BANKING AS SOURCE OF CAPITAL INCLUDING NBFCs

LEARNING OUTCOMES

After going through the chapter student shall be able to understand:

- Bank loans in the form of working capital loan
- Bank loans in the form of term loan
- Financing through Non-Banking Finance Companies (NBFCs)
- Concept of Project Financing
- Working Capital Management
- Reverse Mortgage

1. BANK LOANS IN THE FORM OF WORKING CAPITAL LOAN

When banks provide loan in the form of working capital, they are providing loan for funding the current assets. The working capital loan should be of short term in nature and it is given in the form of a limit. Banks specify a limit to a borrower and the borrower would be drawing the amount within the limit. This facility is called working capital facility. The working capital loan can be provided in Indian Rupees as well as in Foreign Currency. We shall first discuss different working capital loans in Indian Rupees.

1.1 Different products for Working Capital Loan in Indian Rupees

There are different products under which banks disburse the working capital product. These are given as below:
1.1.1 Cash - Credit Account

This is the most popular mode of loan product for funding the fund based working capital requirement of a company. Once the fund based limit has been assessed by the bank and the limit is in place after fulfillment of all the steps, the fund is made available through the cash-credit product. The account operates like a typical current account. At the time of first disbursement, the drawing power is fixed on the basis of the stock statement and the company is allowed to operate within this limit till the next month when a monthly stock statement would be submitted by the company. The company can deposit and withdraw money from the fund as many times as it wants. The Company would pay interest only on the outstanding amount on a daily product basis and the interest is charged on monthly basis. This is explained with the help of the following example:

A company has been sanctioned a fund- based working capital limit of ₹ 200 lacs and interest rate is Base Rate +2% p.a, payable at monthly basis. The present Base Rate of the bank is 11%. The company avails this facility through a cash credit route. The stock statement submitted on 1st of September 2013, stipulates that the drawing power would be ₹ 190 lacs.

The transactions of the company are as follows:

<table>
<thead>
<tr>
<th>Date</th>
<th>Particulars</th>
<th>Withdrawal</th>
<th>Deposit</th>
<th>Balance</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.9.13</td>
<td>To Electricity</td>
<td>15</td>
<td></td>
<td>15</td>
</tr>
<tr>
<td>5.9.13</td>
<td>To Salary</td>
<td>45</td>
<td></td>
<td>60</td>
</tr>
<tr>
<td>6.9.13</td>
<td>To Raw Material Supplier</td>
<td>100</td>
<td></td>
<td>160</td>
</tr>
<tr>
<td>10.9.13</td>
<td>To Other creditor</td>
<td>30</td>
<td></td>
<td>190</td>
</tr>
<tr>
<td>11.9.13</td>
<td>By Sales Proceeds</td>
<td></td>
<td>30</td>
<td>160</td>
</tr>
<tr>
<td>12.9.13</td>
<td>To purchase</td>
<td>25</td>
<td></td>
<td>185</td>
</tr>
<tr>
<td>16.9.13</td>
<td>By Sales</td>
<td></td>
<td>50</td>
<td>135</td>
</tr>
<tr>
<td>30.9.13</td>
<td>By Sales</td>
<td></td>
<td>80</td>
<td>55</td>
</tr>
</tbody>
</table>

Since the drawing power of the company is ₹ 190 lacs, the balance cannot exceed ₹ 190 lacs. The company can withdraw and deposit as many times as possible provided the balance is within ₹ 190 lacs. In the above-mentioned example, the company withdraws 5 times in a month and deposits 3 times in a month. This is one of the major advantages of the cash credit system enjoys by the corporate. The cash management responsibility is shifted to the bank. The bank has to block the entire ₹ 190 lacs for this account throughout this month though the company has only drawn this amount once i.e. on 10.9.13. If we define that the idle fund from this account is the difference in amount between the
drawing power and the amount availed and the opportunity cost is 7.00% p.a the total opportunity cost is calculated below:

