working capital requirement of Rs.10 crores or above. On such additional credit, the borrower has to pay a higher rate of interest more than the normal rate of interest.

3. Concept of Cash Credit

Definition – Cash Credit is an agreement between a bank and a firm specifying the amount of short-term borrowing the bank would make available to the firm over a given period of time. It is the primary institutional source of working capital finance in India.

Cash credit is an arrangement under which a customer of a bank or financial institution is allowed an advance up to certain limit against credit granted by bank. In practice, the operations in cash credit facility are similar to those of overdraft facility except the fact that the company need not have a formal current account. Here also a fixed limit is stipulated beyond which the company is not able to withdraw the amount. Legally, cash credit is a demand facility, but in practice, it is on continuous basis. There is no commitment charge therefore interest is payable on the amount actually used by the borrower and not on the sanctioned limit. Cash credit limits are sanctioned against security of current assets (Debtors, Stock etc.) or fixed assets (Mortgage of property).

This account is the primary method in which Banks lend money against the security of commodities and debt. It runs like a current account except that the money that can be withdrawn from this account is not restricted to the amount deposited in the account. Instead, the account holder is permitted to withdraw a certain sum called "Credit limit" or "credit facility" in excess of the amount deposited in the account. This limit is sanctioned by the bank based on an assessment of the maximum working capital requirement of the organization minus the margin. The organization finances the margin amount from its own funds. The customer has to pay interest on the excess amount he/she has withdrawn. The Cash Credit facility is quite useful to those businesses where cash payment like wages, transportation, cash purchases are to be made and the receivables are not realized in time. Cash Credits are, in theory, payable on demand. These are, therefore, counter part of demand deposits of the Bank.

4. Cash Credit Policy of Indian Overseas Bank

IOB is offering Cash Credit facility to an Individual or a firm under three categories,

(a) Cash Credit against Stocks or Goods & book debts not more than 90 days
(b) Cash Credit against Deposits, LIC, NSC, KVP, etc.
(c) Cash Credit against Immovable Property (Easy Trade Finance - Mortgage Loan)

(# For Micro Small & Medium Enterprises (MSME), IOB has a Cash Credit facility under CGTMSE scheme where collateral security is not required.)

The following table shows key information regarding the policies of three types of Cash Credit offered by Indian Overseas Bank,

Nature of Credit Facility	*Target Group*	*Security*	*Margin*	*Interest (%)*	*Any other requirements*
CC against Stocks / Goods	Wholesaler, Retailer, Manufacturing Industry, etc	Hypothecation of Stocks / Goods to the bank	25%	14.00% Presently	Submission of stock statements in each month
CC against Miscellaneous Securities	Any Individual who is having a Current account	Term Deposits, LICs, NSC, KVP	10% to 25%	11% to 14% Presently	Present Value of securities must be calculated at the time of credit limit enhancement.
CC against Immovable Property	Contractors, General Order Suppliers who don't keep fixed stocks	Equitable Mortgage of Land & Building	30% of Property	13.25% Presently	Valuation of the Property must be performed in every three years.

4.1 Documents Required for Appraisal

(a) Balance Sheet and Profit & Loss statements for last 2-3 years & Projected 2 years,
(b) IT Returns for last 3 years,
(c) VAT Return,
(d) Trade License
(e) CIBIL Report,
(f) Credit Report Cum Opinion Sheet (CRCOS),
(g) KYC documents,
(h) Stock statement,
(i) Valuation report of stocks,
(j) Insurance papers of proposed security,
(k) Godown inspection report
(l) Asset-Liability statement of borrower (& guarantor where applicable),
(m) Deed of Hypothecation,
(n) Valuation report of property (where applicable)
(o) Title deed of Immovable Property (for Mortgage Loan)
(p) Guarantor's statement,
(q) Current account statement for last 12 months.

5. Rules & Regulations Followed by IOB for Providing Cash Credit Facility

- Applicant must have a running **current account** in IOB.
- Cash Credit accounts will be opened as per terms and conditions of sanction of such credit limits. The Rules prescribed for the current accounts will also apply to Cash Credit accounts, in addition to the sanctioned terms and conditions.
- Advances against goods are to be granted generally in the form of either **as pledge of goods** or **as hypothecation of goods** depending upon the convenience of the borrower,

nature of goods and their marketability, and the integrity and credit worthiness of the borrower.

