of services varying from the bill discounting facilities offered by commercial banks to a total takeover of administration of the sales ledger and credit control functions, from credit approval to collecting cash, credit insurance and provision of finance. Factoring agreement is normally continuous. As new receivables arise, they

are regularly sold to the factor. Under the typical factoring arrangement the client maintains a running account with the factor. As receivables are sold to the factor, the proceeds are put at the client's disposal in this account. Often, clients are given the privilege of overdrawing their account with the factor, or, in effect, of borrowing on an unsecured basis, in addition to drawing against the proceeds of the factored accounts. Also, interest is normally credited by the factor on funds left with him.

Functions of Factoring

A factor performs a number of functions for his client. These functions are:

1. Maintenance of Sales Ledger

A factor maintains sales ledger for his client firm. An invoice is sent by the client to the customer, a copy of which is marked to the factor. The client need not maintain individual sales ledgers for his customers. On the basis of the sales ledger the factor reports to the client about the current status of his receivables, as also receipt of payments from the customers and as part of a package, may generate other useful information. With the help of these reports, the client firm can review its credit and collection policies more effectively.

2. Collection of Accounts Receivables

Under factoring arrangements a factor undertakes the responsibility of collecting the receivables for his client. Thus, the client firm is relieved of the rigours of collecting debts and thereby enables to concentrate on improving the purchase, production, marketing and other managerial aspects of the business. With the help of trained manpower backed by infrastructural facilities a factor systematically undertakes follow up measure and makes timely demand on the debtors to pay the amounts.

Normally, debtors are more responsive to demands or reminders from a factor as they would not like to go down in the esteem of credit institution as a factor.

3. Credit Control and Credit Protection

Another useful service rendered by a factor is credit control and protection. As a factor maintains extensive information records (generally computerised) about the financial standing and credit ratio of individual customers and their track record of payments, he is able to advise its client on whether to extend credit to a buyer or not and if it is to be extended the amount of the credit and the period therefore. Further, the factor establishes credit limits for individual customers indicating the extent to which he is prepared to accept the client's receivables on such customers without recourse to the client. This specialised service of a factor assists clients in handling far greater volume of business with confidence than would have been possible otherwise.

In addition, factor provides credit protection to his client by purchasing without recourse to him every debt of approved customers (within the stipulated credit limit) and assumes the risk of default in payment by customers only in case of customers' financial inability to pay.

4. Advisory Functions

At times, factors render certain advisory services to their clients. Thus, as a credit specialist a factor undertakes comprehensive studies of economic conditions and trends and thus is in a position to advise its clients of impending developments in their respective industries. Many factors employ individuals with extensive manufacturing experience who can even advise on work loan analysis, machinery replacement programmes and other technical aspects of a client's business.

Factors also help their clients in choosing suitable sales agent because of their close relationships with various individuals and non-factored organisations.

Types of Factoring

Over a period of time, the factors world over have devised different types of factoring services to suit the requirements of their clients. On the basis of the nature of the services, factoring may be categorised as:

1. Full Factoring
2. Recourse Factoring
3. Maturity Factoring
4. Advance Factoring
5. Undisclosed Factoring
6. Invoice Discounting
7. Buyer-based Factoring
8. Seller-based Factoring

1. Full Factoring

Under full factoring arrangement, a factor renders services of collection of receivables and maintains sales ledgers, credit control and credit protection. On the basis of credit worthiness of the firm a monetary limit is fixed upto which trade credit provided by the client will be taken over by the factor without recourse to the client. The liability of the factor is limited only to the defaults arising out of customers' financial inability to pay. If the payment is withheld for reasons of dispute regarding inherent defect in goods, quality, quantity, counter claim, etc., recourse will be available to the factor against the client.

2. Recourse Factoring

In this type of factoring the factor does not provide any protection to the client against a customer's failure to pay debts. It may, therefore, not be necessary for the factor to either approve the customer or fix a credit limit. If the customer does not pay the invoice on maturity for any reason, the factor is entitled to recover from the client the amount paid in advance.

3. Maturity Factoring

This type of factoring involves no financing *ab initio* and hence no drawing limit is made available to the client. But the factor administers the client's sales ledger and renders debt collection services. The amount of each invoice is made over to the client at the end of the credit period on an agreed maturity date, less the factor charges. The maturity date is decided upon at the commencement of the agreement by reference to the average-time taken by the client to collect a debt. The maturity date bears no relation to the date on which the receivable is actually due for payment as it is a 'estimated data of collection.'

Such factoring could be with or without recourse. If it is without recourse, the amount will be made over to the client regardless of whether the factor has been able to collect the invoice or not. If the debtor becomes insolvent, on proof of involvency, payment will be made to the client even before maturity. In with recourse factoring, the factor will either pay the client on collection of invoice or on maturity date with recourse later on.

4. Advance Factoring

In this kind of factoring, factor is prepared to pay for debts in advance of receiving the payment due from the customers. This is only a prepayment and not an advance. A drawing limit is made available to the client as soon as the invoice is accounted for.

5. Undisclosed Factoring

Unlike all other types of factoring, in undisclosed factoring customers are not informed about the arrangements between the factor and the client The factor maintains the sales ledger on the basis of the copy of invoice. He provides the client with either debt default cover or finance or both as desired. Debt collection is done by the client who makes over payment of each invoice to the factor. The factor keeps a check on its risk by receiving from the client on age-wise analysis of debts at regular intervals. The types of services which may be offered under an undisclosed arrangement are very flexible. This may be on non- recourse basis and/or seasonal and/or selective basis.

6. Invoice Discounting

Under this arrangement the factor buys all or selected invoices of its client at a discount. The factor neither maintains sales ledger for his client nor undertakes debt collection function. He only provides finance to his client.

7. Buyer-based Factoring

Buyer-based factoring involves factoring of all the buyer's payables. Thus, the factor would maintain a list of 'approved buyers' and any claims on such buyers (by any seller) would be factored without recourse to the sellers.

8. Seller-based Factoring

In this type of factoring the factor takes over the credit function of the seller entirely. After invoicing his customer (who should be previously cleared by the factor), the seller submits a copy of the invoice, the delivery, challan, the buy-sell contract and related papers like quality stipulations and test certificate to the factor who takes over the remaining operations like reminding the buyer for payment, maintaining his account and collecting the amount The seller closes his transaction after assigning the debt to the factor, by treating the transaction as a cash sale. In such a case, the factor is also able to supply additional information to the management, viz., approved, unapproved and disputed claims outstanding, sales analysis by area, by salesman, by products, etc., excise and sales tax payments and the like.

Modus Operandi of a Factor

Where a firm has decided to factor its receivables, it submits particulars such as list of customers, amount of the order, terms of sales, etc., in the case of 'approved' buyers and 90% of the invoice less commission to the factor before despatching any merchandise to its customers. The factor scrutinises each customer's account of the client firm to make a decision whether to 'accept' or 'reject.' A decision may also be taken to 'limit' purchases on account of a single 'buyer.' The factor returns to the client the list submitted with these orders. The client is free to supply to a customer, who has been rejected by the factor at his own risk.

After the goods are despatched, the client firm prepares an assignment schedule and attaches a copy of invoice and deliver challan. In this assignment schedule, complete details about the sale, such as the customer's name, address, terms of sale, due dates and amounts of invoices are recorded. The invoices are stamped before being sent to the buyer directing him to make the payment to the factor. Sufficient copies of each instrument are made out in advance so that all the parties involved have records.

The factor scrutinises the assignment schedule to segregate 'approved' and 'unapproved' buyers. The client company's account is then credited with the entire amount of the invoice less commission, in the case of 'approved' buyers and 90% of the invoice less commission, for 'unapproved buyers.'

The factor prepares on 'accounts current' at the end of the month to reveal the exact financial standing the client has with him. The interest charges and commissions are also recorded therein.

Potentiality of Factoring as a Source of Short-term Finance

Factoring is becoming popular all over the world in view of the variety of services rendered by factors to business organisations. Its importance has tended to increase in recent years owing to growing industrialisation and consequential growth in the volume of industrial production and sales. A factor, by dint of the function of buying debts without recourse, not only provides financial support to his client firm and meets a portion of its working capital, but also relieves the latter of the botheration of collecting the receivables from the customers and suffering losses due to bad debts. The firm may also avoid the necessity of operating a credit department for analysis and collection.

In addition to rendering financial assistance, a factor assists his client in credit planning and control. On the basis of the information and assessment of creditworthiness of potential customers, a factor is able to advise his client whether to extend credit to a particular buyer or not, and if it is to be extended, the amount and period therefor.

A factor may also generate other useful information for his clients. The factor, on account of a large volume of transactions handled by him, is in a position to computerise the operations and hence is equipped to perform book-keeping services for more efficiently and expeditiously than an average business concern.

It is important to note that firms that are small or have seasonal sales patterns may realise substantial savings in credit and collections because the factor serving a large number of accounts can realise economies of scale and also can achieve better diversification with respect to default risk.

However, the most critical fall-out of factoring is institutionalisation and perpetuation of credit and perhaps even delayed payments. Further, any tough stance taken by the factor against a defaulting buyer may have its direct impact on such borrower cutting short his orders on the particular seller. In a buyer's market, few sellers can afford to irritate customers.

Need for Factoring in India

At present the commercial banks in India provide working capital finance through purchasing/discounting of receivables allowing over-draft/cash credit • against hypothecation of outstanding book debts, allowing over-draft/cash credit against bills sent for collection through the bank and allowing overdraft/cash credit against amounts due from Government/Semi-government agencies in respect of supplies made to them. While the banks do finance the receivables, such finance is with recourse to the supplier who bears the risk of default by the debtor. The bank's credit support to the supplier is, thus, for a limited or pre-determined period and on the expiry of the said period, if the dues are not realised, it generally calls upon the supplier/borrower to repay the finance. Thus, the bank finance is always with recourse to the seller, i.e., if the buyer fails to make payment for any reason, the bank recovers the amount involved from its customer, viz., the seller.

Further, banks provide collection services only in respect of bills purchased/discounted or not. But they do not undertake collection of book debts (open account sales) of their customers.

The existing arrangements are not adequate to cater to all the requirements of seller in present conditions. Thus, the basic problems faced by sellers is the growing pressure on their working capital resources on account of their inability to obtain timely payment for their credit sales. While for sales on open element for the period the credit is normally expected to be outstanding, often interest is realised for the period the payments are delayed for the estimated time. Due to growing competition sellers hardly insist on payment of overdue interest and hence frequently suffer erosion in profit margins and working capital deficits.

Delayed payment spanning up to 5 month or more is fairly widespread. At times delayed payment is due to problems experienced by buyers in realising their own dues, thus indicating inter-dependence of different sectors in ensuring timely payments.

The problem of delays could be mitigated to a great extent if there is an efficient system of receivables management and collection machinery. At present only large organisations have separate credit management departments exclusively to attend to these matters. SSI units can hardly afford a separate staff for the purpose. Quite often, when required to attend to their recovery personally. Consequently, they are unable to give due attention to improving their products and enlarging their markets.

While some information on creditworthiness and reliability of buyers in far off places could be obtained through the banks, the information so available is not adequate for the supplier to know the operational, financial and market status of the buyer to decide upon credit terms which may be offered. As a result, they follow cautious approach.

In view of the above, desirability and usefulness of factoring services to suppliers of goods of services in India was considered by the Reserve Bank of India in January, 1988 when it appointed a study group under the chairmanship of Mr. C. S. Kalyansundaram, Ex-managing director of State Bank of India, to examine the feasibility and mechanics of starting factoring organization in India and recommending for their constitution, organisational set-up, scope of activities and other related matters.

While recognising the need for specialised agencies for handling factoring business, the group has cautioned that factoring *per se* would not be a complete solution for delays and defaults in payments. However, it feels that the professional approach of factor in credit assessment, debt collection, manage-ment of sales ledger, etc. should bring about a noticeable improvement in the payment culture.

The group has estimated the aggregate potential demand for factoring services at about Rs. 4,000 crores, it is of the view that in the early years, demand for factoring services would mainly emerge from the SSI sector and those medium and large units, which are

experiencing collection delays particularly in industries such as light engineering, textile, consumer durables, automobile ancillaries and chemicals.

Pricing of Factoring Services

A factor charges fee for the services rendered by it to the client. The fee charged varies depending on the type of services and creditworthiness, quality of portfolio and turnover of the clients. Normally the factoring fee in the U.S., U.K. and European Countries ranges between 1 and 3% of the face amount of the receivables purchased.

If funds are advanced to the seller before the receivables are collected by the factor, an additional interest charge is levied that is normally tied to, and above the prime rate.

In India, while a similar consideration can hold good, the base level of charges of the factors would depend upon the various costs to be borne by him, which in turn depend upon the cost of funds and the cost of management.

The RBI group feels that the price for factoring services may be around 16 per cent per annum for financing and 2.5 to 3 per cent for other services. It feels that such pricing should enable the factors to reach a level of business which will generate reasonable rate of return on their investment. It has emphasized that. the factors will have to become more efficient than banks in handling the receivables of their clients.

Factoring Organisation in India

In most of the developed countries commercial banks have set-up their subsidiaries to perform the factoring functions in view of the fact that banks have considerable experience and have easy access to credit information on both sellers and buyers. Their large network of branches as also availability of sufficient financial resources provide them additional advantages. A few banks in India are expected to set-up subsidiaries to provide factoring services soon.

The RBI study group has suggested that only select promoter institutions, groups of individuals with good trust record in finance and management should be permitted into this new field, at least in the early years. This is considered necessary since such institutions have to set-up good standards and inspire confidence in the public.

The group has further suggested that initially the organisations may be promoted preferably on zonal basis such as one each for north, east, south and west. As regards ownership of such institutions, it feels that factoring organisations in the private sector may not be able to raise sufficient resources at competitive cost for handling business of the expected magnitude. .