<table>
<thead>
<tr>
<th>Date</th>
<th>Drawing Power (DP) lacs (A)</th>
<th>Balance ₹ lacs (B)</th>
<th>Idle Fund ₹ lacs (C) = (A) – (B)</th>
<th>Period (days) (D)</th>
<th>Cost ₹ lacs (E)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1.9.13</td>
<td>190</td>
<td>190</td>
<td>190</td>
<td>2</td>
<td>0.073</td>
</tr>
<tr>
<td>3.9.13</td>
<td>190</td>
<td>15</td>
<td>175</td>
<td>2</td>
<td>0.067</td>
</tr>
<tr>
<td>5.9.13</td>
<td>190</td>
<td>60</td>
<td>130</td>
<td>1</td>
<td>0.025</td>
</tr>
<tr>
<td>6.9.13</td>
<td>190</td>
<td>160</td>
<td>30</td>
<td>4</td>
<td>0.023</td>
</tr>
<tr>
<td>10.9.13</td>
<td>190</td>
<td>190</td>
<td>-</td>
<td>1</td>
<td>0.00</td>
</tr>
<tr>
<td>11.9.13</td>
<td>190</td>
<td>160</td>
<td>30</td>
<td>1</td>
<td>0.005</td>
</tr>
<tr>
<td>12.9.13</td>
<td>190</td>
<td>185</td>
<td>5</td>
<td>4</td>
<td>0.004</td>
</tr>
<tr>
<td>16.9.13</td>
<td>190</td>
<td>135</td>
<td>55</td>
<td>14</td>
<td>0.147</td>
</tr>
<tr>
<td>30.9.13</td>
<td>190</td>
<td>55</td>
<td>135</td>
<td>1</td>
<td>0.025</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Total</td>
<td>30</td>
<td>0.369</td>
</tr>
</tbody>
</table>

In the case of cash credit facility, the bank loses this amount due to idle fund. If the limit is substantially large, the idle fund cost is considerably higher. To help banks overcome this, RBI has stipulated a loan delivery mechanism for all the fund-based working capital limit. Under this system, 80% of the fund based working capital would be disbursed through a product called Working Capital Demand Loan (WCDL) where the repayment is to be specified by the borrower at the time of availing the disbursement. The maximum tenure of WCDL is 1 year and minimum tenure can be 7 days. The remaining 20% of limit can be availed through the normal cash credit route. In the case of WCDL, the cash management lies with the company.

Since, in this product the cash management lies in the hands of the borrower, the borrower would have the incentive of an interest rate concession. Depending on the bank involved, the cost of borrowing would be reduced to the extent of 50 basis points to 150 basis points.

**1.1.2 Bill Discounting**

Bill discounting is a product where a part of the receivable can be financed. Once the assessment of the company is carried out, a portion of the assessed limit representing part of the receivable can be financed through bill discounting mode. When a company sells goods on credit, receivable is generated in the books of accounts of the company. This receivable is of two types: 

*Open Account sales*: Under this process only sales invoice and other sales related documents are drawn by the seller.
Bills Receivable: Under this process, not only all the documents associated with the open account sales are drawn but a Bill of Exchange is also drawn. A typical bill of exchange would look like:

<table>
<thead>
<tr>
<th>₹ __________/-</th>
<th>Date:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Please Pay ______________ (Payee) or Order a sum of Rs _______________ - (Rupees _______________ only) on 90 days (Credit Period) from the date of this document.</td>
<td></td>
</tr>
</tbody>
</table>

(Name & Address of Drawer)       (Name & Address of Drawee)

A scrutiny of the above-mentioned bills of exchange would reveal the following:

- It is an order given by the drawer of the bill of exchange to the drawee to pay to a party after certain days. Here the drawer is generally the seller and the drawee is generally the purchaser. The payee is the bank from whom the seller gets the credit under bill discounting scheme.
- Under normal circumstances, the seller would get the payment after 90 days from the buyer. This is the credit period extended by the seller to the buyer. This is also called the usance period of bills of exchange.
- To improve the cash flow, the seller can get the fund from the Payee immediately on submission of bills of exchange to a bank. The bank would send it for acceptance to the drawee and drawee will accept the bills of exchange to pay on due date.
- On receipt of acceptance from the drawee, the bank would pay to the drawer immediately.
- On due date, the bank would collect the money from the drawee. Since the bill of exchange is a negotiable instrument, protection under Negotiable Instrument Act is available to the payee.

Nowadays, this method of financing has become very popular for Small and Medium Enterprise (SME) financing. Many large companies outsourced their production facility to SMEs. These SMEs may not be financially strong enough to attract very competitive interest rates from the bank. The bank enters into arrangement where the large company which is the buyer of goods of SME would accept the Bills of Exchange drawn by the SME and in that case the exposure is shifted on the Large Company.

