Study Notes

Principles of Lending, Working Capital Assessment and Credit Monitoring

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Introduction

- The main source of funds for a banker is deposits from the public, which are repayable whenever demanded by the depositors.
- The banker while lending should, therefore, follow sound principles of lending and should assess the permissible limits of finance on the basis of accepted norms.

Principles of Lending

- **Cardinal Principles of Lending**
  - The business of lending is not without certain inherent risks, especially when the lending banks depend largely on the borrowed funds. The cardinal principles of lending are, therefore, as follows:
    - Safety
    - Liquidity
    - Profitability
    - Purpose
    - Diversification of Risks
    - Security
  - **Safety**
    - Safety first is the most important principle of good lending.
    - When a banker lends certain monies, he has to ensure that the advance is safe and that the money lent will comeback.
  - **Liquidity**
    - It is to be seen that money lent is not going to be locked up for a long time.
    - The money should return to the bank as per the repayment schedule.
  - **Profitability**
    - A fair return on investment is essential so also in the case of lending by banks.
    - Banks are commercial organisations and profit earning is the motto of banks to pay adequate dividend to the stakeholders. The interest margin of three to four per cent between lending and borrowing is essential to meet their administrative expenses.
  - **Purpose**
    - Loans for undesirable and speculative purposes cannot be granted.
    - Although the earnings on such business activities may be higher, even then a bank cannot resort to these loans.
  - **Diversification of Risks**

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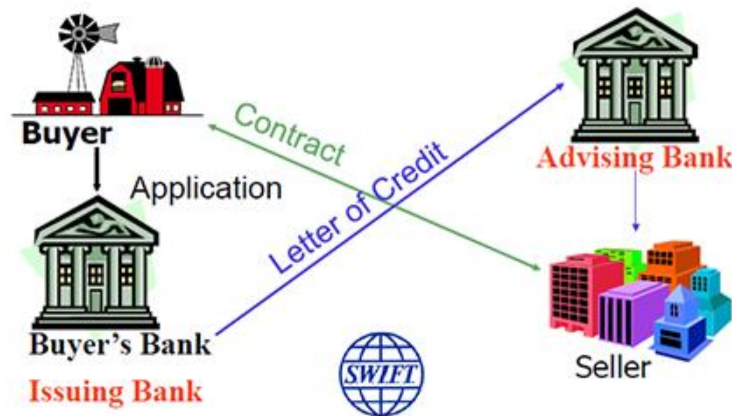
- It means that the banker should not grant advances to only a few business houses, undertakings, cities, industries or regions. It should be ensured that the advances are diversified in a good number of customers.
- **Security**
  - The security offered against the loans may consist of a large variety of items. It may be plot or land, building, flat, shop, ornaments, insurance policies, shares, debentures, bonds etc.

Non-Fund Based Limits

- While ascertaining the credit needs of the borrower, the bankers should assess both the fund based and non-fund based limits required by him together and sanction them as a package. The non-fund based limits are normally of two types:
  - bank guarantees,
  - letters of credit.



- **Bank Guarantees**
  - By issuing a bank guarantee, the guarantor bank accepts the responsibility for an obligation, if the entity with the primary responsibility for the obligation does is one who guarantees an obligation and has a legal duty to fulfil it.
  - On issuing a guarantee, the guarantor pays when the primary debtor fails to meet his obligation.
- **Letters of Credit (L/C)**
  - A Letter of Credit (L/C) is a binding document that a buyer of goods can request

