

Working Capital Financing by Banks and its Regulation

* Dr.Sachin Chavan

Associate Professor, HOD, MBA Department, Zeal College of Engg. Research, Pune.

Abstract:

Working capital is the fund invested in current assets and is needed for meeting day to day operating expenses. Working capital is the fund invested in current assets. It occupies an important place in a firm's Balance Sheet. Working capital financing is a specialized area and is designed to meet the working requirements of a business. The main sources of working capital financing are trade credit, bank credit, factoring and commercial paper. Out of all these, this paper is related only to bank credit which represents the most important source for financing of current assets. The firms generally enjoy easy access to the bank finance for meeting their working capital needs. But from time to time, Reserve Bank of India has been issuing guidelines and directives to the banks to strengthen the procedures and norms for working capital financing. This paper attempts to analyse the role of bank credit in financing working capital needs of firms. It also tries to give a bird's eye view about the guidelines issued by RBI to banks in relation to working capital financing.

Key Words- Working capital, Current Asset, Current Liabilities, Commercial Papers, RBI.

Introduction:

Working capital is that portion of a firm's capital which is employed in short term operations. Current assets represent Gross Working Capital. The excess of current assets over current liabilities is Net Working Capital. Current assets consists of all stocks including finished goods, work in progress, raw material, cash, marketable securities, accounts receivables, inventories, short term investments, etc. These assets can be converted into cash within an accounting year. Current liabilities represent the total amount of short term debt which must be settled within one year. They represent creditors, bills payable, bank overdraft, outstanding expenses, short term loans, etc. The working capital is the finance required to meet the costs involved during the operating cycle or business cycle. Operating cycle is the period involved from the time raw materials are purchased to the time they are converted into finished goods and the same are finally sold and realized. The need for current assets arises because of operating cycle. The operating cycle is a continuous process and therefore the need for current assets is felt constantly. Each and every current asset is

nothing but blockage of funds. Therefore, these current assets need to be financed which is done through Working Capital Financing. There is always a minimum level of current assets or working capital which is continuously required by the firm to carry on its business operations. This minimum level of current assets is known as permanent or fixed working capital. It is permanent in the same way as the firm's fixed assets are. This portion of working capital has to be financed by permanent sources of funds such as; share capital, reserves, debentures and other forms of long term borrowings. The extra working capital needed to support the changing production and sales is called fluctuating or variable or temporary working capital. This has to be financed on short term basis. The main sources for financing this portion are trade credit, bank credit, factoring and commercial paper. It is in this that bank financing assumes significance in the working capital financing of industrial concerns.

2. WORKING CAPITAL FINANCING BY BANKS

A commercial bank is a business organization which deals in money i.e. lending and borrowing of money. They perform all types of functions like accepting deposits, advancing loans, credit creation and agency functions. Besides these usual functions, one of the most important functions of banks is to finance working capital requirement of firms. Working capital advances forms major part of advance portfolio of banks. In determining working capital requirements of a firm, the bank takes into account its sales and production plans and desirable level of current assets. The amount approved by the bank for the firm's working capital requirement is called credit limit. Thus, it is maximum fund which a firm can obtain from the bank. In the case of firms with seasonal businesses, the bank may approve separate limits for 'peak season' and 'non-peak season'. These advances were usually given against the security of the current assets of the borrowing firm. Usually, the bank credit is available in the following forms:

1. Cash Credit – Under this facility, the bank specifies a predetermined limit and the borrower is allowed to withdraw funds from the bank up to that sanctioned credit limit against a bond or other security. However, the borrower cannot borrow the entire sanctioned credit in lump sum; he can draw it periodically to the extent of his requirements. Similarly, repayment can be made whenever desired during the period. There is no commitment charge involved and interest is payable on the amount actually utilized by the borrower and not on the sanctioned limit. Overdraft – Under this arrangement, the borrower is allowed to withdraw funds in excess of the actual credit balance in his current account up to a certain specified limit during a stipulated period against a

security. Within the stipulated limits any number of withdrawals is permitted by the bank. Overdraft facility is generally available against the securities of life insurance policies, fixed deposits receipts, Government securities, shares and debentures, etc. of the corporate sector. Interest is charged on the amount actually withdrawn by the borrower, subject to some minimum (commitment) charges.