Besides, the above working capital product, there is another product by which a company can borrow short term funds. This is called Overdraft.

1.1.3 Overdraft

Overdraft is the facility by which an entity gets loan over and above the value of the security. This can be explained with the help of the following example:
A company has a fixed deposit of ₹ 5 lacs maturing on 15th September 2012. The fixed deposit was made on 15th September 2011 and the interest rate was 6.5% p.a. payable quarterly. Now, on 1st September, the company requires a fund of ₹ 5 lacs. The company has two options:

**Option I:** The Company closes the fixed deposits prematurely and in the process, it loses 1% interest. If the company exercises this option, it will earn interest to the tune of ₹ 27032/-

**Option II:** The Company can take a loan for 15 days against the fixed deposit and continue with the deposit itself. The interest rate on loan of fixed deposit would be 1% higher than the interest rate of fixed deposit. In this case, the company pays 7.5% interest on ₹ 5 lacs for 15 days. The company in this process would earn ₹ 31760/- on its investment.

So in many cases, it is beneficial to avail an overdraft over the fixed deposit amount. This facility is called the overdraft. This is also a very popular retail banking product.

### 1.1.4 Factoring Services

Factoring services are the product by which the receivable is funded. In international transactions, factoring of receivable is also a very important corporate banking product. In most of the international trade transactions, besides the normal credit risks, it involves additional concepts of country and therefore sovereign risks come into play.

Sovereign risks in international business are usually of three broad categories:

- **Transaction Risk:** It is linked to a specific transaction that involves a specific amount within a specific time frame, such as an export sale on six month’s draft terms;

- **Translation Risk:** It stems from the obligation of multinational companies to translate foreign currency assets and liabilities into the parent company’s accounting currency regularly, a process that can give rise to book-keeping gains and losses;

- **Economic Risk:** In the broadest sense, it encompasses all changes in a company’s international operating environment that generate real economic gains or losses.

#### 1.1.4.1 International Factoring and its Advantages

The distinct advantages of a factoring transaction over other methods of finance/facilities provided to an exporter can be summarized as follows:

1. Immediate finance up to a certain percentage (say 75-80 percent) of the eligible export receivable. This pre-payment facility is available without a letter of credit – simply on the strength of the invoice(s) representing the shipment of goods.

2. Credit checking of all the prospective debtors in importing countries, through own databases of the export factor or by taking assistance from his counterpart(s) in importing countries known as import factor or established credit rating agencies.

3. Maintenance of entire sales ledger of the exporter including undertaking asset management functions. Constant liaison is maintained with the debtors in importing countries and collections are
effected in a diplomatic but efficient manner, ensuring faster payment and safeguarding of financial costs.

4. Accordingly, bad debt protection up to full extent (100 percent) on all approved sales to agreed debtors ensuring total predictability of cash flows.

5. Efficient and fast communication system through letters, telex, and telephone or in person in the buyer’s language and in line with the national business practices.

6. Consultancy services in areas relating to special conditions and regulations as applicable to the importing countries.

1.1.4.2 Types of International Factoring

The most important form of factoring is two-factor system.

Two-Factor System

The transaction is based on operation of two factoring companies in two different countries involving in all, four parties: Exporter, Importer, export Factor in exporter’s country and import factor in importer’s country.

The mechanics of operation in this arrangement works out as follows:

1. The exporter approaches the export factor with relevant information which, inter alia, may include:
   a) Type of business,
   b) Names and addresses of the debtors in various importing countries,
   c) Annual expected export turnover to each country,
   d) Number of invoices/credit notes per country,
   e) Payment terms and
   f) Line of credit required for each debtor.

2. Based on the information furnished, the export factor would contact his counterpart (import factor) in different countries to assess the creditworthiness of the various debtors.

3. The import factor makes a preliminary assessment as to his ability to give credit cover to the principal debtors.

4. Based on the positive response of the import factor, the factoring agreement is signed between the exporter and export factor.

5. Goods are sent by the exporter to the importer along with the original invoice which includes an assignment clause stipulating that the payment must be made to the import factor. Simultaneously, two copies of the invoice along with notifications of the debt are sent to the export factor. At this
stage, prepayment up to an agreed per cent (say 75-80 percent) of the invoice(s) is made to the exporter by the export factor.

