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1. Learning Outcomes

After studying this module, you shall be able to:

- Know the concept of financing of working capital
- Understand various modes of finance of working capital by banks
- Understand the regulations of RBI on working capital finance.

2. Introduction - Concept of Working Capital Finance

Working capital can be compared to blood flowing in veins of living beings. Although it is long–term real capital (that is Fixed Assets) which brings business into existence. However even after coming into existence business cannot operate without working capital. Working capital smoothens operating activities of business.

Need of working capital arises since there is time lag between the purchase of raw material for use in production by the business to realisation of cash proceeds arising out of sale of products to consumers. Due to this time lag, funds remain blocked and invested in various current assets such as raw materials, work–in–progress, finished good and Debtors. Hence to support these blocked investment, working capital is needed. Without working capital, business cannot invest in its current assets and without investment in current assets it is difficult to leverage operational capacity provided by Fixed Assets.

Thus working capital is an important component of operating activity of business. Hence it is important for a business to effectively estimate its working capital. Working capital in influenced by many factors such as nature of business (Manufacturing or retail), scale of business (Large, medium or small), business cycle (Boom or recession), Seasonal fluctuation, operating cycle of business (that is time required from purchase of raw material to realisation of sale proceeds from sale of final product to consumers), Operating efficiency, Credit Policy etc. Business has to consider all these factors for effective estimation of its working capital.

After determination of working capital business proceeds to find sources from where its working capital can be financed. In this context it is important to understand the difference between gross working capital and net working capital. Gross working capital means total investment in current assets whereas net working capital means current assets as reduced by current liabilities. Some of its gross working capital requirements are fulfilled from spontaneous sources. These spontaneous sources are current liabilities. When business make investments in current assets then sometime it has not to pay for these investments immediately but after some time. This spontaneous funding is current liability. Thus business is concerned about financing its net working capital rather than gross working capital.

Banks are predominant source of financing working capital of business. As working capital is required for short–term hence business look forward to banks for finance of its working capital. Banks finance working capital in various modes.

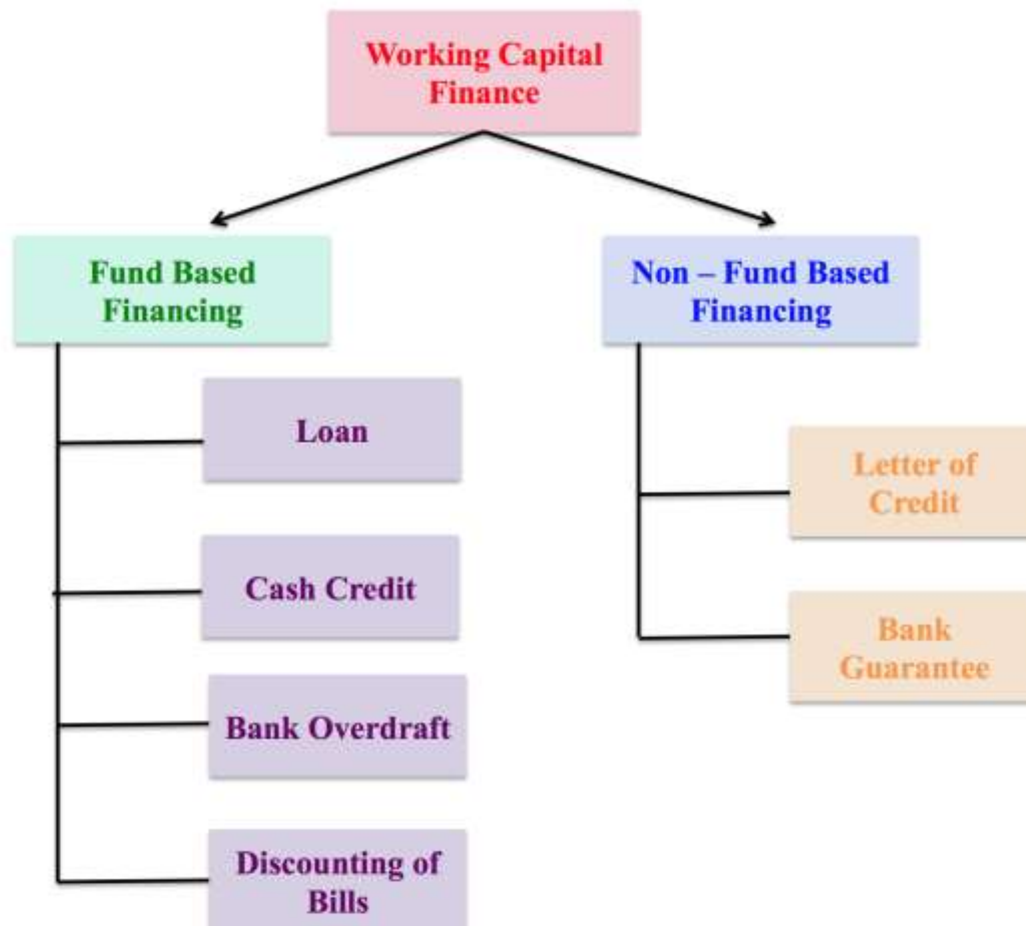
3. Various Modes of Financing Working Capital by Banks