The report of the Working Group on Money Market (Vaghul Committee) constituted by the Reserve Bank of India has also recommended that banks should be encouraged to

set-up factoring divisions which could play a vital role in accelerating efficient and speedy flow of resources to the corporate entities.

Accordingly, Reserve Bank of India has, of late, allowed Canara Bank to set-up Corporate subsidiary with Rs. 10 crore Capital in co-operation with Andhra Bank and small Industries Development Bank to render factoring services in southern region. State Bank of India and Punjab and Sind Bank have been permitted to form subsidiary to provide factoring services in Northern region. With a view to catering to the needs of eastern region United Commercial Bank, United Bank of India and Allahabad Bank have been permitted to float subsidiary with Rs. 5 crores.

India's first factoring company was set-up jointly by Canbank Financial Services Ltd., and Rashtriya Chemical and fertilizers Ltd., to act as a specialised agency to dealers in fertilizers and farmers using the fertilizers through factoring of trade bills and receivables.

Bank Guarantees

Bank guarantee is one of the facilities that the commercial banks extend on behalf of their clients in favour o£ third parties who will be the beneficiaries of the guarantees. In fact when a bank guarantee is given no credit is extended and banks do not part with any funds. There will be only a guarantee to the beneficiary to make payment in the event of the customer on whose behalf the guarantee is given, defaulting in his commitment. So, if the customer fails to pay as per the terms of the guarantee, the banker giving the guarantee has to pay and claim reimbursement from his client. The banker's liability arises only if his customer fails to pay the beneficiary of the guarantee. That is why bank guarantee limits are known as non-borrowings limits or non-fund limits.

Important features - The following points are to be considered regarding bank guarantee:

- Guarantees should be for a definite period and as far as possible should not run for more than one year.
- The guarantees should be in respect of a definite object or enforceable on happening of a definite event.
- Guarantee should be in respect of transactions which arise out of trade and commerce, or any other genuine business.
- Guarantees should be specific as to amount.
- Guarantees should be covered by a counter guarantee by a customer giving the bank absolute right of payment under guarantee on the happening of contingency guaran-teed against.

- Reliable credit reports should be obtained on the customers for whom the guarantee is given. Such reports should be kept uptodate.
- The guarantees should as far as possible relate to the normal business of the customers. The banks will insist the customer to deposit the margin, depending on case to case, before the issue of bank guarantees. The banks will charge commission on bank guarantees issued or extended.

Asset securitisation

The emerging financial scenario has created a fierce competition among the companies to raise funds through innovative financial products from the capital and/or money markets. Additional source of capital can be accessed through securitisation relieving the normal receivable/deposit collection process for finance companies and banks, without disturbing the liabilities side of the balance sheet. Companies can rise finance and increase their lending activity thus enhancing the profitability.

Meaning - The term 'Securitisation' refers to both switching away from bank intermediation to direct financing *via* capital market and/or money market, and the transformation of a previously illiquid asset like automobile loans, mortgage loans, trade receivables, etc., into marketable instruments.

''Securitisation is a process of transformation of illiquid asset into security which may be traded later in the open market."

'Securitisation is the process of transforming the assets of a lending institution into negotiable instruments."

For banks and financial institutions, securitisation, fundamentally, involves conversion of long-term assets into a current asset. It is a structured transaction whereby the bank transfers or sells loans of a particular portfolio to a specially created trust which breaks the loan into convenient amounts and raises money from the investors by selling the instru-ments which represent the loan amounts.

In India, ICICI has paved the way by securitisation of bills of exchange in 1991, and later HDFC and a few other finance companies have adopted this method. At present a number of other companies are adopting this procedure.

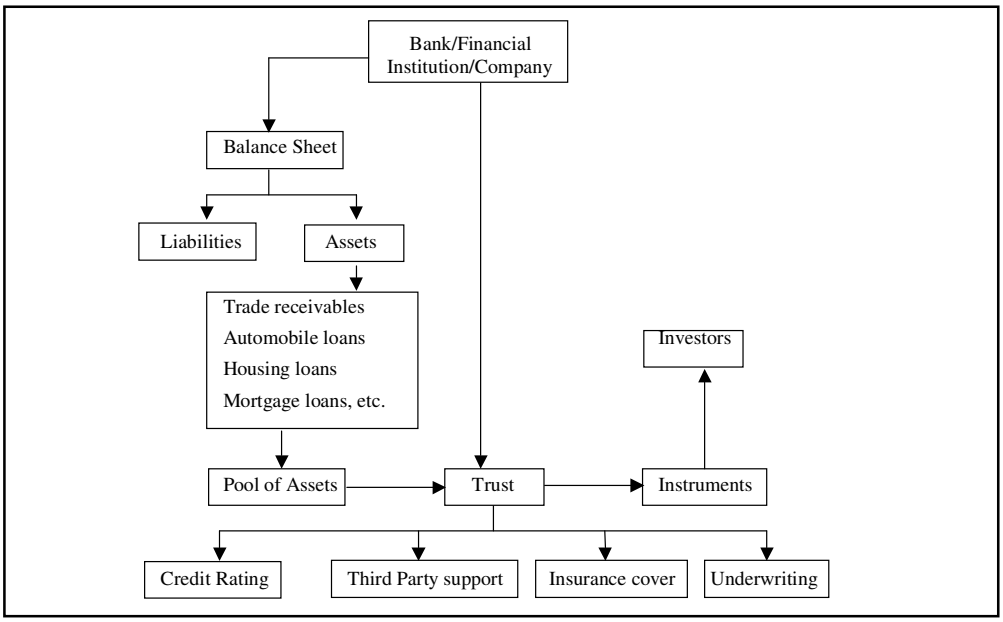
The illiquid assets such as mortgage loans, into loan receivable, cash credit receivables, etc., on the balance sheet of the originator (such as Finance Companies, Financial Institutions, Banks, etc.) are packaged, underwritten and sold in the form of securities to investors through a carefully structured process.

These securities could be in the form of commercial paper, participation certificates. Notes or any other form of security permissible under the legal frame work of the country. In a securitisation process, the underlying assets are used both as a collateral and also to generate the income to pay the principal and interest to the investors of the asset backed securities.

Securitisation process

- Firstly, assets have to be originated through trade receivables, lease rentals, housing loans, automobile loans, etc., according to their maturity pattern and interest rate risk and formed into a pool.
- Secondly, a trust has to be established solely to purchase receivable from the originator, create instruments according to the maturity period and risk of the asset, sell instruments and transfer the funds to the originator. The trust may also act as a receiving and paying agent.
- For this purpose, the trust has to obtain credit rating to make the transactions more attractive to the investor (although the rating is not mandatory).
- The trust would have to obtain some form of liquidity support from a third party lender to cover the possibility that the loan portfolio would generate insufficient payment when due. The trust may also have to obtain insurance cover, often provided by a pool insurance policy.
- It has to appoint a merchant banker or syndicate of merchant bankers for underwriting the whole issue.
- The securities have to be sold to the investors either by a public issue or by private placement.

Obviously, the good quality loans will be eligible for securitisation. The repayment pattern of assets in particular will be the deciding factor to structure the instruments.



Advantages

- The main benefit to the originator is the additional source of capital can be accessed through securitisation relieving the normal receivable, deposit collection process.
- Without disturbing the liabilities side of the balance sheet the originator can raise finances and increase their activity of lending which enhances the profitability.
- The originator can reduce their existing debtors and can reduce their risk.
- By selling the debtors in the form of securities, liquidity of the entity/bank can be enhanced.
- Cash coming in from sale of assets can be used to fund either capital and reserves or to lend again.
- In case cash is used to fund capital and reserves, it results in lowering the debt-equity ratio.
- If in case cash is lent, it increases the turnover and profit ultimately for the business.
- Securitisation also improves the income to asset ratio by increasing income on the one hand and reducing the total volume of assets on the other.
- The main benefit to an investor is that he gets a security which is backed by adequate collaterial and has credit enhancement.
- Most of such securities are rated by credit rating agencies. Hence, it becomes

relatively easier for an investor to compare the risk-return profile of asset backed securities with other investible instruments and make an informed choice.

- In a securitisation exercise the credit risk is shifted partially, or even completely from the issuer of securities to the securitised asset and/or third parties depending on the structure of the transaction. The security, thus, is insulated from other risks associated with the originator or the issuer.

The recent RBI directive that Banks shall extend 40% of the *maximum permissible bank finance* (MPBF) for amounts above Rs. 20 crores, by way of short-term loans repayable within one year, makes them an ideal asset for debt securitisation.

Loan transfers

This type of transaction, where loans are transferred to an existing third party without the creation of a new company, the issuer, as a vehicle for the deal. Technically loans cannot be sold in the same way as tangible assets, but there are three main ways in which the benefits and risks under the loan agreement can be sold to a third party.

- **Novation :** The rights and obligations attached to the loan are cancelled and replaced by new ones whose main effect is to change the identity of the lender.
- **Assignment:** Loans may be assigned by either a statutory or equitable assignment.
- **Sub-participation:** Rights and obligations are not transferred, but the lender enters into a non-recourse, back to back agreement with a third party, the sub-participant whereby the latter pays the lender some or all of the amount of the loan in return for a share of the cash flows.

In this type of transaction the original lender:

- has no residual beneficial interest in the principal of the loan and that the sub-participant has

  no formal recourse to the lender for losses.
- has no obligation to provide further finance.
- does not intentionally bear any losses from interest rate changes.

Hedging approach to working capital financing

Under *hedging approach* to financing working capital requirements of a firm, each asset in the balance sheet assets side would be offset with a financing instrument of the same approximate maturity. The basic objective of this method of financing is that the permanent component of current assets, and fixed assets would be met with long-term funds and the short-term or seasonal variations in current assets would be financed with short term debt. If the long term funds are used for short-term needs of the firm, it can identify and take steps to correct the mismatch in financing.

Consortium lending and loan syndication by banks

When the individual bank finds it difficult to meet the huge financial requirements of a borrower, it gives rise to multiple banking which may be in the forms (i) Consortium lending or (ii) Loan syndication.

Consortium lending- When the financial needs of a single unit are more than a single bank can cater the needs, then more than one bank come together to finance the unit jointly spreading the risk as well as sharing the responsibilities of monitoring and finance. The arrangement is called the '*consortium lending*' and it enables the industrial units to mobilise large funds for its operations. This is generally formalised by a consortium agreement. RBI has advised that banks which are lending to units requiring large outlay of funds form a consortium arrangement among banks. Borrowers enjoying funds based limits of Rs. 50 crores and above from more than one bank should be brought under the above arrange-ment. There is no ceiling or number of banks in consortium. However the share of each bank should be a minimum of five per cent or Rs. one crore whichever is more. It will not be permissible for any bank outside the consortium to extend any additional credit facility or open current account for the borrowers without the knowledge and concurrence of the consortium members.

Loan syndication - On the recommendations of Narasimhan Committee, 1991, and further reviewed by a Committee under the Chairmanship of Mr. J. V. Shetty, then CMD, Canara Bank. Recently RBI guidelines signalled formation of *loan syndication* as a part of lending system. There are two methods of syndication direct lending and through participation.

- **Direct lending:** In respect of "*direct lending*" all the lenders sign the loan agreement independently with the borrower and agree to lend upto their respective share. The obligations of the syndicate members are several and they do not underwrite one another.
- **Through participation:** In this method of lending the lead bank is the only lending bank, so far as the borrower is concerned, that approaches the other lenders to participate in the loan. This normally takes place without the knowledge of the borrower. The lead bank grants a certain portion of the loan to each participant as agreed. It also agrees to pay to the participants a *pro rata* share of receipts from the borrower.

Types of participation - There can be four types of participation :

- **Substitution :** There is an agreement the borrower and the lead bank and other participants to permit the lead bank to disburse the loan on behalf of the participants.
- **Undisclosed agency:** Here, the lead bank is appointed as agent by the syndicate before the loan is signed, but does not disclose this fact to the borrower. It is, therefore, the principal as far as the borrower is concerned.

- **Sub-loan:** Under this method, each participant grants a loan directly to the lead bank on the condition that the lead bank repays only to the extent of receipts from the borrower.
- **Assignment:** The lead bank assigns a proportion of the loan and of the benefit of the loan agreement to the participants in consideration of the Purchase price or pro rata share of the loan to be contributed by them.

Non performing assets

Under the new RBI monitoring system, Bank's performances have been crucially dependent on recognition of income and non-performing assets. On the recommendations of high level committee under the Chairmanship of Sri M. Narasimhan, the RBI had issued circulars from time to time under the heading "*income recognition, asset classification, provisioning and other related matters*". The recommendations of the Committee highlights that the policy of income recognition should be based on objective and based on recovery rather than any subjective consideration.

The non-performing asset, as used in banking parlance, mean an asset the income (interest) of which is overdue for at least two quarters. Banks are not permitted to book income on accrual basis on such assets but only on realisation basis in respect of non-performing assets. For provisioning, the assets (loans and advances) are to be classified as (i) Standard (ii) Sub-standard (iii) Doubtful, and (iv) loss as per the RBI circular issued in this regard. The RBI has also introduced similar circular for revenue recognition, classification of assets, provisioning and other related matters applicable to Non-banking *Finance Companies* (NBFCs) registered with RBI.

Security for short-term financing

In normal course of business, the short-term loans will be provided by the banks against on some specific assets offered to the lender as security for repayment. Accounts receiv-ables and inventory are two types of current assets offered for financing working capital requirements. The following points are worthnoting in providing security of the above current asset.

Pledge of accounts receivables

- The lender evaluates the quality of receivables and the risks involved taking accounts receivable as security.
- Generally the security will be given on the balances lying in debtors in the Books of Account. In specific cases, any special accounts may be pledged to the lender for a particular loan.
- The borrower will continuously reporting the lender of the debtors paid and new debtors balances added in the records.

- Even though the lender have claim on the book debts, only the borrower will collect the receivables and the lenders right will arise when the borrower fails to repay the loans.
- If a loan is made on the notification basis, the notified debtor will directly pay his due amount to the lender instead of the borrower.