6. A copy of the invoice is sent by the export factor to his counterpart, that is the import factor. Henceforth, the responsibilities relating to book-keeping and collection of debts remain vested with the import factor.

7. Having collected the debts, the import factor remits the proceeds to his counterpart that is export factor. In case, payments are not received from any of the debtor(s) at the end of the previously agreed period on account of financial inability of the debtor concerned, the import factor has to pay the amount of the bill to his export counterpart from his own funds. However, this obligation will not apply in case of any dispute regarding quality, quantity, terms and conditions of supply etc. If any dispute arises, the same has to be settled between the parties concerned through the good offices of the factoring companies, otherwise legal action may have to be initiated by the import factor based on the instructions of the exporter/export factor.

8. On receipt of the proceeds of the debts realized, the retention held (say 15-20 percent) is released to the exporter. The entire factoring fee is debited to the exporter’s account and the export factor remits the mutually agreed commission to his importing counterpart.

Thus, the export factor undertakes the exporter risk whereas the importer risk is taken care of by the import factor.

The main functions of the export factor relate to

(i) Assessment of the financial strength of the exporter.
(ii) Prepayment to the exporter after proper documentation and regular audit and post sanction control.
(iii) Follow-up with the import factor.
(iv) Sharing of commission with the import factor.

The import factor is primarily engaged in the areas of

(i) Maintaining books of exporter in respect of sales to the debtors of his country.
(ii) Collection of debts from the importers and remitting proceeds of the same to the export factor.
(iii) Providing credit protection in case of financial inability on the part of any of the debtors.

The two factor systems are by all means the best mode of providing the most effective factoring facilities to a prospective exporter. However, the system is also fraught with certain basic disadvantages, i.e. delay in operations like credit decision, remittance of fund, etc., due to involvement of many parties.

1.1.5 Dealer Financing

This is a new product by which banks are providing funds to the dealers of large companies. In this case, the large corporate, say, Maruti Udyog Limited would provide a list of dealers to a bank, say,
HDFC bank Limited. Generally, the dealer selection would be carried out by the large corporate. The large corporate would identify the category A dealers and the same list would be forwarded to the bank. Now the bank would sanction a limit based on the intake of the dealer from the large corporate. Suppose a dealer purchases ₹ 250 lacs worth of car from Maruti Udyog Limited on monthly basis. Now HDFC bank would pay ₹ 200 lacs to Maruti Udyog Limited on behalf of the dealer. Then the dealer would make the payment to HDFC bank after 1 month with an interest rate. In such a case, the inventory to the tune of ₹ 250 lacs would be funded by HDFC bank. Now, the dealer may have already enjoying fund based limit from the banking system. So the dealer would inform the existing working capital banker that it has already availed ₹ 200 lacs from the HDFC bank and the same stock would not be shown in the inventory which the dealer would give to the existing bank for calculation of drawing power. In this case we have assumed a 20% margin on the inventory. The benefit to the dealer is that it would get lower rate of interest from the HDFC bank. In this type of financing there can be two types of credit enhancement:

• Maruti Udyog Limited would give some kind of guarantee that in case the dealer does not pay, it would make the payment. The payment may be a portion of the loan outstanding. However, in many cases when the principal - in this case Maruti Udyog Limited - is an AAA rated corporate, it may not give the corporate guarantee at all.

• In such a case, the principal may give a stop-order commitment. Under this mechanism, the principal would not dispatch any new consignment to the dealer in case HDFC bank informs it that the dealer has not paid the previous loan amount. Since the dealer is a category A dealer, the dealer may not be willing to land itself in such a situation. In such a case, it would lose its main business. The same product can be extended to many commodity dealers and large company customers.

1.1.6 Term Loan for working capital purpose

Besides the above mentioned working capital product, we can have a product which would cater to the working capital requirement; it is called term loan for augmentation of the margin money for working capital. Under this scheme, the banks would provide a term loan and the purpose of the loan is to augment the margin money for working capital. This can be explained with the help of a simple example:

Let us assume that as on March 31, 2014, a company is estimating a current asset of ₹ 300 million and other current liability of ₹ 30 million. The total working capital gap is ₹ 270 million.