Banks provide working capital finance mainly in two ways:

(1) Fund Based Finance: Fund based financing are those types of financing by banks which involve direct outflow of funds from bank to borrower.

(2) Non–Fund Based Finance: Non–Fund based financing are those types of financing by banks, which do not involve direct outflow of funds from bank to borrower.

Diagrammatically it can be shown as follows:



3.1 Fund Based Financing

Fund based financing are types of financing in which banks directly pays funds to borrowers. Borrower then can withdraw these funds from bank as per their need. The various modes of Fund based financing are discussed as follows:

Loan

In Loan, bank credit the whole proceeds of loan in the borrower account. Thereafter bank charges interest on the amount of whole loan as reduced by any principal repayment. The loan is sanctioned against security. It is prominent method of financing working capital and different banks have kept different limits as to how much of working capital finance should contain loan and cash–credit component. Major part of working capital finance contains loan element.

Repayment of these loans are structured in a way to suit borrower's need. These loans can be repayable at fixed periodic interval or at demand together with interest. However banks strictly observe frequency of repayment so loan do not fall in the category of non–performing asset.

Expected duration of Loan is longer than cash–credit since interest rate on these loan are lesser than interest on cash–credit. Due to lesser interest rate these loan are more attractive to borrower than cash–credit. However one of the major disadvantages of these loans is that interest is charged on whole amount of sanctioned loans, which make these loans sometime costlier than cash–credit.

Cash Credit

In cash–credit, banks do not give whole amount of loan to the borrower. Instead of crediting whole amount of loan in borrower's account, bank sanctioned certain limit in a borrower's account. The limit is sanctioned against security. Thereafter borrower can withdraw any amount within sanctioned limit from the account. Interest is charged not on sanctioned limit but the amount withdrawn by the borrower.

There is no fixed repayment schedule as in loan. Borrower can repay as per their convenience. However interest should be paid regularly so as not to render these cash–credits under the category of non–performing asset.

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Irrespective of the fact that cash–credit is repaid by borrowers at their convenience, expected duration of cash–credit is shorter than loan since interest rate on cash–credit is high. However one of the main advantages of cash–credit is that interest is charged only on amount utilized and not on total sanctioned limit.

Bank Overdraft

Bank Overdraft is a facility in which borrower having current account in bank is allowed to withdraw from bank more than amount lying in the credit of the account but up to certain limit.

This limit is as in case of cash – credit is sanctioned against security. Interest is charged on amount actually withdrawn and not on limit sanctioned. Bank overdrafts are very similar to cash–credits. Borrowers remit the excess amount withdrawn at their convenience. However due to bank strict adherence to standard asset norms, borrowers have to regularly pay interest on overdraft.

Bank overdraft like cash–credit carries high interest rate. Due to high rate of interest, the expected duration of bank overdraft is short and one of its pros is that interest is charged only on amount withdrawn by the borrower.

Discounting of Bills

Bills (including promissory notes) are negotiable instruments for fixed sum that are maturable after the end of maturity period. These bills have common usage in business and are used when persons (debtors) to whom good and services are delivered instead of paying immediately agree to pay in future. At maturity, debtors pay the amount. From the date of inception of till maturity these bills are negotiable instrument. Creditors usually hold these bills till maturity and upon maturity they receive payment from debtors.

