Working Capital Management
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Lecture - 25
Different Modes of Bank Finance

Welcome students. So before proceeding further I would like to discuss with you the concept of you working capital provided by the banks or maybe the little some we will discuss at in detail later on but since we talked in the previous class about the rationing of the working capital by the banks so let us first understand that how the banks provide the working capital finance. What the different base, modes, and say parameters taken into consideration by the banks and how that all is done.

So that I think before proceeding further and talking about other things about inventory management we will like to know about it. See funding of the working capital requirement as I told you by the firms by the businesses we have normally 3 sources. One is spontaneous finance. Once it is exhausted then it is the short term finance. Spontaneous finance includes the supplier's credit and the credit provided by the say your trade expenses like electricity company, water company, by the salaries of employees.

Because all these services are available to us for at least 30 days and we have to pay after 1 month or 30 days. So that is also a sort of credit available. So supplier's credit, then the expense credit. These are the spontaneous sources. So we should try to take maximum advantage out of it. Once that is over, then the next thing is to resort to the short term sources and if you talk about the total list of the short term sources available for funding the working capital say fulfilling the working capital requirements we have about say 9, 10 sources around the globe.

Most of these sources were not prevalent in India. They were not allowed before the opening up of Indian economy or liberalizing the in liberalizing the Indian economy but now they are available in India also right. So earlier till 1991, I would say only bank finance was the only source of fulfilling the short term funding requirement of the manufacturing sector in India. And that was considered as the obligation of the banking sector as well by the government also and by the industry also.

So banks were compelled to provide the liberal working capital help assistance to the industry. But after 1991 since now we are aligning with the rest of the world and the financial system is also changing and even the sources of the investment, sources of funding are also multiplying so we are not having only the one source that is the bank finance but we have the multiple other sources also right.

So in that case we have now say introduced many other sources in this country but because of easy availability of the bank finance even today these other sources are not popularizing right. The other sources are like commercial paper right. What is commercial paper and how we make use of it I will discuss with you later on but commercial paper is the one source, factoring. What is the factor, what is the factoring surveys?

How they fulfill the working capital requirement of the industry, manufacturing industry for fulfilling their short term requirements that is a one source. Then we have the your public deposits right. Then we have the funding available from the institutional sources maybe the development finance institutions or maybe the investment finance institutions. Earlier they were not allowed. Now they are allowed. So these are the sources. Then we have derivative finance.

Then we have forfeiting. That is another source of working capital available. So apart from these sources we have inter-corporate deposits. So in total if you talk about we have not at least means 7, 8 sources or total things goes up to the say 9, 10 sources including spontaneous, short term, and the long term finance. And then once these sources, short term sources are fully exhausted by the firm still there is a requirement of the working capital then we have to resort to the third source that is the long term sources.

Long term sources are also required to be invested for the short term needs if we are going to the bank for fulfilling our major working capital requirement. Because it is a condition, precondition of the banks also that if you are coming to us for seeking the working capital investment then tell us how much you are investing from your own sources.

And since banks cannot ask for any collateral, any security in the normal circumstances from the company to provide the short term finance so they want a security in terms of that part of the investment will come from us and part of the investment has to come from the company itself so banks have in a way restricted that maximum of the total requirement only 75% will be provided by the bank and remaining has to come from the other sources including long term.

That is the reason I have discussed with you sometime in the in the past that the current ratio has to be maintained by the firms minimum that is 1.33:1 so that 1.33:1 means when you are talking about the current ratio as 1.33:1 it means that 1.33:1 is what?