Charge on inventory - The manufacturing and trading companies, generally create charge on their stocks against working capital facilities provided by the Banks or Finance companies. The charge is created on the inventory items in the following ways :

- ***Floating charge :*** With creation of floating charge on the stocks, the borrowing firm gives the lender a general claim against the entire class of assets which are moving items. The lender's right on the stocks will be crystallised only when the borrower defaults in payment of his dues.
- ***Charge against trust receipts:*** When the items in inventory are easily identifiable, such as goods having serial numbers, a trust receipt can be eyed to guarantee a loan. A trust receipt is an agreement between the borrower and lender under which the borrower holds the goods in inventory and immediately forwards any sale proceeds from the sale of the inventory to the lender.
- ***Pledge of Warehouse receipts :*** When the inventory is kept at borrower's warehouse, but which is separated from other inventories can be pledged separately for specific loan purpose based on the warehouse receipt. If inventory is kept at third party warehouse then, there will be cost of warehousing also. The borrower can deal with or operate with the inventory pledged on warehouse receipt only when the charge is lifted by payment or otherwise.

Recommendations various committees Bank Financing

Dehejia Study Group

The National Credit Council constituted, in October 1968, a study Group under the Chairmanship of Shri V.T. Dehejia to examine the subject of the extent to which credit needs of industry and trade are likely to be inflated and how such trends could be checked. Since the bulk of bank credit is short-term, the Group's enquiry was primarily concerned with the inflation of the short-term bank credit. The credit needs of industry or trade may be considered to be inflated or either of the two sectors may be regarded to have received credit in excess of its genuine requirements (i) if, over a period of years, the rise in short-term credit is found to be substantially higher than the growth in the value of industrial production; (ii) if the rise in short-term credit in appreciably higher than the increase in inventories with industry or trade, (iii) if there is a diversion of short-term bank borrowings of concerns in industry for building up of fixed assets or other non-current assets such as loans and investments, (iv) if there is double or multiple financing of the same stocks; (v) if the period of credit is unduly lengthened.

The Group submitted its report in September, 1969.

Major Findings

The major finding of Dehejia Study Group are listed below:

Expansion of Bank Credit to Industry in Excess of Output

The Group found that the bank credit during the period from 1960-61 to 1966-67 expanded at a higher rate than the rise in industrial output. This finding was supported by the available data on inventories in relation to short-term bank credit. Between 1961-62 and 1966-67, the rise in the value of inventories with industry was 80% while the rise in short-term bank credit was as much as 130%. The ratio of short-term bank borrowings to inventories went up from 40% in 1961-62 to 52% in 1966-67. A similar analysis showed that some industries, particularly those in the traditional group, and several industrial units obtained credit from banks over and above the rise in their production. The Group therefore came to the conclusion that in the absence of specific restraints, there was a tendency on the part of the industry generally to avail itself of short term credit from banks in excess of the amount based on the growth in production and/or inventories in value terms.

Fixing Credit Limits by Banks

The basis on which banks fix credit limits had an important bearing on the size of bank credit in relation to the requirements of individual borrowers. For fixing credit limit banks generally took into account several features of the working of the loanee concerns, such as production, sales, inventory levels, past utilisation etc. The prevalent practices of banks in this regard were so varied that they were unlikely to prevent the emergence of excess demand for credit from certain borrowers. By and large, the scheduled banks were inclined generally to relate their credit limits to the security offered by their constituents but many do not appear to make any attempt to assess the overall financial position of the borrowers through a cash flow analysis and in the light of this study fixed their credit limits.

Valuation of Stocks and Margin Requirements

Banks did not generally adopt a uniform method of valuation of stock. The usual method, for indigenous goods was based on ‘cost’ or ‘market value” whichever is lower and for imported goods on landed cost. Similarly, there was considerable divergence in practice as regards the prescription of margins by the banks. Some banks stipulated a lower margin or pledge advances against hypothecation of stocks, while a few others did not make this distinction. In the opinion of the Group, the varying practice could not be said to constitute an important factor in the emergence of excess credit.

Diversion of Short-term Credit to Acquisition of Long-term Assets

A study of 255 companies over the period from 1961-62 to 1966-67 showed a deterioration in their current ratio and the increase in short-term liabilities was utilised for financing the gap between long-term assets and long-term liabilities. One-fifth of the gross-fixed assets of these companies was financed by expansion in short-term liabilities including the bank loans.

The tendency on the part of a number of industrial units to utilise short-term bank credit and other current liabilities for acquisition of non-current assets was, in the Group, due to (a) generally sluggish condition in the capital market since 1962 (b) the limited nature of the appraisal of applications for short term loans as compared to medium term loans and (c) stipulation of repayment schedules for medium loans.

Lending System

The Group considered that the lending system, as was prevalent in Indian banking, would have appear greatly assisted prevalent in Indian banking, would have appear greatly assisted certain units in industry on increased reliance on short-term debt to finance their non-current investment. The working capital advances of banks were granted by way of cash credit limits which were only technically repayable on demand. The system was found convenient in view of the emphasis placed by banks on the security aspect. These short-term advances though secured by current assets were not necessarily utilised for short-term purposes. The result was that cash credit advances had no longer remained a short-term or self-liquidating in as much as although cash accruals arising from sales were adjusted in a cash credit account from time to time. The Group found that on a large number no credit balance emerged or debt balances fully wiped out over a period of years as the withdrawals were in excess of receipts. The possibility of heavy reliance on bank credit by industry arose mainly out of the way in which the system of cash credit—which accounted for about 70% of total bank credit had been operated.

Suggestions

The Group was of the opinion that unless measures were taken to check the tendency for diversion of bank credit for acquiring long term assets, it might assume wider dimensions. The Group made following suggestions for a change in the lending system.

Method of Appraisal of Credit Applications

The appraisal of credit applications should be made with reference to the total financial situation, existing and projected, as shown by cash flow analysis and forecasts submitted by borrowers. This would help a diagnosis of the extent to which current liabilities of industrial units had been put to non-current use and the manner in which liabilities and assets of borrowers were likely to move over a period of time. Initially, advances of,

say Rs. 50 lakhs and over should be analysed this way and then the system may gradually be extended to borrowers with advances of over Rs. 10 lakhs.

Segregation of the Credit Market

The outstandings in the existing as well as further cash credit accounts should be distinguished as between (i) 'the hard core' which would represent the minimum level of raw materials, finished goods and stores which the industry was required to hold for maintaining given level of production and (ii) the strictly short-term component which would be the fluctuating part of the account. The latter part of the account would represent the requirements of funds for temporary purchases, e.g. short-term increase in inventories, tax, dividend and bonus payments etc., the borrowing being adjusted in a short period out of sales. In the case of financially sound companies, the Group was of the opinion to segregate the hard core element in the cash credit borrowings and put on a formal term loan basis and subject to repayment schedule. But when the borrowers' financial position was not too good or the size of the hard core, was so large that repayment could not be expected within 7/10 years, it would be difficult for the banks to continue to carry these liabilities over a long period of time. The possible solutions to be attempted would be: the bringing in of long-term deposits and unsecured loans by the promoters and their friends, additional issue of equity or preference capital, a debenture issue with a long maturity. When the hard core was to be placed on a formal term loan basis, the proposal should be subject to a detailed appraisal. The documents should contain convenants in regard to the end-use of the loan, maintenance of minimum financial ratios, repayment obligations restrictions on investments on shares and debentures. To determine the hard core element of the cash credit account, the Group considered that it would be worthwhile to attempt to study of industry-wise norms for minimum inventory levels.

Double or Multiple Financing

Double or multiple financing may result where credit facilities are granted against receivables either by way of documents against acceptance bills or drawing against book debts; the purchase is also in a position to obtain bank credit by way of hypothecation/pledge of the stocks which have not been paid for. For eliminating double or multiple financing, the Group suggested that a customer should generally be required to confine his dealings to one bank only. In case the credit requirements of borrowers were to be large and could not be met out of resources of one bank, the Group has commended the adoption of 'consortia' arrangement.

Period of Trade Credit

To prevent undue longation of the period of trade credit and the tying up of resources of banks for unproductive purpose, the group suggested that the period of trade credit should not normally exceed 60 days and in special circumstance up to 90 days (excluding

sales of capital equipment on deferred payment terms). The undue delay in the settlement of bills by governments could be discouraged by stipulating that the latter should pay interest on bills if they were not paid within 90 days after their receipt.

Commitment Charges on Unutilised Limits

As a complementary measure to check the extension of extra credit, the group suggested that a levy of commitment charge on unutilised limited coupled with, if necessary, a minimum interest charge could be considered. The commitment levy might be progressively raised with the size of the unutilised limits. As the initial stages, limits sanctioned upto Rs. 10 lakhs might be exempted from the point of view of administrative convenience.

Need for Greater Recourse to Bill Finance

The Study Group emphasised the need for greater recourse to bill finance. The Group recommended that commercial banks, industry and trade should try, where feasible and administratively convenient, to initiate and develop the practice of issuing usance bills as this would not only impose financial discipline, on the purchaser but also help supplier or producer to plan his financial commitments in a realistic manner. An adequate growth in the volume of usance bills would also facilitate the development of a genuine bill market in India. With a view to encouraging the development of such bill market a reduction in the stamp duty on usance bill was recommended by the Group to the government. The Group believed that the loss in revenue following a reduction in stamp duty would be more than made good by the resultant larger volume of usance bills.

Inventory Control

With regard to inventory control, the Group considered that as an integral part of restraining the demand for bank credit by industry, adequate attention should be paid to the question of adequacy or otherwise of stocks of inventories held by various industries and the scope for minimising the stocks needed by industry.

Implications

Financial discipline implicit in Dehejia Study Group was intended to help the corporate and other borrowers in formulating financial plans, regulating production on a more rational basis and economising the demand for bank credit. As regards banks, a periodical release of the part of the resources otherwise locked up in 'roll over' cash credit/ overdraft to industry would enable them to meet to this extent further demands of priority sectors of the economy and to diversify their loan transactions. This, in turn, would increase the scope for mobilisation of deposits. Commercial banks would thus be able to play a more effective role in serving the community and the ends of social justice.

Tandon Study Group

The Reserve Bank of India constituted a Study Group to frame guidelines for follow up of bank credit in July 1974 under the Chairmanship of Shri Prakash Tandon. The terms of reference of the Group were:

(i) To suggest guidelines for commercial bank to follow-up and supervise credit from the point of view of ensuring proper end-use of funds and keeping a watch on the safety of the advances and to suggest the type of operational data and other information that may be obtained by banks periodically from such borrowers and by the Reserve Bank of India from the leading banks.

(ii) To make recommendations for obtaining periodical forecasts from borrowers of (a) business/production plans, (b) credit needs,

(iii) To make suggestions for prescribing inventory norms for different industries both in the

private and public sectors and indicate the broad criteria for deviating from these norms.

(iv) To suggest criteria regarding satisfactory capital structure and sound financial basis in relation to borrowings.

(v) To make recommendations regarding the sources for financing the minimum working capital requirements.

(vi) To make recommendations as to whether the existing pattern of financing working capital requirements by cash credit/overdraft system etc. requires to be modified, if so, to suggest suitable modifications.

(vii) To make recommendations on any other related matter as the Group may consider germane to the subject of enquiry or any other allied matter which may be specifically referred to it by the Reserve Bank of India.

Observations and Recommendations

The Study Group submitted its report to the RBI in August 1975. The summary of the Group's main observations and recommendations is given below:

Supply of and Demand for Funds

Nationalisation of the major commercial banks in 1969 raised expectations of a new sense of direction in bank lending, and indeed advances to new claimants of credit, and especially to small industry and agriculture had since gone up. The public sector has emerged as an important user of credit due both to its growing dominance and its turning increasingly to commercial banks for its working capital finance instead of relying on government. Another new source of demand was the growing awareness of the need to achieve an equitable geographical development of industry, and in its

distribution of credit. Though industrial production increased at a slow pace but the call on bank credit essentially for maintaining inventories even at the same level had gone up with rising prices. If the growth process is resumed then the volume of inventory required to maintain a higher level of production will increase and correspondingly the demand for bank credit.

This state of affairs caused no problem in the year when the credit-deposit ratio in the banking system was low and a sudden spurt in credit demand could easily be taken care of and access to refinance from the Reserve Bank was easy. With control on monetary expansion as part of anti-inflationary policy and a use in demand for funds—both from the old and the new claimants—the existing system of bank lending came under considerable strain and the fundamental weakness of the system had been exposed.

Cash Credit System and Financial Indiscipline

The problem of potential imbalance in demand for and supply of funds is accentuated by the manner in which banks extend credit under the present cash credit system of lending, where a banker sanctions a maximum limit within which the borrower can draw at his will. Under this procedure, the level of advances in a bank is determined not by how much a banker can lend at a particular point of time by the borrower's decision to borrow at the time. When the borrower's need for funds is low, the banker is faced with the problem of large unutilised funds, and when the borrower's need for funds, the banker faces the problem of meeting the demand without notice. In fact, availability of funds with the bank and the customers need do not always match.

The weakness of the cash credit system can be illustrated by taking the following example of a borrower's financial position;

Current Liabilities		**Current Assets**	
Bank borrowings	Rs. 75,000	Inventory	Rs. 1,00.000
Other current	Rs. 10,000	Other current assets	Rs. 10,000
liabilities	Rs. 85,000		Rs.1,10,000

Let us assume that the entrepreneur has raised equity and term loans for covering the cost of fixed assets as well as a portion of current assets. The banker's function is perceived as providing funds required for carrying the balance of the current asset. Against the total inventory of Rs. 1,00,000, an advance of Rs. 75,000 is sanctioned by way of cash credit. The advance is secured by a charge over inventory with an appropriate margin—in this case 25%—the margin representing the borrower's contribution to carry the current assets.