2. Loans – Under this system, the total amount of borrowing is credited to the current account of the borrower or released to him in cash. The borrower has to pay interest on the total amount of loan, irrespective of how much he draws. Loans are payable either on demand or in periodical installments. They can also be renewed from time to time. As a form of financing, loans imply a financial discipline on the part of the borrowers.
3. Bills Financing – This facility enables a borrower to obtain credit from a bank against its bills. The bank purchases or discounts the bills of exchange and provisionary notes of the borrower and credits the amount in his account after deducting discount. Under this facility, the amount provided is covered by cash credit and overdraft limit. Before purchasing or discounting the bills, the bank satisfies itself about the creditworthiness of the drawer and genuineness of the bill.
4. Letter of Credit – While the other forms of credit are direct forms of financing in which the banks provide funds as well as bears the risk, letter of credit is an indirect form of working capital financing in which banks assumes only the risk and the supplier himself provide the funds. A letter of credit is the guarantee provided by the buyer's banker to the seller that in the

case of default or failure of the buyer, the bank shall make the payment to the seller. The bank opens letter of credit in favour of a customer to facilitate his purchase of goods. This arrangement passes the risk of the supplier to the bank. The customer pays bank charges for this facility to the bank.

5. Working Capital Loan – Sometimes a borrower may require additional credit in excess of sanctioned credit limit to meet unforeseen contingencies. Banks provide such credit through a Working Capital Demand Loan (WC DL) account or a separate 'non-operable' cash credit account. This arrangement is presently applicable to borrowers having working capital requirement of Rs.10 crores or above. The minimum period of WC DL keeps on changing. WC DL is granted for a fixed term on maturity of which it has to be liquidated, renewed or rolled over. On such additional credit, the borrower has to pay a higher rate of interest more than the normal rate of interest.

3. SECURITY REQUIRED IN BANK FINANCE -

Banks generally do not provide working capital finance without adequate security. The nature and extent of security offered play an important role in influencing the decision of the bank to advance working capital finance. The bank provides credit on the basis of following modes of security:

1. Hypothecation – Under this mode of security, the banks provide working capital finance to the borrower against the security of movable property, generally inventories. It is a charge against property for the amount of debt where neither ownership nor possession is passed to the creditor. In the case of default the bank has the legal right to sell the property to realize the amount of debt.

2. Pledge – A pledge is bailment of goods as security for the repayment of a debt or fulfillment of a promise. Under this mode, the possession of goods offered as security passes into the hands of the bank. The bank can retain the possession of goods pledged with it till the debt (principal amount) together with interest and other expenses are repaid. . In case of non-payment of loan the bank may either; Sue the borrower for the amount due; Sue for the sale of goods pledged; or After giving due notice, sell the goods.
3. Lien – Lien means right of the lender to retain property belonging to the borrower until he repays the debt.

It can be of two types: (i) Particular lien and (ii) General lien.

Particular lien is a right to retain property until the claim associated with the property is fully paid. On the other hand, General lien is applicable till all dues of the lender are paid. Banks usually enjoy general lien.

4. Mortgage – Mortgage is the transfer of a legal or equitable interest in a specific immovable property for the payment of a debt. In case of mortgage, the possession of the property may remain with the borrower, while the lender enjoys the full legal title. The mortgage interest in the property is terminated as soon as the debt is paid. Mortgages are taken as an additional security for working capital credit by banks.
5. Charge – Where immovable property of one person is made security for the payment of money to another and the transaction does not amount to mortgage, the latter person is said to have a charge on the property and all the provisions of simple mortgage will apply to such a charge. A charge may be created by the act of parties or by the operation of law. It is only security for payment.

4. REGULATION OF BANK CREDIT

Till the sixties, bank credit for working capital was available easily and in convenient form to industrial borrowers. 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. Banks have not been concerning themselves about the soundness of the borrower or about the actual end use of the loan. Bank financing was mainly security oriented. This security oriented system tended to favor borrowers with strong financial resources irrespective of their economic function. This resulted in the concentration of economic power. Another problem was that the increase in the bank credit was not commensurate with the expansion in the level of inventory and production. This resulted in a number of distortions in financing of working capital by banks.