Now the working capital banker would be providing a fund-based working capital limit to the tune of ₹ 180 million, stipulating that the borrower has to bring in ₹ 90 million in the form of margin money for working capital. Now as on March 31st, 2013 the company has Margin Money amounting to 75 million for Working Capital. So the company has to bring in an additional amount of 15 million in the form of augmentation of net working capital. The company decides to take ₹ 10 million from a bank in the form of a 3-year term loan. Such loan is called Margin Money For Working Capital Loan. This loan would be paid over a period of 3 years. The security of this loan cannot be the current asset. So the security of
this loan would be in the form of other than current asset which can be noncurrent assets of the company or any other asset outside the company’s books of account.

1.2 Different working capital product under Foreign Currency

One should always be aware about the competitive advantage of a particular type of borrowing source. Funds can be from the domestic sources as well as from the foreign sources, one should avail the right sources so that the overall cost goes down. Broadly, if a business borrows in foreign currency, then the total interest payment would be calculated as follows:

Benchmark Interest Rate (say 6 months LIBOR etc.) + Spread + Foreign Exchange Premium

Different working capital product under Foreign Currency has been discussed as follows:

1.2.1 Buyer’s Credit

Suppose a business entity ABC Limited wants to import ₹200 million worth of raw material from Germany. Now the buyer i.e. ABC Limited has arranged a foreign fund of maximum 360 days from the date of import from HSBC Frankfurt. In case no such facility was there, ABC Limited would have to make the payment from the cash credit account, and for this amount, it has to pay the interest rate at Base Rate + Spread say 13% p.a. Now Indian bank would give a Financial Guarantee or Letter of Undertaking (LOU) or Stand By Letter of Credit (SLC) in favour of HSBC, Frankfurt that in case ABC Limited does not make the payment, it would make the payment. For this LOU /SLC/FBG, the Indian Bank would charge 1% p.a. to the customer ABC Limited. Now, once the customer submits this instrument to HSBC Bank, Frankfurt, HSBC bank would lend to ABC and ABC would make the payment towards its supplier. Now the interest rate would be in foreign currency. If the 6 months’ dollar LIBOR is 0.5% p.a. and the spread is 150 bps and the forward premium is 600 bps the total cost of the borrowing is 8% p.a. When we add the FBG commission, the total cost comes to 9% p.a. So ABC could save a net of 4% p.a. interest rate on ₹ 200 million. The tenure of such buyer’s credit would be a maximum of 360 days from the date of import. The Indian bank, while issuing the SLC/FBG, would now earmark the cash credit limit of the borrower. So the buyer’s credit is disbursed under the sub-limit of Cash Credit Facility.

1.2.2 Pre shipment credit in foreign currency

If the business entity is exporting to the tune of pre shipment credit, funds can be disbursed under foreign currency. Such type of financing product is called PCFC. The benefit of this product is that the overall cost of fund is LIBOR + Spread. Since export is involved, it would lead to natural hedge and further hedging is not required. In fact, every exporter should avail this facility. Exporter should avoid availing fund under Rupee credit since the interest rate for such kind of financing would be charged as per Base Rate plus spread.

1.2.3 Post Shipment Credit in Foreign Currency (PSCFC)

Under this product, the post shipment credit to an exporter can be disbursed in foreign currency. The benefit for such type of product is that the cost of the borrowing would again be in LIBOR plus spread.
Since the actual payment would come in USD, the credit would itself be self-liquidating in nature. In case the Indian business entity is neither importing nor exporting, the entity cannot borrow in foreign currency short term except FCNR(B) loan. Under this scheme, the customer would be able to borrow only in the form of FCNR (B) loan.

1.2.4 Foreign Currency Non Resident Bank Loan [FCNR (B)] Loan

This has been one of the most popular methods of working capital finance. Before going into the benefits of the product, we shall first discuss the product itself. Foreign Currency Non-Resident (Bank) is the name of a deposit scheme operated by Indian bank to collect deposits from Non Resident Indians and Overseas Corporate Bodies (OCB). These deposits are collected in United States Dollars (USD), Japanese Yen (JPY), Euro, Great Britain Pounds (GBP), Canadian Dollar and Australian Dollar. The deposit can be taken for a minimum period of 12 months and a maximum period of 36 months. The interest and principal is to be paid in foreign currency. When a bank accepts FCNR (B) deposits, it accepts deposits in these foreign currencies. The Indian bank has the following options before it:

1. It keeps the deposit in the dollar form and invests in overseas bank account. The benefit of this mechanism is that the bank has fully hedged the currency conversion risk and the counter party risk is nil. The drawback of this mechanism is that in this process, the earning is substantially lower.