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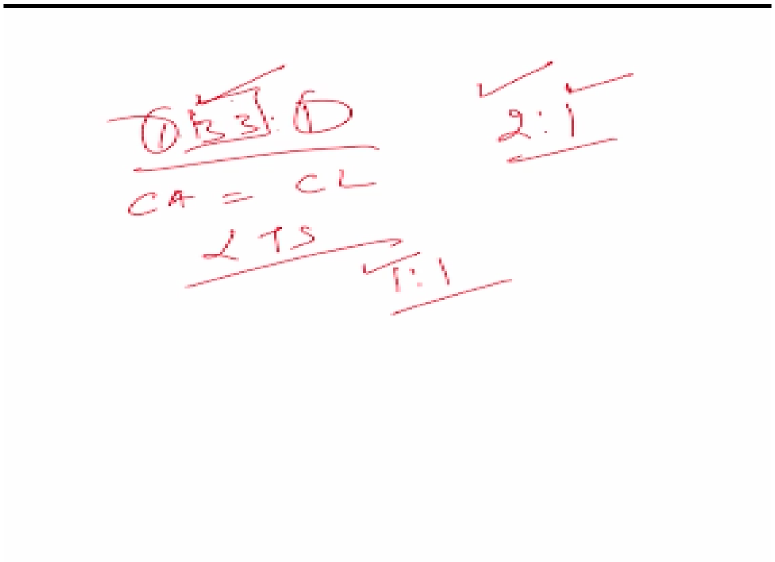

It means this is the current liability. This is the current liability or what is this 0.33. Why current assets are supposed to be means 1.33 times of the current liabilities. This 0.33 is expected to come from the long term sources LTS. And this is the requirement of the banks. Earlier I have discussed with you in the past that the ratio was 2:1. So current assets are supposed to be 2 times of the current liabilities and here 1:1 is the funding coming from the short term sources including spontaneous but remaining 1 has to come from the long term sources.

So it was a very expensive situation but now the banks have agreed that okay if you do not want to maintain 2:1 ratio you maintain 1.33:1 ratio. So 1 point means 0.33 is the cushion which the banks seek that if for example if the ratio is only say current ratio is allowed as 1:1 as we know that some of the current assets are not possible to be converted into cash as and when we want it as we have seen in case of inventory, as we have seen in case of receivables.

As we have seen in case of the prepaid expenses. So that is not possible. So why this cushion we keep? That if some of the assets are not convertible into cash as and when the current liabilities become due at least we have some liquid funds available which come from the long term sources that is one-third of the current asset that is 0.33%. So those funds can be utilized for repaying the bank's funds or say say liquidating or paying off or honoring any other current liability.

So this is the cushion required by the banks. This is the security in a way you can call it as. This is a collateral, this is the security required by the bank; so the current ratio is 1.33:1 minimum these days and earlier it was 2:1. So this requirement is of the banks, not of anybody else because banks want some security that as and when our payment becomes due to be made then where is the security.

And if there is a lack of liquidity with the bank, with the firm, then at least the long term funds kept for the purpose or invested in the short term assets they can provide the liquidity to the firm. So now even today as I told you despite we have number of sources of the funds available but we are still depending upon the bank finance for fulfilling our working capital requirement, reason for that is that it is very easily available, most secured, regular source of finance, and without providing any kind of the collateral by the manufacturing unit, manufacturing firm.

No collateral is required. Bank cannot ask for any security normally and its easy availability and mode of providing the funds by the banks to the firms for fulfilling their working capital requirements is also most convenient to the firms. Now what are the modes? How the banks provide the funds to these companies or these firms, we have 3 modes. When you talk about these modes, we have 3 modes here for means how the firms take the working capital from the banks. So let us see these 3 modes. These 3 modes are CC limit.

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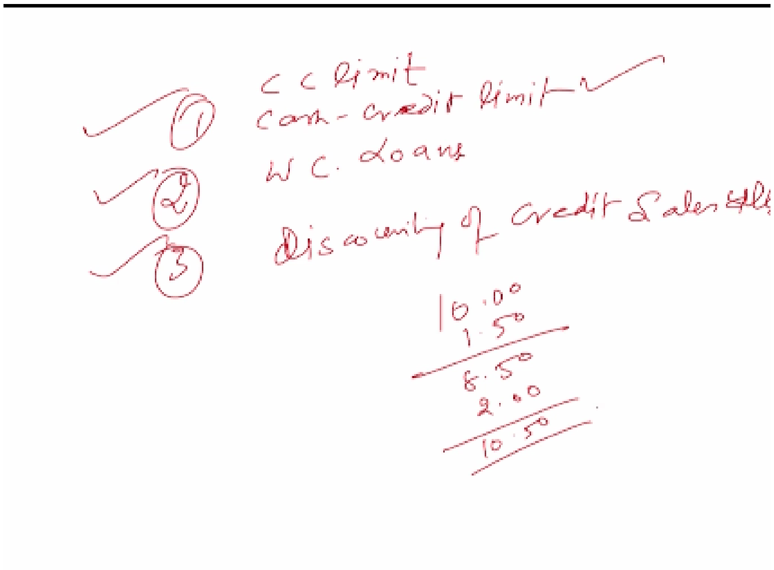