- Goods should be readily **marketable**. They should not be subject to violent fluctuations in price and/or rapid deterioration in quality. **Perishable goods and goods of inflammable character should not be accepted as security.**
- Branches should ensure proper **valuation** of stocks is done before they are accepted as security. Branches should call for the documentary evidences in all the cases, which can be in the form of paid invoices/bills. Such documentary evidence must be scrutinized thoroughly to find out the ownership of the borrower to goods and to ascertain the basis of valuation of goods.
- Branches have to exercise due care and caution while sanctioning hypothecation advances to INDIVIDUALS and FIRMS, as the bank has to pass through various legal requirements to secure the hypothecated goods and to bring them to sale. In whatsoever be the case, when an advance is made against hypothecation, the branch should ensure all the time that the **hypothecated goods are free from all encumbrances.**
- Goods under pledge or hypothecation to the Bank **must be insured for their full value** at the prevailing market rates against the following risks, at all times and in all places: **(a)** Fire **(b)** Strike & Riot **(c)** Burglary **(d)** Risk against self combustion in respect of goods which are by their nature susceptible to auto combustion. **(e)** Any other type of risk which is specific to the commodity accepted as security and also specific to the location of the godown. (**eg.** earth quake damage, cyclone damage, damage by sea water, damage by flood water.)
- Stocks hypothecated to the bank **must be inspected atleast once in a month** at irregular intervals. There should be an element of surprise and hence inspection should be carried out at irregular intervals.
- **Stock statement must be submitted by the borrower in each month** for CC against stocks. Drawing power will be fixed on the basis of stock value of each month. In case of CC against Mortgaged property, it needs to be submitted once in a year (at the time of renewal).
- In the case of godowns under hypothecation, the Chief Manager / Senior Manager / Manager should inspect regularly and submit the **Godown Inspection Reports** to the controlling offices, as required from time to time.
- Godowns with goods already stored should be accepted only from borrowers of **undoubted standing and integrity and after careful verification of stocks.**
- **Obtaining periodical statements and a study of the same is useful** for the branches to keep a close watch on the conduct of the account, by which the branch could sense signals of sickness and can arrest the trend of the account becoming sick/speculative/overtrading.
- Branches should make thorough **credit investigation** into the past experience and antecedents of the borrower/guarantor by calling for independent market reports/credit reports, if it is a new connection. Branches may seek the assistance of bank's own credit investigator wherever they are provided in compiling the credit reports on these prospective borrowers. Branches should conduct the inspection of the borrower's business premises and godowns, before any proposal is submitted for sanction.
- Advances against hypothecation of goods are granted only for financing the working capital requirements of the borrowers. Branches should take proper care while releasing the advances and ensure that the Working Capital is released only after completion and implementation of the project in the case of manufacturing concerns and when the manufacturing activity has really commenced. Branches **should ensure proper end use of the Working Capital and that diversion of funds is not allowed under any circumstances**, say, for acquiring the fixed assets.
- Though the goods remain in the possession of the borrowers, the **Bank's sign board should be displayed prominently on the premises** to serve as a notice to the public about the Bank's interest in the stocks.
- In case of Mortgage Loan, **Valuation of the Property proposed as security must be done in every three years** by Bank's empanelled valuer / engineer.
- Title deed or Deed of Conveyance of the property must be kept with Bank & it should be registered with **Central Electronic Registry of Securitization Asset Reconstruction and Security Interest of India or CERSAI.**
- Before a mortgage of immovable property is created, a full report on the title of the property should necessarily be obtained from the Bank's approved local lawyer, through whom a search should be made in the Sub - Registrar's Office to **ensure that no prior mortgage on the property exists**. Enquiries must also be made regarding the persons occupying the property and, if they are not the owners, the terms on which they have possession.
- **Guarantor's statement is to be taken** in case of Mortgage loans & Advances against hypothecation of goods.
- **Analysis of financial statements** must be performed before appraising a proposal.
- The entire business transactions need to be routed through the particular Cash Credit account.
- **Overdue interest is chargeable @ 2.00%** (presently) over and above the normal interest rate on the overdue amount.
- Cash Credit limits **are valid for 12 months** & it is **renewed / reviewed every year**.