2. After accepting the deposits, the bank converts this foreign currency into domestic currency. Subsequently, it lends the domestic currency to the Indian company and earns domestic interest rate. On due date of payment of interest and principal, the bank converts the Indian currency into foreign currency as it has to pay back to the depositor both interest and principal in foreign currency. The benefit of this mechanism is that the earning to the bank is more. However, the drawback is that the bank incurs a foreign exchange risk.

3. There can be another process by which some of the benefits from both the alternatives can be retained. Such process would lead to the development of the product called FCNR(B) loan. In the case of FCNR (B) loan, the bank can lend to Indian corporate in foreign currency held by the bank under FCNR(B) deposit. The benefit to the bank is that without incurring the conversion risk (as mentioned under drawback in option 2), the bank can earn more as the Indian corporate would pay more compared to that of the foreign bank (as mentioned in option 1 above).

2. BANK LOAN IN THE FORM OF TERM LOAN

Banks provide long term loan for asset purchase as well as margin money for working capital purpose. In the case of asset purchase, a bank would provide a long-term loan which would be repaid either from the cash flow generated from the business or from refinancing or disinvestment. In such a case, the security is generally created on the asset which is purchased out of the term loan. Besides, some other collateral is also taken as security in the form of term loan. In the case of term loan for working capital purpose, generally, other assets are taken as security. Those assets can be immovable properties the borrower generally has.
Trade Credit for capital goods purchase

As discussed in the case of working capital, if the term loan is borrowed in the form of foreign currency, the interest cost can come down. However, there are certain restrictions on term loan which can be borrowed in foreign currency. One such facility is called suppliers credit or buyer's credit for import of capital goods. Since we have already discussed the mechanism of supplier's credit and buyer's credit, we shall not discuss the same.

3. FINANCING THROUGH NON-BANKING FINANCE COMPANIES

After discussing different sources of fund from the banking system, we shall now concentrate on the different funding options which a Non-Banking Financial Service Company (NBFC) provides to Indian borrowers.

NBFCs provide normal term loan in the form of different products. A few of the important products which are present in the market are:

- Loan Against Property
- Equipment Loan
- Term Loan
- Lease Rent Securitization
- Promoter Funding

3.1 Loan against Property (LAP)

If a business entity or its promoter is having an unencumbered immovable property, against this the NBFC would provide a loan. Generally, the loan amount is 65% of the market value of the property. The document requirement for such type of loan is relatively relaxed compared to the bank. Besides, end use restriction is also relaxed in such cases. In such cases, when the borrower requires funds for certain purpose and within short period of time, it can avail the loan in the form of Loan against Property.

The LAP fund can be used for the following purpose by the borrower:

(i) Purchase of another asset

LAP fund can be used for purchasing another real estate or land. Since banks fund cannot be used for purchase of land, many borrowers in India resort to this product for further purchase of land.

(ii) Bringing in margin money for another loan from the bank

A borrower needs to bring in margin money for any type of loan it takes from the bank. The borrower may not have the margin money in the form of cash. So the borrower or promoter can raise LAP from the NBFC and the same would be injected in the company as margin money. This is explained with the help of an example:
Example

ABC Limited, has a working capital limit of ₹ 35 crores for which it has to bring in the margin money for working capital to the tune of ₹ 3 crores. The company does not have cash and bank balance of more than ₹ 0.25 crores. But the promoter has immovable properties worth ₹ 5 crores. The promoter would take LAP to the tune of ₹ 2.75 crores from an NBFC with the company as a co-applicant. Now this money would be brought in the company by the promoter in the form of either unsecured loan or in the form of equity. Since LAP is given for a longer period i.e. a minimum of 7 years, the cash flow from the business would be sufficient to repay the LAP amount.

(iii) Debt Consolidation purpose

LAP is also used for Debt and Security Consolidation purpose. This is explained with the help of the following example.