from the bank in order to guarantee that the payment for goods will be transferred to the seller.
- In order for the payment to occur, the seller has to present the bank with necessary documents as per L/C terms.
- While sanctioning the letter of credit limits for the purchase of raw materials, the banker has to collect the following particulars:
  - Value of raw materials consumed in the ensuing year as projected
  - Value of raw materials that are purchased on credit out of the above
  - Time taken for advising the letter of credit to the beneficiary
  - Time for shipment and the consignment to reach the customer's destination.
  - Credit period (usance period) agreed between the beneficiary and the customer
  - Credit period projected and reckoned for calculation of the maximum permissible bank finance (MPBF) while sanctioning the funded limits to the borrower customer Once the above information is available, the banker can assess the letter of credit limit as explained in the following illustration:
- Estimation
  - Value of raw material consumption projected: Rs. 3,600 lakh
  - Value of raw material (to be) bought on credit: Rs. 2,400 lakh
  - Time for advising L/C: 10 days
  - Shipment time: 20 days
  - Credit period agreed upon between the seller and the customer OR the credit period projected as available in CMA format considered for calculation of MPBF while sanctioning funded limits, whichever is less: 30 days
  - Time required for one cycle of operation of L/C will be 10 + 20 + 30 = 60 days.
  - Assuming 360 days in a year, there could be 6 rotations/cycles in a year. If the raw material consumed, to be bought on credit is Rs. 2,400 lakh in a year, the limit of L/C per rotation/cycle will work out to Rs. 2,400 lakh /6 = Rs. 400 lakh
  - The letter of credit limit required, given the above situation, would be Rs. 400 lakh. A banker should ensure that the stocks procured through the L/C are taken under hypothecation and are not included in the stocks declared as security for the fund based limits granted to the customer. If the L/C limit is sanctioned for purchase of capital goods, the same is taken under a hypothecation charge by the banker.

Working Capital and Term Loans

- **Concept of Working Capital -** The term working capital denotes the requirement of the money by a manufacturing enterprise for its day-to-day financing of:
  - purchase a raw materials, stores and spares
  - payment of wages to employees

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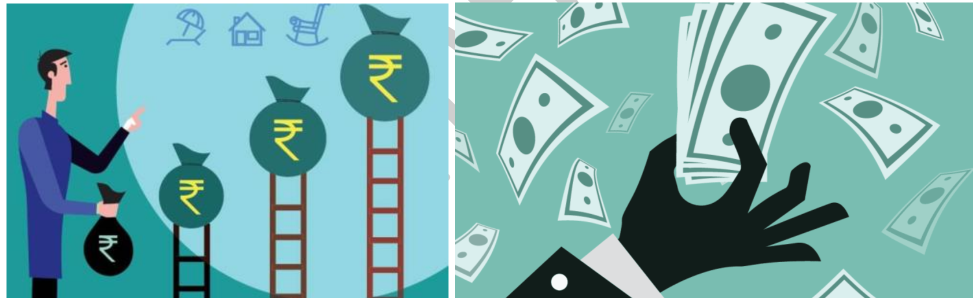
- payment of other expenses towards energy, fuel and water consumption, statutory dues, rates and taxes carriage expenses etc.
- other expenses required to be incurred in connection with the production, selling and administration etc.

- The banks normally define the working capital as the sum total of inventory, receivables and other current assets held by a business entity.
- It is computed by the banks through the concept of the operating cycle, i.e. the time taken by a business entity to get the money released from the raw materials, semi¬finished goods, finished goods, receivables etc., it carries at a point of time.
- The time taken to convert the inventory of raw materials, semi-finished goods, finished goods and the due receivables into cash generally differs from industry to industry.
- There are two concepts of working capital:
    - Gross working capital means the firm's investment in total current or floating (circulating) assets.
    - Net working capital means
        - the excess of current assets over the current liabilities or,
        - that portion of a firm's current assets financed by the long-term funds.

          The long-term resources comprise owned funds of the company, i.e. paid-up capital/reserves including the current year's profits and term loans from banks and financial institutions/debentures etc.



Adequacy of Working Capital

- A firm should have adequate working capital, i.e. as much as needed by the firm.
- It should neither be excessive nor inadequate. Both situations are dangerous.
    - Excessive working capital means the firm has idle funds, which earn no profits for the firm.
    - Inadequate working capital means the firm does not have sufficient funds for running its operations, which ultimately results in production interruptions leading to reduced profitability which may even lead to losses.

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Difference between Term Loans and Working Capital

- The major difference between term loans and working capital finance lies in the purpose of the finance, the type of assets created out of it and the form in which the advance is made by the bank.

Term Loan	Working Capital
Term loans are utilised for establishing, expanding or modernising a manufacturing unit by acquisition of fixed assets.	Working capital finance is utilised for operating purposes resulting in the creation of current assets for production and the sale of finished goods.
Term loans are usually of medium- or long-term duration and are repayable in quarterly or half yearly instalments over an agreed period of time.	The working capital finance is generally availed of in cash credit hypothecation accounts with frequent drawings and repayments and is payable on demand.

- The major sources of working capital funds for investment in current assets are; trade credits/unsecured loans/deposits/bank borrowings/advance payments/stage-by-stage payments, etc.