First mode is CC limit. CC limit is called as cash credit limit. This is the first mode. Second is working capital loans and third mode is discounting of credit sales bills. These are the 3 ways banks provide the working capital finance to the manufacturing sector. Now what is CC limit? Cash credit limit it is called as CC limit. Cash credit limit means when firm has a surplus cash available, deposit in this account and when firm needs funds to fund some current asset or to pay for acquiring some current asset withdraw cash from this account which is called as credit.

Cash means depositing and credit means borrowing as and when there is a need. So this is a flexible account available. Manufacturing firms after working out its working capital requirement they move to the bank and they request the bank that our working capital, annual working capital requirement is say 1 million, 10 lakh rupees. So you are requested to sanction a say CC limit account or this sum through CC limit account.

And we should be helped for that. Bank would ask the company to provide the 3 previous you call it as years' financial statements and bank could analyze overall financial performance of the company, liquidity performance of the company and everything and if bank feels that yes company's overall financial performance, liquidity position is okay, acceptable then mutually bank and firm would arrive at an amount.

And say for example both the sides agree that yes the firm deserves 1 million from the bank side it is approved and the firm is also able to convince the bank that yes we need 1 million rupees of the working capital limit. So after this mutual agreement, an account will be opened by the bank in its own branch in which the firm has requested in the name of the firm and that account will be called as the CC limit account, cash credit limit account.

And a sum of Rs 1 million will be earmarked to that account, will be kept safe in that account. Now you see 10 lakh rupees are available to the firm for fulfilling their short term working capital requirements, 1 million rupees is available. If say after sanctioning the limit next day morning firm receives a truckload of the raw material and immediately the firm has to make a payment of 2 lakh rupees.

In the firm's kitty or in the firm's account there are only 50,000 Rs lying. Firm has to make the payment of 2 lakh rupees. Firm is not at all in problem now because they have got the CC limit account and they have that account from where they can withdraw 1.5 lakh rupees extra and immediately complete the payment of 2 lakh rupees, 200,000 Rs payment can be made. So the balance of that account will go down by 1.5 lakh rupees.

So it will come down to 8.5 lakh rupees now. One week after firm received 2 lakh rupees of the payment from their buyers who have bought on credit from the firm and that 2 lakh rupees so this is the condition of the bank that now you will not maintain 2 accounts in the same branch or in the at the any other branch of the same bank or in any other bank. Your total cash and the credit will be routed through this account. This is a condition. Both the sides have to agree.

So when the firm needed 1.5 lakhs, firm withdrew from the account and when the firm has got surplus means the receipt they have got from the buyer who have bought from the firm on credit then that 2 lakh rupees firm will deposit in the same account right. Now that account will become when it was how much it was 10 lakh rupees. When 1.5 is withdrawn how much the balance, 8.50.

Now if 2 lakh rupees are available say if 2 lakh rupees are received by the firm in that case, 2 lakh rupees are available what will be there now; 2 lakh rupees are available. So the balance of this account will go up to 10.50 lakhs, 10.50 lakhs right. Banks has given only 1 million, 10 lakhs. Now the account has overflown. That is by 50,000 Rs. It means firm used that 1.5 lakh rupees for how much period?

Only for 1 week and they used only 1.5 lakhs not the entire 10 lakhs. So beauty of the account for the manufacturer or the benefit of this account for the manufacturer is that manufacturer has to pay the interest to the bank only for this amount of 1.5 lakh rupees and for the period of 1 week right. 1.5 lakh rupees and only for a period of 1 week because he has borrowed 1.5 lakh rupees only, withdrawn 1.5 lakh rupees and he has used that money for 1 week only.