So long as there is security, which is declared in the periodical stock statements, the borrower is permitted to draw up to the drawing limit, computed on the basis of the value stocks less stipulated margin, or the sanctioned limit, whichever is lower.

Under this system, it is possible for a borrower to draw against available security and utilised the funds for purposes other than increasing his current assets of repaying his other current liabilities; he can, for instance, use the funds for acquiring fixed or non-current assets, as the following example illustrates:

Current Liabilities		**Current Assets**	
Creditors for purchase	Rs. 50,000	Inventory	Rs. 1,00,000
Bank borrowings	Rs. 75,000	Other current assets	Rs. 10,000
Other Current liabilities	Rs. 10,000		
	Rs. 1,35,000		Rs. 1,10,000

Inventory of the value of Rs. 1,00,000 is carried to the extent of Rs. 50,000 by creditors for purchases; but the borrower is enabled to borrow up to Rs. 75,000 on the security of stocks worth Rs. 1,00,000 less the prescribed margin of 25%, the drawing limit being Rs. 75,000. Had the customer drawn genuinely for meeting his current assets requirements only, his maximum eligibility (assuming nil contribution from him to carry the current assets) would have been Rs. 50,000; the excess of Rs. 25,000, he can divert to non-approved uses without the banker's knowledge.

Such diversion of bank funds was made possible by the banker's fixation on security under the cash credit lending system. To the extent that outstandings in a cash credit account never fell below certain level during the course of a year, there was an element of what is called a 'hard core' borrowings which was in reality a quasi-permanent lock-up of bank funds in the borrower's business. The time is now opportune to review the existing system and effect changes in such a way that under the new system the borrower could plan his credit needs and the banker would be able to plan his deposit credit function to assure finance to industry for its genuine production needs.

Norms of Inventories and Receivables

According to the Study Group, the main function of a banker is only to supplement the borrower's resources to carry a reasonable level of current assets. The Study Group has, therefore, stipulated norms for 15 major industries. Not only will the bank credit be regulated according to the norms but the units in these industries (except cotton and jute) themselves are not supposed to carry inventories/receivables in excess of the stipulated norms. In the case of cotton and jute industries, while stocks would be maintained according to the permission of the Textile or Jute Commissioner, the bank credit would be regulated according to the norms.

- Bunched receipt of raw materials including imports.
- Power cuts, strikes and other unavoidable interruptions in the process of production.
- Transport delays and bottlenecks.

- Accumulation of finished goods due to non-availability of shipping space for exports or other disruptions in sales but not under circumstances where a sales stimulation is needed through reduction in prices.
- Build up of stocks of finished goods, such as machinery due to failure on the part of purchasers for whom these were specifically manufactured to take delivery.
- Need to cover full or substantial requirements of raw materials for specific export contract of short duration.

For the industries, for which no norms have been stipulated banks are expected to keep in view the purpose and spirit behind the norms exercise and prevent excessive build-up of inventories receivables.

Working Capital Gap and Bank Finance

The Group has identified working capital gap viz., the borrower's requirements of finance to carry current assets (based on norms) other than those financed out of his other current liabilities, could be bridged partly from his owned funds and long term borrowings and partly by bank borrowings.

The maximum permissible level of bank borrowings could be worked out in three ways:

(i) Bank can work out the working capital gap, i.e., total current assets less current liabilities other than bank borrowing and finance a maximum of 75% of the gap; the balance to come out of long-term funds, i.e., owned funds and term borrowings.

(ii) Borrower to provide for a minimum of 25% of total current assets out of long-term funds, i.e., owned funds plus term borrowings. A certain level of credit for purchases and other current liabilities will be available and the bank will provide the balance. Total current liabilities inclusive of bank borrowings will not exceed 75% of current assets.

(iii) Same as (ii) above, but excluding core current assets from total current assets on the theory that core current assets should be financed out of long-term funds, i.e., owned funds plus term borrowing.

The three alternatives may be illustrated by taking the following example of a borrower's financial position, projected at the end of the next year:

TABLE-1: Balance Sheet

Current Liabilities		**Current Assets***	
Creditors for purchase	100	Raw materials	200
Other current liabilities	50	Stocks-in-process	20
	150	Finished goods	90
		Receivables including bills discounted with bankers	50
Bank borrowings, including bills discounted with bankers	200		
	350	Other current assets	10
			370

* As per suggested norme or past practice, whichever is lower in relation to projected production for the next year.

The 1st Method would mean the banker financing upto a maximum of 75% of the working capital gap of 220, i.e., 165 and the borrower providing at least 55 out of his long-term funds, i.e., owned funds plus long-term borrowings. This method will give a minimum current ratio of 1:1.

The 2nd Method would mean the borrower financing a minimum of 25% of total current assets (92) through long-term funds and the gap, i.e., maximum of 128 (278-150), will be provided by the bank. This will give a current ratio of at least 1.3.1.

TABLE-2: Permissible Levels of Bank Finance

1st Method		**2nd Method**		**3rd Method**	
Total current assets	370	Total current assets	370	Total curreni assets	370
Less: Current Liabilities other than bank borrowings	150	Less: 25% of above from long-term sources	92	Less: Core current assets (Illustrative figure) from long-term sources	95
	-----		-----		-----
			278		275
Working capital gap	220	Less: current liabilities other than bank borrowings		Real current assets	275
				Less: 25% of above from long-term sources	. 69 206
Less: 25% of above from long-term sources	55	Working capital gap	220	Less: current liabilities other than the bank borrowings	150 56
Maximum bank borrowings permissible	165	Maximum bank borrowings permissible	128	Working capital gap	220
				Maximum bank borrowings permissible	56
Excess borrowings	35	Excess borrowings	72	Excess borrowings	144
Current ratio 1.17:1		Current ratio 1.33:1		Current ratio 1.79:1	

The 3rd Method would mean a further reduction in bank borrowing and strengthening of the current ratio.

It is important to note that in an exercise like this for computing the level of bank finance, the classification of current assets and current liabilities should be made as per the usually accepted approach of bankers and not as per definitions in the Companies Act. For instance, instalments of term loans payable within 12 months from the date of balance sheet are classified by the banker as current liabilities while it is not so in the balance sheet prepared in accordance with the requirements of the Companies Act. These differences in classification have been brought out in the form for analysis of balance sheet prescribed by the Reserve Bank under its Credit Authorisation Scheme.

The 3rd Method will provide the largest multiplier of bank finance; however, to avoid hardship to borrowers, a beginning may be made with the 1st Method, placing all borrowers in this method within a period of about one year, and the ideal of the 3rd Method may be reached in stages. The liberal approach under the 1st Method has been suggested as the first step, particularly to facilitate financial structuring of new companies, setting up projects in backward areas and also for flexibility in restructuring of existing companies with a weak financial base.

Style of Credit

Once the quantum of bank funds to finance a reasonable level of current assets is agreed to, there is also need to change the style of extending bank credit. Instead of making available the entire credit limit as a cash credit for a year, it may be bifurcated into a loan and a demand cash credit, which will be reviewed annually. The loan component would comprise the minimum level of borrowing which the borrower expects to use throughout the year, while the cash credit part could take care of his fluctuating requirements. As the loan would carry interest throughout the year, it will induce a discipline in the customer to plan his need carefully to ensure that as little of it as possible lies idle.

The demand cash credit should be charged a slightly higher rate of interest than the loan component. This approach will give the borrower an incentive for good planning. In order to ensure that customers do not use the new cash credit facility in an unplanned manner, the financing should be placed on a quarterly budgeting-reporting system for operational purposes.

Bill Finance

Apart from loan and demand cash credit, a part of the total requirements within the overall eligibility, could also be provided by way of bill limits to finance receivables. It is desirable that, as far as possible, receivables should be financed by way of bills rather than cash credit against book debts, though the latter cannot be altogether eliminated, particularly when the period of credit is short and the amount is small. These bills could be on a demand basis or on a usance basis depending on the marketing practice in the industry.

To the extent feasible, the banking system should move towards financing the purchaser, who is in fact the debtor, rather than the seller, who is the creditor. In other words, the seller will be paid off immediately after the sale and the bank credit will be extended only to the purchaser. As regards financing of the purchaser, however, there are two different points of view. One view is that purchases should also as far as possible, be on the basis of bills, for the following reasons:

- the amount will be drawn only at the time of actual need.
- the end-use of credit is automatically taken care of,
- credit to purchaser is directly related to his actual need, which is not the case with the seller's bills, where credit is extended as a measure of sales promotion irrespective of the purchaser's ability to pay or his need for credit.
- a bill enables discipline to be imposed in respect of payments for purchases-it ensures timely payment to suppliers, which a system of book entries does not always ensure.

It is argued on the other side that under the proposed revised system, the cash credit mode of financing is superior to bill financing in respect of the borrower's purchase operations for the following reasons:

- drawals for non-approved purposes will be detected by the new information system proposed and by scrutiny of cheques; end-use of credit will be effectively taken care of by the proposed information system,
- the cost of operations to the borrower and the banker will be high; borrower will have to pay more for cost of stamp duty which the banker's administrative cost will go up because of additional paper work without the assistance of mechanisation or computerisation, and
- the advantages of centralised borrowing by way of a close watch over aggregate outstandings, debit and credit summations and borrowing trends would be lost.

In view of the foregoing, it seems desirable that each banks should take its own decision, in consultation with the borrower, having regard to the size of his operations, the individual transactions and the administrative set-up obtaining in the bank.

Coverage of the Proposed Approach

The proposed approach to lending and the style of credit may be extended to all borrowers having credit limits in excess of Rs. 10 lakhs from the banking system, while the information system may be introduced, to start with, in respect of borrowers with limits of Rs. 1 crore and above from the entire banking system. Progressively, banks should extend this system, first to borrowers with limits of Rs. 50 lakhs to Rs. 1 crores and next to those enjoying limits of Rs. 10 lakhs to Rs. 50 lakhs.

Information System

To meet the specific requirement of the new ventures and to ensure the end-use and safety of bank advance, the borrower is expected to subject himself to the budgeting and reporting system. The borrower will supply appropriate operational data and figures relating to financial position at periodical intervals on the prescribed forms which have been devised for the purpose. The information so furnished by the borrower will have to be screened thoroughly and speedily and a view taken of his total activities.

All borrowers with total credit facilities from the Banking System in excess of Rs. 10 lakhs should submit (i) Operating Statement (ii) Funds Flow Statements (iii) Peak Level Balance Sheet and Proforma Balance Sheet for the ensuing year at the ensuing, year at the time of submitting the loan application (whether for renewal/enhancement of fresh limits). The borrower with aggregate credit facilities from the banking System exceeding Rs. one crore should submit (i) quarterly operating statement (ii) quarterly funds flow statement and (iii) current assets and current liabilities every quarter for the purpose of follow-up.

Follow-Up

A bank has to follow-up and supervise the use of credit to verify first, whether the assumptions on which the lending decision was taken continue to hold good, both in regard to the borrower's operations and the environment, and second, whether the end-use is according to the purpose for which the credit was given. From the quarterly forms, the banker will verify whether the operational results confirm to earlier expectations and signs, if any, of significant divergence reading as red signals to both the banker and the customer. However, variance of say +10% may be treated as normal. In addition to the quarterly data, the larger borrowers should submit a half-yearly proforma balance sheet and profit and loss account within two months from the end of the half year.

Management Efficiency

Management competence is an important factor, in the efficiency of operations. reflected in profitability and working capital and financial management. The banker should be kept in mind appraisal of management may be essential particularly when more emphasis has been on viability and development rather than on security alone. Further, changes in ownership or managerial pattern may also have to be watched, where circumstances warrant.

Inter-firm Comparison

To facilitate inter-firm and industry-wise comparison for assessing efficiency, it would be of added advantage if companies in the same industry could be grouped under three or four categories, say, according to size of sales and the group wise

financial ratios compiled by the Reserve Bank of India, for furnishing to banks. Besides examining financial and operating ratios, certain productivity ratios may also be examined to determine efficiency in use of resources—*man, money, machines* and materials. A banker can choose his own criteria, but some useful ones are: labour efficiency; capital efficiency and fixed assets efficiency.

Classification of Customers

For purposes of better control, there should be a system of borrower classification in each bank, within a credit-rating scale. Such a system of classification according to credit-risk will facilitate easy identification of the borrower whose affairs require to be watched with more than ordinary care. An incidental advantage of such classification will be the formulation of a rational base for purpose of fixing the rates of interest for the respective borrowers.

Norms for Capital Structure

The debt-equity relationship is a relative concept that depends on several factors and circumstances such as the state of the capital market at any one time, government policy on created money, the need to maintain current assets at a specified level (which again is contingent on other factors), marginal efficiency of capital or the opportunity cost, etc. The experience of other countries in this matter may not be of much assistance in formulating guidelines in the Indian context. In discussing norms for capital structure, the Group kept in mind both the relationships—long-term debt to equity and tota'l outside liabilities to equity. Where a company's long-term debt-net worth and total outside liabilities-net worth ratios are worse than the medians, the banker would endeavour to persuade the borrower to strengthen his equity base as early as possible. This would be a more practical approach for the banker than attempting to legislate absolute standards of long-term debt—net worth and total outside liabilities—net worth ratios for all industries or even industry by industry.

The impact of taxation in considering this subject is also important for, under the tax structure, it is advantageous to trade as much as possible on borrowed capital to maximise earnings per share. The higher the level of borrowings, or the financial leverage, the greater is the advantage in view of this and coupled with the cheap money policy, there may be limited incentive to the borrower for efficient management of funds. Introduction of higher interest rates in the banking system has changed this position. In fact, the lending banker likes to see as high an equity stake as possible because it makes advances safer and, in times of credit shortage, makes available bank funds so further. However, one cannot lose sight of the need to promote the capital market while resolving this dichotomy of interest between the banker and borrower as the ultimate goal being to assist in maximising investment and production. If the end-product of industry has to be sold at a cheaper price and adequate dividends are also to be given to make equity

attractive to the investor, no company can afford, even if it were possible, to trade entirely on owned funds, nor rely too heavily on borrowed funds. There has thus to be a balance between the two—what the company provides and what it borrows.