If persons who are holding bills are in need of fund then they can get bills discounted by any third party. Third party can also be a bank. Bank discounts bill by deducting some amount from amount finally payable on bill at maturity. This deduction depends upon the three factors that is:

(i) Amount of bill
(ii) Prevailing Interest Rate
(iii) Time remaining to maturity

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Discounting of bill is one of the prominent methods for working capital fiancé. However it comes under the category of cash–credit and for this reason it carries higher rate of interest. Bank before discounting bill also verify financial stability of debtor along with genuineness of transaction.

3.2 Non – Fund Based Financing

Non–Fund based financing are those types of financing in which banks do not directly pays funds to borrowers. Help is given to borrower not in form of fund but in form of gurantees. The various mode of non – fund based financing are as follows:

Letter of Credit

Letter of credit is a guarantee given by bank to seller of good and services on behalf of buyer assuring seller that in case of default in payment of good and services by buyer, bank shall make payment to seller to the extent of amount remaining unpaid. Thus in letter of credit, seller gives finance to the buyer but on the responsibility assumed by bank on behalf of buyer. Thus letter of credit is indirect form of finance by banks, which becomes enforceable only if seller fulfills conditions of delivery of good and services.

Letter of credit are predominantly used in international business since both buyers and sellers are unknown to each other. In international business, sellers are exposed to number of risks and for this reason they are reluctant to supply good and services in foreign country. However seller is willing to subsumes these risks if guarantee is provided by bank in form of letter of credit.

Bank Guarantee

Bank guarantee is also a guarantee provided to lender on behalf of borrower assuring that in the event of default by borrower, bank shall take over responsibility and duly fulfill commitment towards lender for payment. In this case also, lender and not bank provide finance. However bank only provide funds in case of borrower's default. Bank guarantee is similar to letter of credit except with the difference that bank guarantee is enforceable from its initiation whereas letter of credit become enforceable when seller satisfies conditions as to delivery of goods and services.

Thus banks are major source for financing working capital whether by fund based method or non–fund based method. Reserve Bank of India has almost removed all restrictions regarding working capital finance and has given autonomy to Banks to decide the norms for working capital finance for its borrowers.

4. Regulation of Reserve Bank of India (RBI) on Working Capital Finance

4.1 Norms for Determination of Limits for Working Capital Finance by Banks

RBI had substantially liberalized the regulations regarding working capital finance in year 1997. Now banks have liberty to follow any of the below mentioned norms to finance working capital requirements of their borrowers. These norms are discussed as under

Norms based on Tandon Committee Report

RBI constituted Tandon committee in year 1974 and the recommendation of Tandon committee is still followed by most banks in India. This committee prescribe the maximum permissible bank finance that bank can sanction to its borrowers for financing their working capital. The committee recommended three alternative methods and these three alternative methods are as follows:

(1) First Method: Under first method, bank can finance maximum up to 75% of the net working capital needs of the borrower. Net working capital means current assets as reduced by current liabilities. Current liabilities will not include liabilities due to bank. The remaining 25% of the net working capital requirements is required to be filled by owner's fund and other long–term borrowing.

(2) Second Method: Under second method, bank can finance maximum up to 75% of the gross working capital as reduced by current liability. Hence while calculating maximum permissible bank finance under second method current liabilities are deducted from 75% of gross working capital. In this case also, current liabilities will not include liabilities due to bank. The remaining 25% of the gross working capital requirements is required to be filled by owner's fund and other long–term borrowing.

(3) Third Method: Under this method, working capital is divided into two parts that is core current assets and other currents assets. Core current assets are those assets, which are very necessary for operation of business and include raw material, work–

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in–progress and finished goods. Under this method bank can finance maximum up to 75% of other current assets as reduced by current liability. The whole core current assets and remaining 25% of other current assets is required to be finance by owner's fund and other long–term borrowing.

Tandon committee emphasized the importance of periodic information and reporting from the borrowers so their financial stability can be vouched and reviewed periodically. Tandon committee also stressed that majority of working capital requirement should be finance through loan and cash credit should be used minimally.