Major Banks was nationalized in 1969 and with that, approach to lending also changed. Consequently, bank credit has been subjected to various rules, regulations and controls. The basic objective of regulation and control of bank credit is to ensure its equitable distribution to various sectors of the Indian economy. The RBI has been trying, particularly from the mid-sixties onwards, to bring a measure of discipline among industrial borrowers and to redirect credit to priority sectors of the economy. The RBI has been issuing guidelines and directives to the banking sectors towards this end. Important guidelines and directives have derived from the recommendations of certain specially constituted groups assigned with the task of examining various aspects of bank finance to industry.

5. RECENT RBI GUIDELINES REGARDING WORKING CAPITAL FINANCE

In the past, working capital financing was constrained with detailed regulations on how much credit the banks could give to their customers. The recent changes made by RBI in

the guidelines for bank credit for working capital finance are discussed below:

1. The notion of Maximum Permissible Bank Finance (MPBF) has been abolished by RBI and a new system was proposed by the Indian Banking Association (IBA). This has given banks greater freedom and responsibility for assessing credit needs and credit worthiness. The salient features of new system are:
 - For borrowers with requirements of up to Rs. 25 lakhs, credit limits will be computed after detailed discussions with borrower, without going into detailed evaluation.
 - For borrowers with requirements above Rs. 25 lakhs, but upto Rs. 5 crores, credit limit can be offered upto 20% of the projected gross sales of the borrower.
 - For large borrowers not selling in the above categories, the cash budget system may be used to identify the working capital needs.

However, RBI permits banks to follow Tandon/Chore Committee guidelines and retain MPBF concept with necessary modifications.

1. Earlier RBI had prescribed consortium arrangements for financing working capital beyond Rs. 50 crores. Now it is not essential to have consortium arrangements. However, banks may themselves decide to form consortium so that the risks are spread.
2. The disintegration of consortium system, the entry of term lending institutions into working capital finance and the emergence of money market borrowing options gives the best possible deal.

3. Banks were advised not to apply the second method of lending for assessment of MPBF to those exporter borrowers, who had credit export of not less than 25% of their total turnover during the previous accounting year, provided that their fund based working capital needs from the banking system were less than Rs. 1 crore. RBI has also suggested that the units engaged in export activities need not bring in any contribution from their long term sources for financing that portion of current assets as is represented by export receivables.
4. RBI had also issued lending norms for working capital, under which the banks would decide the levels of holding of inventory and receivables, which should be supported by bank finance, after taking into account the operating cycle of an industry as well as other relevant factors. Other aspects of 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.

6. CONCLUDING REMARKS

From the above discussion we can say that bank credit occupies an important place in financing working capital requirements of industries. Working capital financing is a specialized line of business and largely dominated by commercial banks. Generally, the bank finance for meeting working capital needs is easily available to firms. But it has been always difficult to determine the norms for an adequate quantum of bank credit required by an industry for working capital purpose. Various committees have been set up for examining the working capital financing by banks and to recommend norms for and to regulate bank credit. Besides this from time to time, Reserve Bank of India has been issuing guidelines and directives to the banks to strengthen the procedures and norms for working capital financing.

REFERENCES:

1. Bhalla, V. K., (2003), Working Capital Management, New Delhi, Anmol Publications Private Limited, 5th Edition.
2. Chandra, Prasanna, (2001), Financial Management: Theory and Practices, New Delhi, Tata McGraw Hill Publishing Company Limited, 5th Edition.
3. Khan, M. Y. and Jain, P. K., (2004), Financial Management: Text and Problems, New Delhi, Tata McGraw Hill Publishing Company Limited, 4th Edition.
4. Maheshwari, S. N., (2004), Financial Management: Principles and Practices, New Delhi, Sultan Chand & Sons Educational Publishers, 9th Edition.
5. Pandey, I. M., (2001), Financial Management, New Delhi, Vikas Publishing House Private Limited, 8th Edition.
6. Srinivasa, S., (1999), Cash and Working Capital Management, New Delhi, Vikas Publishing House Private Limited.