After that he has deposited 2 lakh rupees back in the bank so it means now the again account is 10 lakhs plus 50,000 which is extra he has deposited. On this extra 50,000 Rs firm will not get any interest right. It is this account is considered as a current account. Normally, even if the firm has its own money which is invested in the bank or account is open and some balance is maintained in that account, that account is called as current account.

And no interest is paid by the bank to the firm on that account and in this case also since now it has crossed the sanction limit of 10 lakh rupees it has become 10,50,000 Rs so for the additional 50,000 Rs bank will not pay any interest. The benefit to the firm is that firm is getting easy liquidity and only they are bound to pay the interest on that amount which they have withdrawn from the sanctioned limit and for the period they have utilized it.

This is called as the CC limit account. So most beautiful account, most beneficial to the most beneficial to the manufacturer right. This is called as CC limit account. So one account is opened. Firm can withdraw maximum up to that limit of 10 lakh rupees, less anytime and they can use it for the given period of time. After that if they receive the funds from some source they deposit it back and then only pay the interest for the period you were using the funds and only on that amount which is withdrawn and utilized agreed.

Now this is the one way and this is the most convenient mode of getting the working capital finance from the banks by the manufacturing sector in India. There is nothing better than this. In US for example this CC limit account is not available. They call it as credit line system. If the firm if the people withdraw money from the bank or if they want any kind of the working capital finance from the bank in US.

That is why the bank finance is the least preferred in US and is the most preferred in India. Why it is more preferred in India, I just told to you but why it is not preferred in US? In US what happens? If any firm goes to the bank and seeks the credit line for fulfilling its working capital requirements bank would say yes if its requirement is 1 million dollars, we will give you 1 million dollars. We will sanction this but that will be in the form of loan, not as a CC limit.

And against that loan you have to give the collateral also. Collateral is in the form of what will be done? Bank will sanction a loan of 1 million dollars, open an account, sanction that loan of 1 million dollars and credit that amount in that account. Firm can at any time whenever they want money to be paid to some supplier, they can withdraw part of that amount as and when or how much they want and remaining will be there. Maximum they can withdraw is 1 million dollars.

But to have that facility they have to open another account in the same branch and half of that sanctioned loan say 5 lakh dollars, 500,000 dollars they have to deposit in that account. So it means 1 lakh sorry 1 million dollars loan and a deposit of 5, half a million, 5 lakh rupees in the another account. Bank would charge interest on that entire 1 million dollar or the total 10 lakh dollars. But bank would not provide on any interest on that additional that is 5 lakh rupees kept in the same bank in the another account as a collateral.

So in fact the actual facility available they actual loan available to the firm is of the half a million not of the 1 million because half a million is deposited by the firm in the other account, most expensive to the firms in US the manufacturing sector firms in US. So they do not resort to the bank finance because it is very expensive. In a very difficult scenario when they do not find any other source then they move to the this source, they resort to this source.

Otherwise, they do not depend upon the bank finance because it is very expensive in US. But whereas it is very you can call it as convenient and cheap or cheapest in India. Now the other source is or other modes of providing working capital finance by the banks to the manufacturing sector in India other 2 modes are as I have written here that is working capital loan. If you talk about the working capital loan in that case it will be like a loan.

If 10 lakh rupees are required as a working capital by the firm and bank says that we will not give you CC limit. We will give you loan. So in that case it will work like a normal loan account; 1 million rupees will be sanctioned by the bank, will be earmarked in the account, deposited in the account, kept safe in the account. Firm withdraws either entire 1 million rupees or firm does not withdraw even a single rupee out of that firm has to pay the total interest applicable on that account or on that loan for the period for how much that loan is taken by the firm.

It means that beauty of the CC limit is absent here. In the CC limit what happens that you have safe deposit of 1 million rupees, 10 lakh rupees. As and when you withdraw, want to withdraw it how much you want to withdraw it, withdraw it, pay the interest on the withdrawn amount and for the period you have used the funds. That feature is not available in the working capital loan account.