Credit Appraisal Techniques

- In the credit appraisal process, the decision maker makes an attempt to find the answer to two important questions.
    1. Whether the entrepreneur requires funds, also what are his credentials? If the answer to the first question is positive, then,
    2. The extent of his requirements and the ways in which the requirements can be met?

Estimation of Working Capital Needs

- A customer has to satisfy his bank about his character, capacity, capital and collateral, in brief he has to establish his creditworthiness.

- If the overall appraisal is satisfactory, the bank will finance only the residual gap in the customers' resources, after taking into consideration the expected availability from all other sources of funds.
- Generally, there are four methods of estimating the working capital requirements of a borrower:
  - The operating cycle method
  - The projected net working capital method
  - The projected turnover method
  - The cash budget
- These methods require the preparation of:
  - Projected financial statements
  - Projected fund flow statements
  - Projected cash flow statements/cash budgets

1. **Operating Cycle Method**
   a. If part of raw materials is available on credit, then bank finance will be required only for that portion of the raw materials which represents fully paid purchases.
   b. Similarly, if advance payments are received against orders, only that part of the finished goods net of the advance payment will require bank credit.
   c. Borrowers in the small and medium enterprises segment face a problem in collecting dues from their customers, particularly from the corporate sectors. In order to provide a relief to borrowers who face such a situation, the banks as part of their loan policy, decided as follows:
      i. While assessing working capital requirement, creditors will not be set-off against stock
      ii. The borrowers will submit details age-wise list of sundry creditors and sundry debtors as well as the stock statement,
      iii. Only those debtors will be considered who are outstanding for less than the period specified (up to 180 days maximum) from a case to case basis,
      iv. The total outstanding creditors will be netted from the total outstanding eligible debtors. If creditors are in excess, the excess portion will be deducted from the value of stocks. If debtors are in excess, the bank could consider financing the surplus debtors as per the banks policy,
      v. The borrower will have to hypothecate his entire book debts to the bank,

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vi. The bank will not finance the borrower's book debts if creditors exceed debtors.

2. **Projected Net Working Method**
   a. The margin requirements have to be met by the borrower from the accruals during the course of the year and/or other long-term funds, in the form of net working capital.
   b. The projected net working capital, if higher than the current level maintained by the borrower, would be built up progressively with the growth in production, sales and profits.
   c. Therefore, during the initial stages in the current year, the NWC would generally be lower than the assessed, and in such circumstances, the borrower may not be able to maintain the stipulated current ratio, ranging from 1.25 to 1.33 or higher. On the merits of each case, banks, in such circumstances, may accept either of the two alternatives.
      i. Release the assessed limits/credit on the borrower's undertaking to augment the NWC to the required level within a time frame of 2 quarters, provided the borrower maintains a current ratio between 1.17 and 1.25. In the meantime, the borrower brings in short-term funds from other sources to meet the shortfall in NWC.
      ii. Release a temporary limit equivalent to the shortfall in NWC for a short term, say one quarter, in addition to the duly assessed limits. In this case, the short-term loan from the bank is in lieu of the market borrowings that the borrower had to raise as the other alternative: Here again, the borrower has to maintain a lower current ratio between 1.17 and 1.25, but restore the ratio within a stipulated time frame.

3. **Projected Turnover Method**
   a. Banks, as a matter of policy and based on RBI guidelines, assess the working capital requirements including those of village industries, tiny industries, (SSI units and traders) with a fund based working capital limit of up to Rs. 4 crore by the turnover method.
   b. RBI has given following instructions:
      i. Twenty per cent of their projected annual gross sales turnover may be considered as minimum working capital finance by banks,
      ii. In order to ensure that a minimum margin supports the working capital needs of a borrower, a five per cent contribution is given by the promoters,
      iii. Guideline for the turnover method is framed, assuming an average operating cycle of three months. If the cycle is more than three months, the borrower should bring in a proportionately higher stake in relation to his requirement of the bank finance,
      iv. Drawing power is calculated through stock statements. Unpaid stocks are not to be financed, as it would result in double financing.
   c. The critical issue in the turnover method is the determination of the projected annual gross sales or turnover.