Problems in Implementing Tandon Committee Report

The Reserve Bank of India in its notification dated August 21, 1975 considered some of the main recommendations of the Group and advised the banks accordingly. The scheme was required to be implemented at the micro-level where advances were made to the borrowers. But a thorough understanding of the scheme required knowledge about the analysis of financial statements and credit appraisal by the officers at branch level. This knowledge was slowly spreading and till the officers at the grass root level were equipped with the basic knowledge of credit appraisal, the implementation was bound to be quite slow.

Another problem was that of gearing the attitudes of the bankmen to this new scheme being something new as being not in the routine nature of credit appraisal, it was difficult task to kindle the interest of the staff to study the Tandon Scheme for enforcing it in the case of big industrial customers. In addition, the new scheme also called for in-depth knowledge about each industry and various units in each industry so that the norms could be realistically applied in each case to determine the level of current assets, working capital gap and the style of credit.

It's not only the bankers but also the customers were required to be trained in understanding the implications of the norms and the quarterly information system, an innovation brought in by the Tandon Committee. No doubt the big parties had the qualified staff to give the data in forms prescribed on quarterly basis, but these forms were not forthcoming in time. If they were submitted each time after the current quarter or even much later upon reminder, the very purpose of calling for quarterly data were to be defeated as in that event follow-up supervision and control were difficult or not possible.

In the case of some of the big parties, it had been found that they were run like family concerns on partnership or proprietary basis and they did not maintain proper books of accounts. Such parties were likely to plead inability to furnish the data as per the Tandon form. To make matter worse or difficult for banks, they maintained account in regional language too. Even if the forms were coming with lot of persuasion and understanding from the borrowers, it was difficult to convince them in individual cases to abide by the norms for carrying current assets if they were already above the norms. No doubt, ultimately it was the banker's judgement that should prevail in credit decisions after a dialogue with the parties, but in super-imposing such decisions over the customers' judgement, there was likely to be misunderstanding or clash sort of thing with the borrowers. It was quite possible that aggrieved borrowers getting lesser limit might perhaps consider higher limits.

Another problem which was no less important could be about the manipulation in the figures of "other current assets", "other current liabilities" etc. as the permissible bank finance was based on figure work only. Further it was felt that the calculation of excess finance poses a realistic problem because while the working capital gap was computed on the basis of the projected net current assets, the figures of liability were the existing ones and not the projected levels. For growing higher levels of current assets, the Committee provided exceptions where under higher holdings might be permitted. It was feared that each party might argue to be brought within the exceptions to circumvent the rigours of the norms.

However, in order to improve the operational efficiency and to develop a belter understanding of the new lending system of banks, if all the banks are serious in implementing the Tandon Scheme and if they are able to get the cooperation from their customers, the problem areas are nothing and can be ignored. On the other hand, if unwarranted concessions and deviations are shown by banks against the ethics of the implementation of the scheme as a whole, the very philosophy of the Tandon Scheme will be defeated and it will create a situation in which the scrupulous banks will regret for going the Tandon way.

Chore Committee

While reviewing the monetary and credit trends in March 1979 the Governor of the Reserve Bank of India stressed the need for exercising continued restraint on expansion of credit. He also indicated in his meeting with bankers the need for considering certain long-term issues relating to banking operations. In his letter dated 16th March 1979 to all scheduled commercial banks, he indicated:

"I would like to initiate action on certain structural matters which need further examination. It is necessary to take a fresh look at another major problem faced by banks in implementing the credit regulatory measures, viz., the extensive use of the cash credit system. Its drawbacks have been pointed out by the various Committees in the past including the Tandon Committee, which suggested the bifurcation of credit limits into a demand loan and a fluctuating cash credit component. Although the banks were advised to implement this recommendation, I am afraid, the progress achieved has been very slow. Clearly, this problem needs to be looked into further and for this purpose I proposes to set up immediately a small Working Group, to report to me.....on the reforms to be introduced".

It was in this context that the Reserve Bank of India appointed the Working Group under the Chairmanship of Shri K.B. Chore to review the system of credit in all aspects. The term of reference of the Working Group were as follows:

(1) To review the operation of the cash credit system with reference to the gap between sanctioned credit limits and the extent of their utilisation;

(2) In the light of the review, to suggest:

(a) modifications in the system with a view to making the system more amenable to rational management of funds by commercial banks, and/or

(b) alternative types of credit facilities, which would ensure greater credit discipline and also enable banks to relate credit limits to increase in output or other productive activities; and

(3} To make recommendations on any other related matter as the Group may germane to the subject.

The Group made following recommendations in its final report. Recommendations

Credit System

The advantages of the existing system of extending credit by a combination of the three types of lending, viz., cash credit, loan and bill should be retained. At the same time, it is necessary to give some directional changes to ensure that wherever possible the use of cash credit would be supplanted by loans and bills. It would also be necessary to introduce necessary corrective measures to remove the impediments in the use of bill system of finance and also to remove the drawbacks observed in the cash credit system.

Bifurcation of Credit Limits

Bifurcation of cash credit limit into a demand loan portion and a fluctuating cash credit component has not found acceptance either on the part of the banks or the borrowers. Such bifurcation may not serve the purpose of better credit planning by narrowing the gap between sanctioned limits and the extent of utilisation thereof. It is not likely to be voluntarily accepted and it does not confer enough advantages to make it compulsory.

Reducing Over-dependence on Bank Borrowings

The need for reducing the over-dependence of the medium and large borrowers—both in the private and public sectors-on bank finance for their production/trading purposes is recognised. The net surplus cash generation of an established industrial unit should be utilised partly at least for reducing borrowing for working capital purposes.

Enhancement of Owner's Contribution

In order to ensure that the borrowers do enhance their contributions to working capital and to improve their current ratio, it is necessary to place them under the Second Method of lending recommended by the Tandon Committee which would give a minimum current ratio of 1.33:1. As many of the borrowers may not be immediatly in a position to work under the Second Method of lending, the excess borrowings should be segregated and treated as a working capital term loan which should be made repayable in instalments. To induce the borrowers to repay this loan, it should be charged a higher rate of interest. For the present, the Group recommends that the additional interest may

be fixed at 2% per annum over the ratio applicable on the relative cash credit limits. This procedure should made compulsory for all borrowers (except sick units) having aggregate working capital limits of Rs. 10 lakhs and over.

Peak Level and Normal Non peak Level Limits to be Separate

While assessing the credit requirements, the bank should appraise and fix separate limits for the 'normal non-peak level' as well as for the 'peak level' credit requirements indicating the periods during which the separate limits would be utilised by the borrower. This procedure would be extended to all borrowers having working capital limits of Rs. 10 lakhs and above. One of the important criteria for deciding such limits should be the borrowers' utilisation of credit limits in the past.

Financing Temporary Requirements through Loan

If any ad-hoc or temporary accommodation is required in excess of the sanctioned limit to meet unforeseen contingencies the additional finance should be given, where necessary, through a separate demand loan account or a separate 'non-operatable cash credit account'. There should be a stiff penalty for such demand loan or non-operatable cash credit portion, at least two per cent above the normal rate, unless Reserve Bank exempts such penalty. This discipline may be made applicable in cases involving working capital limits of Rs. 10 lakhs and above.

Penal Interest

The borrower should be asked to give his quarterly requirement of funds before the commencement of the quarter on the basis of his budget, the actual requirement being within the sanctioned limit for the particular peak level/non peak level periods. Drawing less than or in excess of the operative limit so fixed (with a tolerance of 10% either way) but not exceeding sanctioned limit would be subject to a penalty to be fixed by the Reserve Bank from time to time. For the time being the penalty may be fixed at 2% per annum. The borrower would be required to submit his budgeted requirements in triplicate and a copy each would be sent immediately by the branch to the controlling office for record. The penalty will be applicable only in respect of parties enjoying credit limits of Rs. 10 lakhs and above, subject to certain exemptions.

Information System

The non-submission of the returns in time is partly due to certain features in the forms themselves. To get over this difficulty, simplified forms have been proposed. As the quarterly information systems, is part and parcel of the revised style of lending under the cash credit system, if the borrower does not submit the return within the prescribed time, he should be penalised by charging the whole outstanding in the account at a penal rate of interest, 10% per annum more than the contracted rate for the advance from the due date of the return till the date of its actual submission.

Relaxation from Norms

Requests for relaxation of inventory norms and for ad-hoc increase in limits would be subjected by banks to close scrutiny and agreed to only in exceptional circumstances.

Toning Up-Assessment Technique

The banks should devise their own check lists in the light of the instructions issued by the Reserve Bank for the scrutiny of data at the operational level.

Delays in Sanction

Delays on the part of banks in sanctioning credit limits could be reduced in cases where the borrowers cooperate in giving the necessary information about their past performance and future projections in time.

Bill System

As one of the reasons for the slow growth of the bill system is the stamp duty on usance bills and difficulty in obtaining the required denominations of stamps, these questions may have to be taken up with the state governments.

Sales Bill

Bank should review the system of financing book debts through cash credit and insist on the conversion of such cash credit limits into bill limits.

Drawee Bill System

A stage has come to enforce the use of drawee bills in the lending system by making it compulsory for banks to extend at least 50% of the cash credit limit against raw materials to manufacturing units whether in the public or private sector by way of drawee bills. To start with, this discipline should be confined to borrowers having aggregate working capital limits of Rs. 50 lakhs and above from the banking system.

Segregation of Dues of Small Scale Industries

Banks should insist on the public sector undertakings/large borrowers to maintain control accounts in their books to give precise data regarding their dues to the small units and furnish such data in their quarterly information system. This would enable the banks to take suitable measures for ensuring payment of the dues to small units by a definite period by stipulating, if necessary, that a portion of limits for bills acceptance (drawee bills) should be utilised only for drawee bills of small scale units.

Discount House

To encourage the bill system of financing and to facilitate call money operations an autonomous financial institution on the lines of the Discount Houses in UK may be set up.

Correlation between Production and Bank Finance

No conclusive data are available to establish the degree of correlation between production and quantum of credit at the industry level. As this issue is obviously of great concern to the monetary authorities the Reserve Bank may undertake a detailed scientific study in this regard.

Communication of Credit Control Measures to Branches and Follow-up

Credit control measures to be affective will have to be immediately communicated to the operational level and followed up. There should be a 'Cell' attached to the Chairman's office at the Central Office of each bank to attend to such matters. The Central Offices of banks should take a second look at the credit budget as soon as changes in credit policy are announced by the Reserve Bank and revise their plan of action in the light of the new policy and communicate the corrective measures to the operational levels as quickly as possible.

Monitoring of Key Branches and Critical Accounts

The banks should continuously monitor the credit portfolio of the 'key' branches irrespective of the fact whether there is a change in credit policy or not. For effective credit monitoring, the number of critical accounts should be kept under a close watch over the utilisation of limits and inventory build up.

Delay in Collection of Bills/Cheques

To reduce the delay in collection of bills and cheques, return of documents by the collecting branches, etc, the Group suggested to tone up the communication channels and systems and procedures within the banking system.

Bill Facilities and Current Accounts with other Banks

Although banks usually object to their borrower's dealing with other banks without their consent, some of the borrowers still maintain current accounts and arrange bill facilities with other banks. Apart from diluting the control over the advance by the main banker, this practice often enables the borrower to divert sales proceeds for unapproved purposes without the knowledge of his main banker. Banks should be suitably advised in this matter by the Reserve Bank to check this unhealthy practice.

Marathe Committee

With the incorporation of the guidelines of the Tandon Committee and the Chore Committee, bank lending to industry came increasingly under the direct supervision of the Reserve Bank of India. In 1982 it was felt that an independent review of the Credit Authorisation Scheme (CAS) which had been in operation for several years would be useful and accordingly the Reserve Bank of India appointed a Committee in November 1982 to review the working of the Credit Authorisation Scheme. The Committee which

came to be referred as the Marathe Committee submitted its report in July 1983. The starting point for the Marathe Committee's work provided by the objectives of the CAS, was enlarged and re-defined and noted by the Committee as follows:

(a) To ensure that additional bank credit is in conformity with the approved purposes and priorities and that the bigger borrowers do not pre-empt scarce resources.

(b) To enforce financial discipline on the larger borrowers where necessary, on uniform principles;

(c) Where a borrower is financed by more than one bank, to ensure that the customer's proposal is assessed in the light of the information available with all the banks; and

(d) To bring about improvement in the techniques of credit appraisal by banks and their system of follow-up.

Recommendations

The Marathe Committee which was given wide terms of reference to examine the Credit Authorisation Scheme from the point of view of its operational aspects stressed that the CAS is not to be looked upon as a mere regulatory measure which is confined to large borrowers. The basic purpose of CAS is to ensure orderly credit management and improve quality of bank lending so that all borrowings, whether large or small, are in conformity with the policies and priorities laid down by the Central Banking Authority. If the CAS scrutiny has to be limited to a certain segment of borrowers, it is only because of administrative limitations or convenience; and it should not imply that there are to be different criteria for lending to the borrowers above the cut off point as compared to those who do not come within the purview of the Scheme. Further, the Committee was of the view that it is not possible to avoid delays or improve quality of lending merely by concentrating on a single point. The borrowers have to do their bit by providing all the necessary and relevant information in time and in adequate detail. The long time taken in commercial banks in processing applications has to be reduced by suitable organisational changes. Similarly the time taken for scrutiny in the Reserve Bank also requires attention partly because it is the last stage of the process, and because of earlier delays. it is found more irksome by the borrower. Improvements in the system as a whole has to be a conscious and continuous process in order to achieve the desired result. The major recommendation of the Marathe Committee was in the area of providing an incentive for the borrowers to comply with all the requirements of the scheme including the information system and for the banks to improve the quality of credit appraisal. It recommended that 'banks be allowed discretion to deploy credit in CAS cases which fulfil the following requirements, without RBI's prior authorisation:

(i) The estimates/projections in regard to production, sales, chargeable current assets, other current assets, current liabilities (other than bank borrowings) and

net working capital are reasonable in terms of past trends and norms (wherever specified), and assumptions regarding most likely trends during the future projected period.