Example

ABC Private Limited (ABPL) gave a 3000 square feet building located at Thane in Mumbai 10 years back as collateral to a banking facility of ₹ 20 lacs. At that time the value of the building was ₹ 18 lacs. Now the value of the building is ₹ 300 lacs. The overall borrowing has increased by ₹ 40 lacs. Now the company tells the bank to replace this security with another collateral of ₹ 80 lacs. However, most of the time the banker would not accept this. Now the company can take LAP of ₹ 45 lacs against the new collateral and bring own fund of ₹ 15 lacs and pay off the bank limit. Once the ₹ 300 lacs collateral is released from the bank, the company would now process the loan application for ₹ 60 lacs with a new bank where it would mention upfront that it would provide a collateral of ₹ 80 lacs. Once this loan is sanctioned, the LAP would be repaid by the borrower. This is known as security consolidation /debt consolidation.

(iv) Promoter Funding

This is another important product which NBFC can give. Due to capital market exposure, banks have restrictions on lending to the capital market. Now, for acquiring another company in the domestic market, bank borrowing cannot happen as it is prohibited by the RBI. So the borrower (acquirer) would approach the NBFC to fund such acquisition in the form of term loan. In such a case, the promoter shares are pledged if the company is listed or unlisted. If the company is unlisted, then apart from these shares, listed shares which promoter or company is holding in its books would also be taken as security.

4. PROJECT FINANCING

Banks provide facilities for two purposes. For building up current assets of the borrower, banks provide fund based and non-fund based facilities in the form of working capital. For building up current assets of the borrower, banks can provide project loan and term loan. The basic difference between Project Financing and Term Loan is that in the case of Project Financing, the loan is secured by way of primary
securities and no collateral securities are available. Besides, the cash flow from the assets financed would only be available to repay the project finance loan.

In the case of term loan, the collateral security is available and other cash flows are also available over and above the cash flows from the primary assets. Since the assessment part is the same in the case of both kinds of financing, we shall be using terminology project financing and term loan interchangeably. Besides banks provide term loan for building up of assets which is other than current assets. So term loan is provided for the following purposes:

- Building up of fixed assets of the borrower
- Building up portion of current assets of the borrower
- Building up other non-current assets of the borrower

### 4.1 Determination of Project Cost & Means of Finance

The first step in any project loan assessment is the determination of project cost. Project cost calculations are different for different categories of term loan. If the term loan is provided only for the capacity expansion of a lower end SME, the project cost would be only the fixed assets cost. However, if we are giving the loan for setting up a new unit the project cost can be composed of three components:

(i) Fixed Asset Cost and Contingencies
(ii) Interest during Construction
(iii) Margin Money for working capital

So we can generalize the concept where the project cost can be defined as:

Project Cost = Fixed Asset Cost and Contingencies (I) + Interest During Construction (II) + Margin Money For Working Capital (III)

Depending on the nature of the borrower, we can exclude second and third component from the determination of project cost. One of the basic principles is that if the risk of the borrower is high then II and III would not be included in the project cost and this amount needs to be funded with equity. Similarly, in the case of existing unit, project cost would not include II and III part as this would be funded purely by the equity part. However, if the borrower is a good borrower and its credibility is high, we can include both II and III.

### 4.2 Fixed Asset Cost determination

First lenders would ask the borrower to submit quotation from reputed suppliers. The fixed asset would consist of the following:

(i) Land
(ii) Building
(iii) Plant and Machinery
(iv) Furniture and Fixture
(v) Information Technology

(i) Land: For almost all cases, land would not be financed by the term lender. So term lender would first ask the borrower to submit the land documents. In case land has not been purchased, the lender would not disburse the fund unless proof of land purchase has been shown to the lender by the borrower.

(ii) Building: In the case of a project where building has to be constructed, the lender would ask the borrower to submit detailed quotation for the building construction. Lender’s engineer should verify the correctness of the quotation and the engineer should give written report in this regard. In case lender’s engineer reduced the cost, the lender would communicate the same to the borrower and borrower has to accept this reduced quotations. While selecting the contractors for the construction of the building, the lender should ensure the following:

- The capacity of the contractor to execute such job
- The net worth of the contractor
- Past track record

(iii) Plant and Machinery: The borrower should submit multiple quotations and the lender should check the price of the equipment from the market. Lenders must also check about the following aspects of the plant and machinery:

- Suppliers credibility of the market
- Machines performance
- Comprehensive Maintenance Contract and its provisions
- Any adverse opinion of the machines being purchased in the recent periods

(iv) Furniture and Fixture: We shall adopt the same process as in the case of the building.

(v) Information Technology: In the case of IT, we shall take quotation from renowned vendors. It is advisable that at the time of first purchase, extended warranty period may be included in the quotations and the same to be included in the project cost.