6. 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:

a) ***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.
b) ***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.

c) ***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.

d) ***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.

e) ***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.

7. Recommendations of Various Committees on Working Capital Finance

7.1 Nayak Committee Recommendations (Turnover method)

As per Nayak Committee recommendation, 25% of Projected Annual Turnover (PAT) is to be financed as working capital requirement. Of which, 20% of PAT is to be financed by bank borrowing and 5% of pat to be financed by borrower's margin.

a) For SSI units

SSI units having working capital limits of up to Rs. 5 crore from the banking system are to be provided WC Finance computed on the basis of **20 percent of their projected annual turnover.**

b) For Technology and Software Industry

Technology and Software Industry units with working capital limits of up to Rs 2 crore, assessment may be made at 20 percent of the projected turnover.

7.2 Tandon Committee Recommendations

Like many other activities of the banks, method and quantum of short-term finance that can be granted to a corporate was mandated by the Reserve Bank of India till 1994. This control was exercised on the lines suggested by the recommendations of a study group headed by Shri Prakash Tandon.

The study group headed by Shri Prakash Tandon, the then Chairman of Punjab National Bank, was constituted by the RBI in July 1974 with eminent personalities drawn from leading banks, financial institutions and a wide cross-section of the Industry with a view to study the entire gamut of Bank's finance for working capital and suggest ways for optimum utilisation of Bank credit. This was the first elaborate attempt by the central bank to organise the Bank credit. The report of this group is widely known as Tandon Committee report. Most banks in India even today continue to look at the needs of the corporates in the light of methodology recommended by the Group.

As per the recommendations of Tandon Committee, the corporates should be discouraged from accumulating too much of stocks of current assets and should move towards very lean inventories and receivable levels. The committee even suggested the maximum levels of Raw Material, Stock-in-process and Finished Goods which a corporate operating in an industry should be allowed to accumulate these levels were termed as inventory and receivable norms. Depending on the size of credit required, the funding of these current assets (working capital needs) of the corporates could be met by one of the following methods:

a) First Method of Lending

Banks can work out the working capital gap, i.e. total current assets less current liabilities other than bank borrowings (called Maximum Permissible Bank Finance or MPBF) and finance a maximum of 75 per cent of the gap; the balance to come out of long-term funds, i.e., owned funds and term borrowings. This approach was considered suitable only for very small borrowers i.e. where the requirements of credit were less than Rs.10 lacs. When MPBF is calculated as per 1^{st} method of lending, it will result in minimum current ratio of 1:1.

$$\mathbf{MPBF = 0.75\ (TCA - OCL)}$$

b) Second Method of Lending

Under this method, it was thought that the borrower should 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 to fund the buildup of current assets and the bank will provide the balance (MPBF). Consequently, total current liabilities inclusive of bank borrowings could not exceed 75% of current assets. RBI stipulated that the working capital needs of all borrowers enjoying fund based credit facilities of more than Rs. 10 lacs should be appraised (calculated) under this method. When MPBF is calculated by using 2^{nd} method, it will result in a minimum current ratio of 1.33:1. **This method is generally followed by most of the banks.**

$$\mathbf{MPBF = [0.75\ (TCA) - OCL]}$$

c) Third Method of Lending

Under this method, the borrower's contribution from long term funds will be to the extent of the entire Core Current Assets, which has been defined by the Study Group as representing the absolute minimum level of raw materials, process stock, finished goods and stores which are in the pipeline to ensure continuity of production and a minimum of 25% of the balance current assets should be financed out of the long term funds plus term borrowings.