(ii) The classification of assets and liabilities as 'current' and 'non-current' is in conformity with the guidelines issued by RBI.

(iii) The borrower has been submitting quarterly operating statements for the past 6 months within the stipulated time and undertakes to do so in future also,

(iv) The borrower undertakes to submit his annual accounts promptly and the bank carries out the annual review of facilities irrespective of the fact whether the borrower needs enhancement in credit facilities or not.

The progress made in the adoption of the 'fast track' represented by the above recommendation of the Marathe Committee has been rather slow. This is not perhaps surprising, as the five eligibility conditions which have been laid down are quite comprehensive and further the sanction of credit facilities under the 'fast track' would still come under post-disbursal scrutiny of the RBI as in the case of sanction of credit facilities above Rs. 1 crore and below the cut-off point (now Rs. 4 crores for prior authorisation).

The Marathe Committee envisaged that the need for a regulatory role for the Reserve Bank in respect of individual credit limits will diminish, if not disappear if the banks are able to evolve an operational culture which will be immune to unhealthy pressures and which will have an in-built discipline in conforming to the broader parameters of policy laid down by the Central Banking Authority. It however, cautioned that the "gradual diminution of the area in which prior authorisation by the Reserve Bank is needed before banks can disburse credit to individual parties should not, therefore, mean any erosion of its role"

The basic approach to regulation of credit to industry and trade adopted by the Reserve Bank over the years as briefly reviewed above may be broadly summed up as follows:

(a) The basis of bank lending should be changed from security-based lending to lending based on funds flow.

(b) Credit needs are to be assessed and met by banks based on industry-wise working capital norms, deviations 'from these norms beyond the prescribed tolerance limits being seen as evidence improper credit use by the borrower requiring prompt rectification.

(c) Reliance of borrowers on bank finance for financing working capital should be progressively reduced by insistence on maintenance of a current ratio of 1,33:1 by a growing segment of borrowers, the minimum acceptable ratio being 1:1.

(d) Assessment of credit needs should be made on the basis of detailed information

to be provided by borrowers on past performance and future projections of working capital needs and overall performance.

(e) Final clearance by RBI of credit requests for amounts above the cut-off point under CAS was an essential element in the credit allocation system as banks were not always in a position to resist pressures from their larger clients, nor adequately equipped to undertake scrutiny of credit requests with the required degree of thoroughness.

(f) Continuous efforts are to be made by the borrowers, banks and the Reserve Bank to improve the information system which is seen as the key to the success of the approach to credit allocation outline above.

The borrowing community has over the years argued strongly against what it considers as the inflexibility and other inadequacies of the system of working capital financing adopted by the banks and the Reserve Bank of India. They have had the opportunity to present their views, in writing and during discussions, to the various committees and Study Groups appointed by the Reserve Bank of India to improve the methods of bank lending to industry and trade. Their criticism of the credit appraisal system as it has evolved over the past two decades covers conceptual as well as procedural aspects of the system. Some of these criticisms voiced by them are pointed out below.

Variation in Inventory level: The norms evolved by the Tandon Committee for assessing working capital requirements of different industries have been criticised by borrowers on the ground that the norms do not provide for variations in inventory levels occasioned by the operation of several commercial factors, apart from locational factors and impact of unforeseen developments. For example, it is pointed out that in the case of industrial units located in areas with inadequate transport facilities inventory levels would reflect the longer lead time for supply of raw materials and despatch of finished goods. It has also been argued that the norms which may be valid under ideal conditions, do not distinguish between different units and variations in market conditions overtime.

The levels of inventories in particular and the level of total working capital requirements also depend on a host of *extraneous factor* in the economy over which the borrower, has no control. These factors are inadequate and uncertain availability of power affecting production schedules, transport bottlenecks resulting from non -availability of railway wagons, non-availability of shipping space in the case of exports, changes in import policy, bottlenecks at the ports, bunching of imports, unanticipated changes in prices of raw materials and products made available by the public sectors canalising agencies, government policies regarding the permitted level of stocks in specific industries, *ad hoc* allocations by canalising agencies of scarce raw materials, strikes and disturbed industrial relations affecting purchase of supplies or sales of finished goods, uncertainties associated with imposition of duties in the annual budget of the government, sudden

changes in supply schedules prescribed by large public sector buyers, and so on. Under these circumstances borrowers point out that with the best of efforts they cannot project their working capital requirements even for one quarter, let alone for a year, with any degree of certainty. The management of these uncertainties itself consumes considerable time and efforts, and sanction of credit based on rigid norms compounds the difficulties in managing the industrial unit. These problems get magnified in the case of smaller borrowers as they are less able to determine the terms of purchase or sale of goods and have a weaker financial structure as compared to the larger borrowers.

Specification of different norms for different stages of production and marketing, detailed instructions regarding classification of items as current liabilities and current assets, difficulties in assessing the validity of projections of working capital requirements based on uncertainties referred to above, all combine to make the credit appraisal process a difficult and time consuming exercise. Again it is stated that during the protracted time over which credit appraisal is being undertaken, unforeseen developments occur, prices and market situation change, monetary policy stance may change, resulting in a need to revise earlier projections which leads to another cycle of delays. This brings in a tendency to inflate the amount of credit sought in the original application for sanction of credit limits.

Long-term Resources Contribution: The main thrust of the Chore Committee recommendations was on bringing a larger segment of borrowers under the Method II of lending wherein the borrowers are required to contribute long term resources through their own funds and term loans to the extent of 25 per cent of total current assets as against Method I of lending where their contribution would be no more than 25 per cent of the difference between current assets and current liabilities excluding bank borrowings. The borrowers are of the view that a rigid enforcement of this change would hurt industrial units. The resources at the disposal of the borrowers are limited and the application of Method II of lending should be gradual and based on the capacity of the units to augment their internal resources and term loans in situation where the financial strength and industry characteristics of different borrowers vary widely, and the state of the capital market is also not uniform over the years. Borrowers have argued that they need funds for modernisation, expansion and diversification, and further many of them need to improve their capacity utilisation which calls for higher levels of working capital. While term lending financial institutions insist on greater contributions by the borrowers towards the cost of fixed investment in projects being financed by them, bank insist on higher contributions by borrowers for financing their working capital requirements. The borrowers feel that both these demands can hardly be met by them at the same time with their limited resources.

Form of Bank credit: Bank credit sanctioned to borrowers takes the form of cash credit loans and bill financing. While cash credit is the more favoured form of financing,

banks specify separate limits for each type of assistance. The Chore Committee particularly stressed the need to insist on providing a part of the assistance by way of drawee bill limits. Separate limits are also specified for raw materials, finished products and receivables. The borrowers point out that this compartmentalisation hampers their ability to make the best use of the credit sanctioned to them and should therefore, be dispensed with, particularly since the components of working capital undergo changes in the course of operations. The banks too have to spend considerable time and effort to monitor the use of bank credit in accordance with the various sub-limits specified by them. There is no doubt that the importance of timely availability of credit should be reflected in the credit appraisal process at all stages, and borrowers should facilitate quick decisions by promptly providing the information called for by banks.

Margin requirements: Long term financial institutions have reason to be concerned that their relatively cheaper assistance is diverted to building up of working capital. At the same time banks are vigilant that borrowers do not appropriate larger than justified bank credit by diverting their own resources for expansion, modernisation or inter-corporate transactions. New companies find it difficult to have adequate margin for working capital as they are expected to conform to Method II of lending by banks from the time they start operations. Borrowers with a pronounced seasonal operation also face difficulties in meeting margin requirements during the peak season even when they are able to bring in their contribution during the year as a whole as required under Method II of lending. These factors appear to have complicated the financing of industrial operations.

Tax Concessions: Tax concessions available on additional fixed investment are attractive to industrial concerns who are naturally keen on availing of these concessions to the maximum extent possible, even if it means that they do not maintain margins stipulated by the bankers or margins for working capital at levels which they estimated while working out their project cost. Only when the borrowing concerns improve turnover of their capital, strengthen their equity base and obtain long term funds from the capital market will they be able to maintain adequate working capital margins on a regular basis. These options are open more to the larger companies who have a good past record of operations than to others, including new companies who are not well known in the capital market.

Credit Utilisation: The overall credit limit for a borrower is determined on the basis of Tandon/Chore norms and is generally thought of as being based on cash flow projections. But this is not really the case. The approach outlined by the Tandon Committee rests on the use of balance sheet data and the norms, therefore, are derived on the basis of funds flow statements. As a result, the true cash requirements of a borrower are not properly discernible in the statements provided to the banker for assessment of credit limits. The extent of mismatch between credit limits and the credit requirements of the

borrower would necessarily vary according to the scale of activity and seasonal factors. There is another aspect of credit limits which needs to be highlighted. The credit limit sanctioned to a borrower which is valid until it is reassessed, does not represent the extent of credit which the borrower is free to avail of at any point in time. The utilisation of credit limit depends on the borrower having the necessary drawing power as computed from the stock statements submitted to the bank periodically. This means that the utilisation of credit limits is related, through the application of margin requirements, to the level of inventories, book debts and other eligible assets indicated in the stock statement available to the banker. This is so because the operating banker prefers to base his decision to lend on a legal document such as the stock statement rather than on funds flow or even a cash flow statement indicating credit requirements for a given future period generally of three to six months. Bank lending, therefore, essentially retains its security orientation despite the application of more sophisticated norms. Credit limits based on Tandon/Chore norms serve the purpose of providing a ceiling to the utilisation of credit based on drawing power. Thus the quantum of credit that can be utilised by a borrower at any given time is equal to the drawing power or the credit limit, whichever is lower. The present credit appraisal procedures do not prevent utilisation of credit facilities over and above what is justified on the basis of a cash flow analysis, so long as the drawing power is not exhausted. As the stock statements are available once a month or less frequently, and their submission can be delayed if it suits the borrower, the drawing power based on the latest available stock statement does not necessarily represent current credit requirements. Moreover, banks are often obliged to condone excess drawals when they are in the nature of *fait accompli*, these being detected with a lag when the stock statement for the relevant period is submitted.

Information System: One of the major causes of delay in sanctioning of credit limits by banks has been the failure of borrowers to submit the quarterly statements under the prescribed information system in the time and in adequate detail. This is so even after the Chore Committee revised the formats relating to the information to be submitted which were introduced when the Tandon Committee recommendations were implemented. Even in the case of larger borrowers whose credit requests were subject to prior authorisation of the Reserve Bank of India, it was found that out of the 2321 applications processed by the Reserve Bank of India in 1982, further particular were sought in as many as 702 cases. The Marathe Committee has noted "while there has been considerable improvement in the commercial bank's appraisal systems, there are still wide variations as between banks and sometimes, in the quality of proposals put up by the same bank. There are delays, often inordinate, in processing applications. Similarly, among the borrowers also many have introduced modern techniques for the management of working capital and finance. In several cases, tools like planning for working capital, cash budgeting and management information systems are increasingly being used. But

here again there is considerable variation even amongst large borrowers; and the relatively smaller ones are still way behind, Altogether, while the working of the CAS has contributed a great deal and the banks as well as the borrowers have in many cases improved their systems, there is still long way to go." Considering that the CAS has been in operation since 1965, these observations of the Marathe Committee are not encouraging. The reluctance of borrowers to comply with the requirements of the information system which constitutes a critical element for the success of the present system of credit appraisal is a real hurdle in the way of achieving the objectives of the credit appraisal system. The use of the funds flow approach based on balance sheet information in setting credit limits instead of a cash flow approach also makes monitoring of credit limits over the short term a difficult task.

The operation of the credit appraisal system since the introduction of the Tandon Committee norms has evidently succeeded in reducing dependence of industrial borrowers on bank finance for meeting their working capital requirements. In the case of medium and large public limited companies in the manufacturing sector the ratio of bank finance to total current assets declined from 30.1 per cent in 1974-75 to 26.8 per cent in 1980-81, as revealed in the regular suryes of the finances of such companies undertaken by the Reserve Bank of India. In the case of large publics limited companies in the manufacturing sector for which survey results are available, it is seen that the ratio job bank finance to total current assets declined from 26.9 per cent in 1980-81 to 26.3 per cent in 1981-82 and further to 23.1 per cent in 1982-83.

The reduced reliance on bank finance has been made possible for the better established companies since 1980 by either greater access to the capital market facilitated by modifications in the official guidelines for the issue of convertible and non-convertible debentures. For the bulk of the lessor known industrial borrowers however, this would not be the case. The latter have responded of stricter credit appraisal by banks by resorting to ways and means in increasing their current liabilities. The RBI survey indicates that to 1980-81 the ratio of current liabilities excluding bank borrowing in current assets was 53.3 per cent for large public limited companies in the manufacturing sector. In comparison the ratio was 45.5 per cent for the medium and large public limited companies in 1980-81 having risen from 36.9 per cent in 1974-75. This is not a surprising finding and one can reasonably surmise that the effect of stricter credit appraisal was being passed on successively by the larger borrowers to the smaller and weaker borrowers, to greater or lesser degree depending on prevailing economic conditions and the stance of monetary policy.