In the loan you have to be very careful as a manufacturer while working out your requirement that entire amount of the 1 million should be properly utilized. Otherwise you will be paying only interest back to the bank and you may not be using the entire 1 million rupees. So this is expensive source. Third one is discounting of the credit sale bills. I have discussed with you this source or this mode sometime in the past also.

But again I recall discounting of the credit sale bills means when the firms sell to the people or to their customers or to their distribution channels distributors, wholesalers, or retailers on credit right on credit. So there is a time period for which the credit is given. And the buyer is not going to pay the funds back to the firm if the firm require the funds before the end of the credit period. So in that case what happens? Firms get these bills discounted from the banks.

They go the bank, say for example they have sold for say 5 lakh rupees to some XYZ Limited. Now the credit period given is 45 days. XYZ Limited will pay to ABC Limited after 45 days or on the 45th day but if the firm needs the funds, ABC needs the funds after 10 days they would request XYZ but XYZ say we are unable to fulfill your request then the other source is ABC will go to the bank and they would ask that we have sold for 5 lakh rupees to XYZ Limited.

This is a good creditworthy firm having a good financial reputation. They will pay us 5 lakh rupees after 45 days but we need money today so please keep the bills as a security, discount these bills and give us the money. Bank would like to know who is this XYZ Limited and if their financial reputation, their credibility is found okay, acceptable to the bank in that case bank would immediately agree to discount the bills.

And maximum up to the 80% amount of that credit sale bills means 80% of the 5 lakhs that is 4 lakh rupees bank would immediately give to the firm to ABC who is a seller and they will retain the 20%. On the due date when XYZ Limited will make the payment to the bank, maybe to the ABC or sometimes on the instruction of ABC to the bank directly sometime what happens that the seller gives the instruction to the buyer that you directly make the payment to the bank.

We have already got your bills discounted from the bank, you make the payment to the bank. So once the bank receives that amount maybe directly from buyer XYZ Limited or through ABC, ABC will receive that amount and that will be credited by or that will be deposited by ABC in the bank. So bank will then recalculate the whole thing. How much amount was given, 4 lakh rupees. For how much period of time, say 35 days right. What was the agreed rate of interest?

They would calculate the interest on that agreed rate on that 4 lakh rupees for a period of 35 days. They will calculate that and they will take they will deduct it out of that 20% they have because they have received now 100%. So they have given 80% to the firm but 20%. So out of that 20% they will first adjust the interest. After that bank would deduct its own administrative charges and commission.

Because banks also charge some administrative charges and commission on such transactions. So they would adjust that also. After adjusting for their interest, for commission and administrative charges if any amount is left out of that 20% means 1 lakh rupees. Then that will be again remitted by the bank to ABC Limited maybe for example that total cost of discounting of the bills becomes 50,000 Rs.

So bank will deduct 50,000 out of the remaining 1 lakh and remaining 50,000 will be credited into the account of ABC Limited. So it means in that case what happened. ABC got 4.5 lakh rupees against the total payment of 5 lakh rupees which they had to receive after 45 days from XYZ Limited but in that case the major benefit to ABC was they could get the funds as and when they were required.

Because funds are most useful at that time when they are required and they are easily available. If the funds are not easily available as and when they are required so what is the purpose of that investment that money or those funds if they come after the need is over. So the benefit to the ABC is they could get even 4.5 lakhs against 5 lakhs, against 5 lakhs but at the time when they needed it. So that saved the ABC's financial reputation, credibility and overall goodwill in the market.

And for XYZ Limited they made the payment after 45 days. So they are also safe. For the bank, bank provided this facility to ABC but the earned in lieu of that they earned 50,000 Rs revenue just in a period of 35 days. So this is the bill discounting facility. Now earlier till 1991 this was the condition by the government that total working capital will be provided by the banking sector to the manufacturing sector and largely in the form of the CC limits.

But now these conditions have been revised by RBI because banks have the pressure of this particular say system of funding because bank has earmarked 1 lakh, 1 million rupees in the CC limit account and they are getting interest only for that amount which is withdrawn and utilized by the firm and for the period for which that amount is utilized. So their funds are blocked that is 10 lakh rupees, 1 million.