MPBF = 0.75 (TCA – CCA) - OCL

(This method was not accepted for implementation and hence is of academic interest only)

7.3 Chore Committee Recommendations

This committee was formed by RBI to review the cash credit system of banks. The important recommendations of the Committee are as follows:

- The banks should obtain quarterly statements in the prescribed format from all borrowers having working capital credit limits of Rs. 50 lacs and above.
- The banks should undertake a periodical review of limits of Rs. 10 lacs and above.
- Banks should discourage sanction of temporary limits by charging additional one per cent interest over the normal rate on these limits.
- The banks should fix separate credit limits for peak level and non-peak level, wherever possible.
- Banks should take steps to convert cash credit limits into bill limits for financing sales.

8. Conclusion

Arrangement of working capital financing forms a major part of the regular activities of a firm. It is a very crucial activity and requires continuous attention because working capital is the capital required by a firm to sustain its day to day operations. Without appropriate and sufficient working capital financing, a firm may get into troubles. Insufficient working capital may result into nonpayment of certain dues on time. Inappropriate mode of financing would result in loss of interest which directly hits the profits of the firm.

From a banker's perspective, 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. Indian Overseas Bank is playing a significant role by providing necessary working capital assistance to businesses including MSME units in a hassle-free manner.

Government of India is attaching great importance to MSME sector and taking various policy measures to enhance the flow of credit to this sector. Further research work on working capital finance to MSME sector can open up many dimensions for researchers.

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Appendices

1. Assessment of Working Capital as per Various Committees' Recommendations

a. Projected Annual Turnover (PAT) Method (Nayak Committee Recommendation)

Example:

A	Projected Sales turnover for the next year	Rs. 100
B	25% of the Estimated Sales	Rs. 25
C	Minimum margin at 5% of Projected Sales turnover	Rs. 5
D	Actual Net Working Capital as per financial statement	Rs. 10
E	B - C	Rs. 20
F	B - D	Rs. 15
G	Maximum Permissible Bank Finance [(B-C) or (B-D) whichever is less]	Rs. 15
H	Additional margin to be brought in (C-D)	Rs. 0

b. First and Second Method of Lending

(Tandon Committee Recommendation)

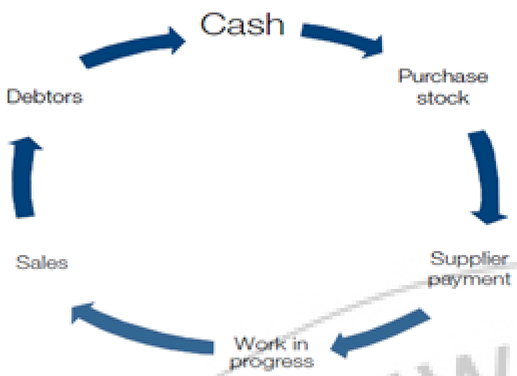
A	Current Assets			Rs. XXX
B	Current Liabilities other than Bank Borrowings			Rs. XXX
C	Working Capital gap (A-B)			Rs. XXX
D	Minimum Stipulated NWC	D1	1st method: (25% of TCA)	Rs. XXX
		D2	2nd method: (25% of WCG)	Rs. XXX
E	Actual / Projected NWC			Rs. XXX
F	C – D1 or C – D2			Rs. XXX
G	C – E			Rs. XXX
H	MPBF (F or G whichever is less)			Rs. ****
I	Excess borrowings / short fall in NWC (D-E)			Rs. XXX

c. Drawing Power Method
(For Units with Small Limits)

Example:

Particulars	Stock Value (Rs.)	Margin	Drawing Power (Rs.)
Paid stocks / Raw materials	100	25%	75
Semi finished goods	100	50%	50
Finished goods	100	25%	75
Book Debts	100	50%	50

d. Operating Cycle Method



A	Raw Material Holding Period	X days
B	Work-In-Process Holding Period	Y days
C	Finished Goods Holding Period	Z days
D	Debtors Collection Period	P days
E	Creditors Payment Period	Q days
F	Duration of Operating Cycle (X + Y + Z + P – Q)	T days
G	No. of Operating Cycles in a Year (365 / T)	N
H	Working Capital Requirement (Operating Expenses p.a / N)	Rs. ****

#As per IOB's policy, it is normally presumed that the working capital cycle will be of three months.