Burden of Financing Sales: The transmission mechanism of the impact of stricter enforcement of working capital norms in financing the larger borrowers noted above is suggestive of a similar transmission of the burden of financing sales to government and semi-government agencies and public sector organisations who as a group are considered

to be slow in releasing payments for supplies. The industrial units whose funds are locked up for long periods due to delayed payment by government agencies would perforce delay, in turn, their payments to their own suppliers, starting off a chain of events resulting in an extra burden of financing being placed on the small scale industries who generally are unable to obtain their supplies other than against cash payment. This problem has been recognised for quite some time now and not much progress has been made in evolving a suitable solution. Even the Tandon Committee came up against this problem while it was laying down norms for working capital financing. It noted that "like the public sector, government purchase agencies are the biggest buyers in the country. Today payments by Government and public sector will only increase the level of receivables of industry and consequently the working capital requirements from banks for productive purpose. It would be useful if the Reserve Bank could initiate discussions on this matter. We also feel that Government should, pending streamlining its procedures, agree to pay interest on established delayed payments." Even after a period of almost ten years since the Tandon committee made these remarks, no improvement in the position was noticeable. The Tandon Committee itself did not provide any cushion for such delayed payments from government agencies in evolving working capital norms, even though their recommendations were meant to cover all borrowers with credit limits of Rs. 10 lakhs or more, thereby including a large number of small scale industrial units.

It is a matter of concern that the combined effect of stricter enforcement of credit norms in the case of the larger borrowers, and delayed payments by public sector and government agencies and other large units would be such as to place a heavy financial burden on the suppliers in the small scale sector, who are as a consequence driven to take recourse to credit from outside the organised sector at relatively higher cost as compared to bank finance. Remedial measures by way of earmarking credit limits for making payments to ancillaries and small scale industries have been thought of but are still an insignificant element in the present system of credit allocation and perhaps not easy to implement.

Like the small scale industries sector, another sector which finds itself at a considerable disadvantage in the present system of credit allocation, is the trade and distribution sector. As regards its role as a supplier of raw materials to the industrial sector it shares to some extent the problems faced by the small scale industries in regard to working capital finance, though not all units in the trade sector are small or financially vulnerable, or weak in terms of bargaining power. The trade sector, in addition, has also to face a different kind of problem in regard to working capital finance.

Kannan Committee Report (The Latest Committee)

With a view to free the banks from rigidities of the Tandon Committee recommendations in the area of Working Capital Finance and considering the ongoing liberalisation in the financial sector, IBA constituted, following a meeting of the Chief Executives of selected public sector banks with the Deputy Governor of Reserve. Bank of India on 31.8.96, a committee on 'Working Capital Finance' including Assessment of Maximum Permissible Bank Finance (MPBF), headed by K. Kannan, Chairman and Managing Director of Bank Baroda.

The Committee examined all the aspects of working capital finance and gave far reaching recommendations on the modalities of assessment of working capital finance in its report submitted to IBA on February 25,1997. It observed that since commercial banks in India are undergoing a metamorphosis of deregulations and liberalisations, it is imperative that micro-level credit administration should be handled by each bank individually with their own risks-perceptions, risks-analysis and risks-forecastings. The final report of the Committee was submitted to RBI for its consideration in March, 1997. In its final report, the Kannan Committee also pointed that alongwith modification of existing systems of working capital assessment and credit monitoring, certain undermentioned areas require to be given greater attention:

(1) Regular interface with the borrower to have a better understanding of (i) his business/activity; and, (ii) problems/constraints faced by him and the future action plan envisaged;

(2) Periodical obtaining of affidavits from the borrowers, declaring highlights of their assets, liabilities and operating performance (in lieu of subjecting even the high rated/high valued borrowers to several routine inspections/verifications) in order to bestow faith-oriented, rather than *ab initio* doubt-oriented, approach in monitoring the credit dispensation.

(3) Periodical exchange of information between/among financing banks/financial institutions to pick-up the alarm signals at the earliest.

(4) Establishing, within, a time bound programme, a "Credit Information Bureau" to provide updated information of existing/new borrowers before taking a credit decision. (Modality of Information Bureau in advanced countries may be taken' as a guide for floating an appropriate Credit Information Bureau).

Accordingly, the Kannan Committee recommended that the arithmetical rigidities, imposed by Tandon Committee (and reinforced by Chore Committee) in the form of MPBF-computation, having so far been in vogue, should be given a go-by. The committee also recommended for freedoms to each bank in regard to evolving their own system of working capital finance for a faster credit delivery in order to serve more effectively various segments of borrowers in the Indian economy.

Concurring with recommendations of the Kannan Committee, Reserve Bank of India (vide circular No. IECD No. 23/08.12.01/96 dated 15.04.1997) advised to all the banks, *inter-alia*, as under:

It has now been decided that the Reserve Bank of India shall withdraw forthwith the prescription in regard to assessment of working capital needs based on the concept of maximum permissible bank finance (MPBF) enunciated by Tandon Working Group. Accordingly, an appropriate system may be evolved by banks for assessing the working capital needs of borrowers within the prudential guidelines and exposure norms already prescribed".

The turnover method, as already prevalent for small borrowers. may continue to be used as a tool of assessment for this segment: since major corporates have adopted cash budgeting as a tool of funds management, banks may follow cash budget system for assessing the working capital finance in respect of large borrowers; there should also be no objection to the individual banks retaining the concept of the present maximun, permissible bank finance, with necessary modifications or any system".

Reserve Bank of India further directed that: Working capital credit may henceforth be determined by banks according to their perception of the borrower and the credit needs. Banks should lay down, through their boards, transparent policy and guidelines for credit dispensation in respect of each broad category of economic activity.

New System of Assessment of Working Capital Finance

Considering that Indian economy has already ushered into shores of'liberalisation and deregulations necessiating the banks in India to expeditiously integrate with global trends, followed by an ongoing process of elimination of barriers between operational areas of development banks and commercial banks, the Kannan Committee could not find any convincing justification to continue with separate assessment/fixations of jargon of various sub-limits, within overall working capital requirements, such as pre-sale finance, post-sale finance, domestic credit, export/ import credit, fund based limits and non-fund based limits. Instead, the Committee felt that *Line of Credit System* (LCS), as is prevalent in many advanced countries, should replace the existing system of assessment/fixation of sub-limits within total working capital credit requirement. Under LCS, the borrower's working capital credit requirement is assessed at an outer limit (i.e., the maximum limit) which is flexible enough to be used in one or more of the following forms as selected by the borrower in lieu of his requirements from time to time. In other words, the Line of Credit is not a credit facility *per se*, but, is an outer limit for total (funded and non-funded) working capital finance, and within this outer limit, various types

of working capital funded and non-funded credit facilities (illustrative list furnished in Table-1) with appropriate limits shall be made available to the borrower.

TABLE 1

Note: The directive of Reserve Bank of India for Loan Delivery System in Working Capital finance are to be complied with scrupously.

The Committee noted:

Entire Current Assets are to be the prime security for the confirmed Line of Credit—LCS (i.e., fixed/outer limit of working capital finance—whether funded finance or non-funded finance) and any excess drawings/requirement over and above the confirmed LCS may be subjected to additional rate of interest, say, upto 2.00%, to take care of the bank's cost of managing the uncommitted funds/obligation. However, specific long term working capital requirements such as (Sales to Electricity Boards, Bills Discounting under IDBI/SIDBI scheme etc. guaranteed by State/ Central Government is proposed to continue to be separate as is at present. The financing pattern in this regard would continue to be assessed taking into account quantum of Deferred Receivables as is the practice at present.

In the above context, the committee suggested that the existing system of assessment of working capital finance (based on MPBF-computations of Tandon Committee recommendations) may be replaced by a new system of assessment of working capital finance, ambodying essence of the deeply considered recommendations of the committee. The new system is proposed for all borrowers engaged in legally permitted economic/ financial activities excepting the following give in Table 2.

TABLE 2

1.	NBFCs (Non banking Finance Companies)	for whom, separate guidelines for assessment of W/C finance are devised by RBI;
2.	Construction Companies/Contractors	for whom, separate guidelines for assessment for assessment of W/C finance are suggested by RBI;
3.	Tea Companies	for whom. Cash Budget system is used to assess W/C finance
4.	Ship breaking companies	Existing system of W/C finance is to be continued.

5.	Diamond Industry	Existing system of W/C finance is to be continued.
6.	Small Scale Industrial Undertakings requiring W/C funded finance upto Rs. 2 crores;	for whom, RBI has directed to use "Turnover Method" propounded by Nayak Committee"
7.	Small borrowers (all sectors) requiring: Working Capital finance upto Rs. 2.00 Lacs (Rupees Two Lacs)	Most of such borrowers are usually covered under one or the other Schemes Sponsored by various Governments/local bodies. Therefore, financing— requirements of such borrowers shall be met as per the directives of the relevant sponsored scheme.
8.	Specific Long term working capital requirements such as Bills Discounting under IDBI/SIDBI— schemes etc.	Existing separately set out guidelines to continue to be in force.

***Note:* In Case of All Non-Priority Sector Borrowers, not covered under above points from '1' to'8', the Working Capital Credit requirement shall be assessed as per the Turnover Method applicable for SSI-Borrowers requiring W/C-finance upto Rs. 200.00 lacs.

As a consequence of the proposed withdrawal of the existing system of working capital finance based on "MPBF-system", though a large leeway is available to the bank to adopt a new method/system, the committee envisaged to retain, with appropriate modifications, strengths, and to remove weaknesses, of existing MPBF-system simultaneously doing away with its rigidities as regards (i) computation of working capital bank finance, and (ii) supervision and monitoring of the credit dispensed by the banks so that the proposed new system ensures faster credit delivery with inherent need and merit based flexibilities. Therefore, the committee proposed to shift emphasis from the "Liquidity Level Lending (which is *de facto* security based lending— practised and stipulated so far by the banks), to the "Cash Deficit Lending" (which is in essence *need based lending*—indicating the financial support required by a borrower). The cash deficit lending has been aimed at to *percieve the borrower's requirement*, rather than to assess, after the deserving risk-analys and risk-forecasting on case to case basis with perusal of the acceptability of the borrower's overall financial status, projected level of liquidity and activity, market reports, industry/activity profile and the economic strata which a particular borrower belongs to. As such, the new system of working capital finance may be called as *Desirable Bank Finance* (DBF). The committee recommended to put DBF—method in force immediately with the aim to make it fully operational over a period of 3-4 months, i.e., with effect from April 1, 1998 in order to afford, wherever necessary, adequate breathing time to bank staff and borrowers for developing familiarity with DBF method and also to coincide with start of new financial year for most of the borrowers as well as for the bank to afford operational convenience.

- The outlines of the DBF-method, as conceived by Kannan Committee, are discussed hereunder:

1. General Guidelines

1. The DBF method shall be applicable to working capital finance granted by a bank whether it is in sole banking or in multiple banking or in consortium banking arrangements. In multiple banking or consortium banking, there may be a situation where other banks are following a different method of working capital finance. In such a case:.

(a) if a bank is leader or holding the highest share in total working capital finance (i.e., total of funded and non-funded finance), the bank shall adopt the DBF-method and other banks shall be requested to accept the same;

(b) if a bank is not a leader or holding smaller percentage shares in total working capital finance (i.e., total of funded and non-funded finance), the bank may accept the assessment done by the consortium leader or the bank having largest share in the working capital financing, as the case may be, provided the bank is *prima facie* satisfied with efficacy of the method adopted by the consortium leader or the bank having largest share; otherwise, the bank shall follow DBF-method.

(2) Wherever any of borrower is having multi-division activities/businesses, the working capital credit requirement shall be perceived/assessed separately for each of the division as is done at present.

(3) At present, classification of Current Assets and Current Liabilities for the purpose of arriving at current ratio and for computing MPBF are different and the dual approaches often causes misunderstandings and confusions. Therefore, the committee proposed that, henceforth, there will be only one single classification of Current Assets and Current Liabilities and will be substantially be the same as is directed in the Form No. 111 (i.e., the extant CMA-guidelines for classification of C/As and C/Ls for the purpose of arriving at Current Ratio) subject to the changes briefed out hereunder:

(a) The components of the inventory procured under any of the Non-funded limits (viz., Letter of Credit and Guarantee) shall form part of Total Current Assets and the corresponding outstanding liabilities for payments therefore shall be added to Total Current Liabilities so as to arrive at the real financial position and short term solvency position of the borrower.

(b) Accordingly, the cash margins for L/Cs and Guarantees shall be part of total Current Assets.

(c) The amount of the Inter- corporate Deposits (ICDs), repayable by the

borrower within a period of 12-months, shall be treated part of Total Current Liabilities. Similarly, if the borrower has made investments in ICDs for a period lesser than-12-months, then, such ICDs shall be treated as Current Assets and the other ICDs shall be treated as Non-current Assets.

(d) The instruments/outstandings, such as, Commercial Paper (CP), Certificate of Deposits (CD) and other money market instruments, represent temporary (for a period less than 12 months) parking of the funds by the borrower. Such instruments/outstandings are to be treated as Current Assets.

(e) However, ICDs, investments in shares and debentures (including in associates and subsidiaries), even held for a period of less than 12 months, shall be treated as Non-current Assets.

(f) Wherever, DBF-method envisages any item's classification different, from the extant CMA-guidelines, the classification of Current Assets and Current Liabilities shall be done in conformity with the DBF-method.

(4) Before sanction of any adhoc/excess over the sanctioned limit (whether funded or non-funded facility), the borrower shall be asked to submit a proper Cash Flow statement so as to satisfy timely adjustment/liquidation of the adhoc-excess. The adhoc-excess may be subjected, at the discretion of the sanctioning authority, to levy of additional interest upto 2.00% p.a. to moot the cost of arranging additional funds/ obligations for the adhoc/excess.

(5) Banks' instructions on follow-up and supervision of working capital finance shall continue to be in force, mutatis mutandis with DBF-method and its guidelines narrated hereinafter.

(6) There shall be no commitment charge on unutilised portion of working capital finance. However, on a persistent default in availing at least 80% of the sanctioned limit, the Branches, where such accounts are maintained, shall ensure to review/to get reviewed, as the case may be, the borrower's working capital credit requirement by the competent authority for necessary revision/modification in the sanctioned limit.