Projected Turnover Norms based on Nayak Committee Report

Recommendation based on Tandon Committee was not suitable for small–scale borrowers. Subsequently RBI constituted Nayak committee in year 1991 for examining the problems faced while lending to small–scale industries. Nayak committee recommendations for financing working capital were based on Projected Turnover. Committee recommended that working capital for borrower to be estimated at 25% of the projected turnover of borrower. Bank can finance up to 80% of estimated working capital and the borrower would contribute rest of the 20%.

Cash Flow Method

This method is still not widely used by banks due to complexity involved in preparing cash budget for succeeding twelve months. In this method, cash flow statement is made monthly–wise for the one year. Cash budget is made on the basis of estimated cash inflows and outflows. There may be excess or shortage of cash in any month. Month with highest shortage of cash is identified and working capital loan is allowed maximum to the extent of highest shortage of cash identified above. Bank allows borrower to withdraw amount within maximum limit but upon fulfilling of certain conditions.

Banks in India are nowadays free to adopt any of these three methods. However most banks are still practicing methods recommended by Tandon committee. Cash Flow method is still unpopular with banks due to complications involved in estimation of cash budget.

4.2 Other Regulations

Loan System for Financing Working Capital Loans

RBI has recommended that in case of working capital finance by bank to borrower having limit of Rs. 10 crores or more, at least 80% of the working capital finance should be loan component and balance should be cash–credit component. The logical reasoning of this recommendation is that cash–credits are paid by borrowers at their wish. For this reason cash–credit remain outstanding for long time. But in case of loan, repayments are made at periodic interval and as a consequence outstanding amount of loan gradually decrease over time. Thus to avoid blockage of loan amount with borrowers for unusual long time, RBI has prescribed this recommendation.

Interest Rate for Working Capital Finance

Banks would charge separate interest for loan and cash–credit component. The rate of interest for loan component should be lower than cash – credit component so as to encourage more loan system. The Bank may offer both fixed and floating rate of interest.

The base rate would be minimum rate of interest for working capital finance. Each bank would have its own separate base rate that would be reviewed quarterly. Base rate should cover cost of fund and hence can be determined by one of the following methods:

(i) Average cost of funds
(ii) Marginal cost of funds
(iii) Any other method which is currently in practice

Quarterly review of base rates of banks does not affect the loan given at fixed rate of interest. However loans given at floating rate of interest are affected by quarterly review of base rate and the interest rate on these loans may change due to change in base rate.

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5. Summary

Working Capital is an important component of business and it can be compared to blood flowing in the vein of living body. Without working capital business cannot run smoothly carried out its day-to-day operations. Working capital is needed since there is time involved from purchase of raw material to ultimate realisation of cash from consumers. Due to this delay fund remain blocked in various current assets. Hence to support these blocked investment in current assets, working capital is needed.

It is very important for an organisation to effectively estimate its working capital. In this context it is important to differentiate between gross working capital and net working capital. Gross working capital is total investment in current assets whereas net working capital is total investment in current assets as reduced by current liability. An organisation need to finance its net working capital and bank is most important source of financing working capital.

Bank offers working capital finance in two ways that is fund based and non–fund based. Fund based financing are type of financing where there is direct outflow of funds by banks to borrowers. Examples of fund based financing are loans, cash – credit, bank overdraft and discounting of bills. In loans, bank directly credit the whole amount of loan in the borrower's account and thereafter borrower can withdraw the amount of loan wholly or partially. Interest is charged on whole amount of loan as reduced by principal repayments. In cash–credit and bank overdrafts banks instead of crediting whole amount of loan in borrower's account sanction certain limit to borrower. Borrower can withdraw amount within sanction limit. Interest is charged on amount withdrawn by the borrower and not on sanctioned limit. In discounting of bills bank discount bill before its maturity date. Bill is a negotiable instrument which is payable at maturity. However person in immediate need of money can get these bills discounted by banks before maturity. Amount of discount deducted by bank depends upon interest rate, amount of bill and time remaining to maturity.

On the other hand in non–fund based financing there is not direct outflow of fund by banks to borrowers. In non – fund based financing, lender is actually some other third party and bank gives guarantee to lender on behalf of borrower that in even of default by the borrower, bank shall duly pay remaining dues of borrower. Non – fund based financing includes letter of credit and bank guarantee.