It may be possible that the end of the year on an average firm used 7 lakh rupees out of that 10 lakh rupees. So bank is getting the interest on the 7 lakh rupees who will pay the interest on the remaining 3 lakh rupees. This is the depositor's money banks work on the deposit and loans system. This is the depositor's money. So bank has to pay the interest on the total 10 lakh rupees but bank is getting the interest only on the 7 lakh rupees. So this is the pressure on the banks.

So on the request of the banks RBI has now directed and issued the new policy guidelines that to fulfill the working capital requirement of the companies banks should meet that requirement but in the ratio of 80:20. If the requirement of the firm is the borrower's working capital requirement is say total requirement in all the current assets is say 10 crore and above. If any firm needs 10 crore and above to fulfill their working capital requirement in that case the ratio of 80:20 should be observed, should be followed by the banks.

80% of the finance should be given as working capital loan plus bill discounting facility only 20% can be given as a CC limit. So if somebody's requirement is 10 crores so only a limit of 2 crores can be given by the bank and remaining 8 crores can be given as loan and over a period of time this threshold level is asked to be brought down from the 10 crore to say 8 crore, 7 crore.

So RBI's say attempt is or government's attempt is also that over the period of time we should also discipline our manufacturing sector that they should stop getting or they should forget getting the funds in the route of or under the route of CC limit and they should learn the financial discipline and should try to borrow money from the banks for fulfilling their short term requirements for fulfilling their working capital requirement through working capital loan system and under the mode of discounting of the bills system.

But that has not happened because both the sides are not able to implement it. Banks are under the pressure. They feel that if we implement this policy directive of RBI then what will happen? They may lose very good accounts because then the firms would not like to borrow from one bank say X bank. If the X bank says that I will give you 80% loan and 20% CC limit but the bank buy because now we are in the differential interest rate system.

Banks have the different financial policy, they have the different interest rates on their deposits and loans. They are framing their own policy they are running their bank or the bank is being run by its management in its own style. There is no stipulation by the RBI. Totally means complete decentralization. So one bank may say that I will give you 80% loan, 20% CC limit. Other may say that okay you come to me. I will give you 20% loan and 80% CC limit.

So until and unless all the banks decide together both public and private and foreign banks, if they make an understanding that out rules will be like this; nobody will give beyond this as the CC limit. Nobody will give less than this as a loan. If all the banks are sailing in the same boat then it is fine. But since they are not doing it so far so what is happening in the fear of losing a good account, good borrower if they impose this restriction of 80, 20 limit they may lose the account because the firm may shift to the another bank.

So because of that reason this system of the CC limit even today is also going on and very few people are resorting to the working capital loan or the discounting of the bills, credit sale bills facility. But in the time to come this system will change and maybe if the banks themselves are not doing it RBI may enact some loss or they can issue very strict guidelines that these will be now the modes of providing working capital limit.

And means the total working capital we were provided under these 2 modes maybe they can scrap totally the CC limit so nobody may be no bank may be able to issue the say CC limit or to provide the funds through this mode this may happen. But at the moment it has not happened and that threshold level of the 10 crores has not been implemented by the banks.

So what is this means what is the say CC limit account, how the banks provide the working capital finance to the manufacturing sector in India and you see one more thing they do is that when the CC limit is sanctioned by the banks they clearly specify it that this much out of the 10 lakh rupees this much can be used for inventory, this much can be used for the credit sales, supporting credit sales. This much can be used for prepaid expenses.

This much can be kept as cash. So they also bifurcate it and they means put a condition that your entire amount cannot use as cash. Your entire amount cannot use for supporting your credit sales. Your entire amount cannot use for funding the inventory. So they device the norms and under those norms or limits the funds can be used.

So this is something about the just in nutshell how the banks provide the working capital finance to the firms, to the manufacturing firms and what was the meaning of imposing restriction which we discussed in the previous class so but in detail. All the sources of working capital finance including bank finance I will discuss with you sometime later before we finish the discussion on the current assets and the current liabilities.

So we will continue the discussion on the inventory management and next time in the next class I will discuss with you the concept of incremental analysis in the management of inventory as an important current asset. Thank you very much.