(7) At the time of fresh sanction and sanction for review with modifications in the existing limits, and also for modifications in any of the stipulated terms and conditions, the borrowers are at present required to furnish following forms to which following modifications are proposed in TabIe-3

TABLE 3

Forms Nos	Existing particulars	Proposed Particulars	Remarks
I.	Particulars of existing/ proposed limits from the banking system	Particulars of existing/proposed limits/facilities/finance from: (a) each banks; (b) each financial institution for working capital credit requirement; (c) NRFCs; (d) ICDs.	Applicable to all the borrowers irrespective of the size of the finance required.
II.	Operating Statement	Operating statement with additional particulars required under the DBF-method.	{} () {} {}
III.	Analysis of Balance Sheet	Analysis of Balance Sheet with additional particular required under the DBF-method.	Operational guidelines and the applicability criterion for the
IV.	Comparative statement of Curren Assets and Current Liabilities	Comparative Statement of Current Assets and Current Liabilities with additional particulars required under DBF-method.	various borrowers shall be formulated separately in the micro-level details and guidelines/
V,	Computation of MPBF for Working Capital	Cash Budgets as required under the DBF-method	instructions. {} {)
VI.	Funds Flow Statement	Report on Financial indicators as required under the DBF-method.	{} {)

(8) As already discussed above, under the DBF-method, a Line of Credit (i.e., the outer limit for entire working capital finance) shall be fixed, within which, the borrowers shall be given freedom to select, for full one year or for a part of the year, sub-limits in one or more out of the various existing types of credit facilities. In other words, the line of credit is not a credit facility or credit delivery mode *per se*, but, is an outer limit of total (funded and non-funded) working capital finance, and within this outer limits, various existing types of working capital funded and non-funded credit facilities with appropriate limits shall be made available to the borrower at the discretion of the sanctioning authorities.

(9) RBI had advised that in the interest of developing "bills" culture in the system, out of the total inland credit purchases of the borrowers, not less than 25%, should be through bills drawn on them by concerned sellers. Accordingly, the RBI had again urged to ensure that with effect from January 1, 1998, of the total credit purchases of the borrowers, not less than 25 per cent, should be through bills drawn on them by concerned sellers. The Committee supported the above instruction fully.

(10) The Drawing power shall continue to be calculated with periodical statements

of stock, book-debts etc. as per bank's extant guidelines. However, the care has to be taken for fixation of the "margin" to ensure that against the adequate holding of stocks, book-debts etc., the aggregate drawing power does not become short of the Line of Credit, i.e., the outer limit fixed for total working capital limit. In other words, the existing discrepancy of the drawing power usually being less than the MPBF should not happen while working out the drawing power under the proposed DBF—method.

Categorisation of Borrowers According to Size of Working Capital Finance

1. *For Non-SSI borrowers requiring working capital finance over Rs. 2.00 lacs and upto Rs. 10.00 lacs from the banking system:* Considering size of the limit (extent of funded W/C—finance) required by such borrowers, and also the operational vagaries these borrowers are constrained to face and as also their *en mass* contribution to micro-level economic strata, the Committee proposed a simplified turnover-based method of perceiving W/C credit requirement for such borrowers as per the Annexure-

2. *For Non-SSI borrowers requiring working capital finance over Rs. 10.00 lacs and upto Rs. 500.00 lacs, and SSI borrowers requiring working capital finance over Rs. 200-00 lacs but upto Rs. 500.00 lacs from the banking system:* For this segment of the borrowers also, the Committee proposed to adopt turnover based method of perceiving W/C credit requirement. Nevertheless, since this segment of borrowers are pre-supposed to have a better data base of their operations and of financial health and, size of the limit to these borrowers demands a high level of bank-exposure, the committee proposed relatively detailed analysis and supervision. Therefore, the method enunciated as per the Annexure-2 is proposed.

3. *For all borrowers requiring W/C finance over Rs. 500.00 lacs but upto Rs. 1000.00 lacs (for both SSI as well as Non-SSI borrowers) from the banking system:* The borrowers requiring the above said size of limit are either corporate or likely to graduate to corporate-constitution in near future and, as such, are believed to have a better data-base of their operations. Moreover, the aggregate of the limits under the above said size puts the bank's exposure as a whole at a substantial level. Therefore, the committee proposed that assessment of working capital finance within this size of limit should continue to be on the basis of holding of Current Assets/Liabilities at present and later on switch over to the method of Cash Deficit financing when it is stabilised fully of higher scale of working capital finance. Accordingly, the Annexure-

4. *For all borrowers requiring W/Cfinance over Rs. 1000.00 lac (for both SSI as well as Non-SSI borrowers) from the banking system:* The borrowers,

requiring this size of limit, (i) are in upper strata of the economy; (ii) are predominantly corporates, and therefore, are statutorily required to maintain various financial data base and statements (such as, balance sheet, profit and loss Account, Fund Flow statements etc.) as per the proforma prescribed under the relevant statutes/Acts apart from being statutorily subjected to at least annual audits; (iii) have in-built system to maintain easily and promptly retrievable wide data-base to facilitate in-depth analysis and understanding of the borrower's profile; and, (iv) usurp a lion's share of the bank's lendable resources in the arena of working capital finance. Such borrowers do not generally run out of adequate holding level of inventory and/or receivables but suffer more from the cash deficits arising from time to time. Further, because of the mammoth size of the finance required by such borrowers, the banks are more required to vigil their funds-managing ability to timely resource the funds-availability as well as to conceive a proper funds-deployment.

In view of the above, arriving at a merit based credit decision necessitates a closer risk-forecasting—derived from:

(i) detailed risks-analysis carried out with the intra-firm comparison, and inter-firm comparison if necessary, of the borrower's financial and operational statements and projections; and,

(ii) risk-perceptions based on the interface with the borrowers, the market reports, industry/activity-profile, managerial competence, government policies and cross-country risks (wherever applicable).

In this context, the committee suggested that the quantum of working capital finance should be decided based on perception of the cash-deficit likely to be experienced by the borrower over the foreseeable/predictable near future as per the Cash Budget—proformae on the Annexure-4A. However, since the cash deficit system is to have its induction for the first time, the committee suggested the banks to satisfy upon the veracity of the "perceptions", generated out of the aforesaid, with a list of financial indicators.

It may be noted that reasonableness of Current ratio and Debt equity ratio (DER) as well as margin and holding level of inventory/receivables shall be at the discretion of the sanctioning/recommending authorities as per individual merits on case to case basis. Nevertheless, wherever the sanctioning authorities acquiesces to (i) Current Ratio (a) less than 1.17 for working capital finance less than Rs. 10.00 lacs, and (b) less than 1.33 for working capital finance of and above Rs. 10.00 lacs; and, (ii) Debt equity ratio more than 2:1, necessary justification for accepting lower current ratio and/or higher DER is to be elucidated. However, periodical verification of current assets/liabilities is to be done by the bank's official(s) and/or, subject to approval of the sanctioning authority

and generally on half-yearly basis, by a practising Chartered Accountant (other than the company's statutory/internal auditors). However, wherever the branch-official picks up any alarm signal and consider it necessary that a detailed inspection/verification of the securities charged to the bank is required to be carried out by a Chartered Accountant or approved valuer/engineer, they may do so (in consultation with the next higher authority) without waiting for formal approval of the sanctioning authority provided the branch seeks confirmation for this action within a period of-15-days of having initiating the said inspection/verification.

Some of the recommendations with suitable modification have already been accepted by Reserve Bank for implementation. While announcing the Monetary and Credit Policy for the first half of 1997-98 on 15th April, 1997, Reserve Bank of India *inter-alia* spelt out various measures relating to credit dispensation by the banks. Full freedom has since been given to banks to frame its own methods for assessment of working capital needs of the borrowers. The details of important measures announced by Reserve Bank are us under:

(i) Prescription as regards to assessment of working capital needs based on the concept of Maximum Permissible Bank Finance (MPBF) enunciated by Tandon Working Group has been withdrawn. Banks may evolve an appropriate system for assessing working capital needs of the borrowers, within the prudential guidelines and exposure norms which have already been prescribed by Reserve Bank of India.

Prudential exposure norms as per extant guidelines of Reserve Bank of India provide that the maximum exposure of a bank for all its fund based and non-fund based credit facilities, investments, underwriting, investment in bonds and commercial paper and any other commitment should not exceed 25 per cent of its (bank's) networth to an individual borrower and 50 per cent of its networth to a 'group'. It may however, be noted that while calculating exposure, the non-fund based facilities are to be taken at 50 per cent of the sanctioned limit. To illustrate the point let us consider the following examples:

Example 1.	
Net worth of the bank	*Rs. in crore* 700
Maximum exposure permitted for an individual Borrower (25% of networth of the bank)	175
Maximum exposure permitted for all borrowers under the same group (50% of net worth of the bank)	350
Example 2.	
Limits sanctioned to a borrower	
(i) Fund Based	100

(ii) Non Fund Based	100
Total	200
Total Exposure	
(i) For fund Based limits @ 100% of limits	100
(ii) For Non-funds Based limits @ 50% of limits	50
	150

Total credit limits to the above borrower are Rs. 200 crores wihch are in excess of the maximum exposure norm of Rs. 175 crores. But for the purpose of determining exposure we have taken non-fund based limits at 50 per cent of its value and total exposure is taken at 150 cores which is well within the norm.

As per a recent classification of Reserve Bank, loans and advances against bank's own deposits may not be included while arriving at over all exposure to a borrower.

Total exposure to group is permitted upto 60 per cent if the additional exposure is on account of finance to infrastructure finance. However, exposure norm to individual borrower remains restricted to 25% only even in such cases.

(ii) The turn over method, as already prevalent for small borrowers, may continue to be used as a tool of assessment for this segment. For small scale and tiny industries etc., this method of assessment may be extended upto total credit limits of Rs. 2.00 crores as against existing cut-off point of Rs. 1.00 crore.

(iii) Banks may adopt cash budgeting system for assessing the working capital finance in respect of large borrowers.

Reserve Bank of India has however, not suggested any specific form for assessment of working capital based upon cash budgeting. 'Kannan Groups' has given a form which may be adopted by the banks with suitable modifications. In any case it has been left to the banks to evolve their own method/form for this purpose.

(iv) The banks may also retain the concept of the present maximum permissible bank finance with necessary modification or any other system as they deem fit.

(v) Banks should lay down with due approval of their boards, transparent policy and guidelines for credit dispensation in respect of each broad category of economic-activity.

(vi) Rsserve Bank's instructions relating to directed credit (such as priority sector, export etc.), quantitative limits on lending (such as against shares and for consumer durables etc.) and prohibitions of credit (such as bridge finance, re-discounting of bills earlier discounted by NBFCs etc.) shall continue to be in force.

(vii) The present reporting system to Reserve Bank of India under the Credit Monitoring Arrangement (CMA) shall also continue in force.

MPBF system as per the recommendation. of Tandon Committee report was introduced in November, 1975 and has been well established by now. Despite its prescription being withdrawn by Reserve Bank, most of the banks are still continuing with this approach.

Cash budgeting system will require many changes in the accounting system being present adopted by the borrowers and a new information system, the transition to the new system is, therefore going to be slow and perhaps no Indian Bank has adopted this system of assessment of working capital needs so far in the real sense.

Many banks have however, adopted turnover method for assessment of working capital needs upto Rs. 2.00 crores in respect of all borrowers.

Recent RBI Guidelines Regarding Working Capital Finance

The following recent changes have been made by RBI in the guidelines for bank lending for working capital purposes and by way of term loans. These measures are set out below:

(i) Lending Norms for Working Capital

(a) Banks would henceforth decide the levels of holding of individuals item of inventory as also of receivables, which should be supported by bank finance, after taking into account the production/processing cycle of an industry as well as other relevant factors. RBI would no more prescribe detailed norms for each item of inventory as also of receivables; it would only advise the overall levels of inventory and receivables for different industries to serve as broad indicators for guidance of banks.

(b) Banks would be free to sanction ad hoc credit limits to borrowers, where considered necessary and charging of additional interest for this purpose is no longer mandatory.

(c) Other aspects of the lending discipline, viz., maintenance of minimum current ratio, submission and use of data furnished under quarterly information system, etc. would continue, though with certain modifications, which would make it easier for smaller borrowers, to comply with these guidelines.

ii. Treatment of term loan instalments for assessment of working capital purposes

Hitherto term loan instalments falling due for repayment in the next twelve months were treated as part of current liabilities for assessment of maximum permissible bank finance (MPBF). In terms of current policy, which was imple-mented in stages, such instalments are not required to be treated as an item of current liabilities for the limited

purpose of assessing MPBF. These instalments continue to be treated as current liabilities for all other purposes including for calculation of current ratio.

iii. Export Credit

(i) In order to ensure that the credit requirements of exporters are promptly met and their additional credit requirements out of firm orders/confirmed letters of credit, not taken into account while fixing their regular credit limits, the banks were advised in December 1992 to sanction such additional credit limits, even in excess of maximum permissible bank finance (MPBF).

(ii) Borrowing units engaged in export activities need not bring in any contribution from their long-term sources towards financing that portion of current assets as is represented by export receivables.

(iii) Banks were also advised not to apply the Second Method of Lending for assessment of MPBF to those exporter borrowers, who had to their credit export of not less than 25 per cent of their total turnover during the previous accounting year provided their aggregate fund-based working capital limits from the banking system were less than Rs. 1 crore.

While announcing the credit policy for the first half of 1997-98 (April-Sept.), the RBI has withdrawn its earlier instructions regarding MPBF and has given freedom to banks to determine working capital requirements of the borrowers on their own. The cash credit to loan ratio in the working capital limit has been fixed as follows:

Category of Borrower	Cash Credit to Loan Ratio
(i) Borrowers with a credit limit of less than Rs. 10 crore	Bank and the Borrower can settle freely
(ii) Borrowers with credit limit between Rs. 10 and 20 crore	25 : 75
(iii) Borrowers with credit limit Rs. 20 crore and more	20:80