4. **Cash Budget System**
   a. The current loan policies of most banks state that, for an assessment of the working capital needs of a borrower who enjoys or requires fund based limits in excess of

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Rs.10 crore, the cash budget system should be used.

b. A cash budget is a statement of cash receipts and cash payments. It is distinct from the cash flow statement, in as much as the latter deals both cash and non-cash funds, while the cash budget deals with cash transactions only.

c. Cash budget is a substitute for the operating cycle method for the assessment of working capital.

d. A cash budget is usually prepared for short periods, i.e. a week/fortnight/month or a quarter.

e. Cash budget has to have the following steps in sequence when prepared for a quarter.

   i. Actual receipts and payments during the first, the second and the third month.

   ii. The position of the cash surplus/deficit is computed at monthly intervals. A surplus is generated if the receipts exceed the payment and a cash deficit occurs if payments are more than the receipts during the month.

   iii. The opening cash balance for the first month is adjusted against the cash surplus/deficit that is generated during the month. The adjusted figure is the closing balance at the end of the first month, which becomes the opening balance for the next month, viz., the second month.

   iv. A cash surplus generated during a month results in a higher closing cash balance vis- a-vis the opening balance of the month. Conversely, a cash deficit during the month would cause a lower level of the closing cash balance as compared to the opening balance.

   v. If the enterprise has a net position on borrowed funds (i.e. the company maintains acash credit/ overdraft account), a cash surplus generated during a month brings down the level of the borrowed funds at the end of the month.

Credit Management

- Credit management is the management of the credit portfolio of banks and financial institutions.
- The expression 'credit' refers to short-term loans and advances as well to medium-/long-term loans and off-balance sheet transactions.
- Management includes, within its preview, pre-sanction appraisal, sanction, documentation, disbursement and post-lending supervision and control. In the highly competitive and deregulated environment, banks and financial institutions have to

evolve better systems and procedures to manage the credit needs of their highly demanding customers, particularly in the corporate and retail sectors.

- The developments of the past decade have totally changed the credit management perspectives in banks. The term 'Credit management' encompasses the following:
- `Capital adequacy norms
- Risk management, including asset liability management (ALM)
- Exposure norms
- Risk pricing policy and credit risk rating
- Asset classification, income recognition and provisioning norms
- Appraisal, credit decision-making and loan review mechanism

Additional Notes:

- From 1 April 2002, the exposure ceiling is 15 per cent of the capital funds in the case of a single borrower and 40 per cent in the case of group borrowings.
- Exposure to borrowers, belonging to a group, may exceed the exposure norm of 40 per cent of the bank's capital funds by an additional 10 per cent total up to 50 per cent, provided the additional exposure is on account of an extension of credit to infrastructure projects.
- Several risks affect credit decisions. The main risks are
  - **credit risk**,
  - **market risk** (mainly liquidity risk and interest rate risk) and
  - **operational risk**.
- Credit risk is defined as the possibility of losses associated with a diminution in the credit quality of borrowers or counter parties. Such risks are:
  - Principal/interest amount may not be paid.
  - Funds may not be forthcoming from clients upon invocation of L/C, guarantees.
  - Payments or series of payments due from the counter parties may not be coming in case of treasury operations.
  - Funds/securities settlement may not be effected in securities trading.
  - Availability and free transfer of foreign currency funds may either cease or restrictions may be imposed by the sovereign.
- Market risk is the possibility of loss to a bank, caused by changes in market variables, which are:
  - Interest rate risk
  - Commodity price risk
  - Liquidity risk
  - Foreign exchange rate risk
  - Equity price risk.
- Assets and Liability Management Committee (ALMC) functions as the top operational unit for a bank.
- Banks also face another risk, known as operational risk. The operational risk arises from human or technical error or acts of omission and commission such as ineffectiveness or breakdown in the internal control and internal audit systems. The risk can lead to losses through fraud, errors or a failure in performance in a timely manner.
- Operational risk includes legal risks but excludes strategic and reputation risk. Banks'

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advances portfolio is classified under the following four categories:
  - Standard assets
  - Sub-standard assets
  - Doubtful assets
  - Loss assets
- Provisions at different rates are to be made on the above category of assets.

Credit Monitoring

The credit monitoring in a bank is to ensure that the funds are utilised for the sanctioned purposes and at the same time complying with all sanction terms and conditions The purpose of the exercise is also to avoid the time lag and cost overruns, to detect early warning signals and symptoms of incipient sickness in the units financed by banks and to initiate timely action for recovery or rehabilitation.

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