Once we get all the price of the fixed assets, we determine the time of implementation. Since the implementation period would be spread over time period, the interest incurred during the construction period would be capitalized and the same would be included in the project cost. This interest is called Interest During Construction (IDC).

### 4.3 Margin Money for Working Capital
In the case of Margin Money for working capital or Net Working Capital calculation, we need to project the current assets. Margin money for working capital is a part of project finance. Without working capital project finance disbursement would not take place. Current asset should always be categorized into three parts:

- Inventory
- Receivable
- Other Current Asset

Inventory level may go up in the initial part of the project. Due to initial teething problem, inventory level would come down as the process stabilizes. This may not be true for receivable. Receivable level would go up in the initial stage if the product has competition in the market. For innovative product, receivable level may not go up in the initial phase. Receivable level may not go down subsequently. Holding level is important for calculation of appropriate working capital. Holding level should be based on a realistic situation. Lender should never assume constant current asset. It must determine the current asset from the holding level.

4.4 Evaluation of the project

When we decide for undertaking investment in a capital project, the following are the characteristics:

- Money is invested at a time i.e. out flow of fund takes place at a time;
- Inflow of fund is taking place at different points of time;
- So there is time value of money concept involved in analysing the capital investment decision since there is a considerable difference between the inflow and outflow of fund.

So any good project evaluation criteria must consider this time value of money. However, even today there are certain criteria which do not take into account the time value of money criteria. However, this type of evaluation must not be adopted.

Based on this, we are making a list of different evaluation criteria. The entire evaluation criterion is divided into two categories:

**Category I (where time value of cash flow is not considered)**

- Pay Back method
- Accounting Rate of return

**Category II (where time value of cash flow is considered)**

- Discounted Pay back
- Net Present Value
- Internal Rate of Return.
These techniques have already been discussed in greater detail in the paper Financial Management at Intermediate Level.

4.5 Issues related to Project/Infrastructure Funding

Project Financing is a new concept in India. Presently, not much of project financing happens in India except in the infrastructure sector. So issues related to infrastructure funding can be best methodology to analyse the appropriate assessment process of project funding.

Every infrastructure proposal should have the following sections:

- Technical Feasibility
- Financial Viability
- Bankability
- Risk Analysis
- Uncertainty Analysis

4.5.1 Technical Feasibility

Under this section technical feasibility of project is carried out through the Technical Feasibility Report broadly containing following heads:

- Approved technical consultant
- Coverage area:
  - Use of technology in previous project
  - Remaining life cycle of technology
- Risks associated with advent of newer technology
  - Any negative impact of the technology on the environment
  - Ease of availability of the technology during the operation of the project
- Forecasting area:
  - Sales/revenue prediction
  - Methodology of sales/revenue prediction
  - Approval status of the same with the regulatory/other bodies
- Past track record:
  - Back testing of projections and actual
  - Acceptability criteria

4.5.2 Financial Viability

Under this section, the viability of the project is carried out. RBI said that bankers should follow the following methods:

- Discounted Pay Back
- Internal Rate of Return
Bankers can also follow more advanced methods of evaluation.

**Adjusted Present Value (APV):** As mentioned earlier first three methods are covered in the paper of Financial Management at Intermediate Level. Let us discuss the APV method here.

Normally financing decisions and investment decisions are handled separately. Since level of gearing adopted by a firm can influence the decision, APV technique offers some advantages over NPV. Accordingly, at the side effect of financing is also considered along with investment decision and accordingly formula for evaluation shall be as follows:

\[ \text{APV} = \text{Base NPV} + \text{Present Value of Impact of Financing} \]

or \[ \text{NPV}_g = \text{NPV}_u + \text{PV of tax relief on debt interest} \]

Where, \( \text{NPV}_u = \text{Value of ungeared company} \)

Thus, it evaluates the NPV from the perspective of an geared company giving the increase in \( V_u \) by considering the benefit to the company of increasing the debt for its funding.

**Illustration**

XYZ Ltd. is planning to introduce a new product. The initial investment required is ₹ 48 lacs. Total requirement of ₹ 48 lacs will be met by, ₹ 8 lacs from internally generated funds, ₹ 15 lacs from a right issue and remaining from a long-term loan at 12% p.a. The ratio of loan reflects debt capacity of the company. Corporate taxes are payable at 40% p.a. on net operating cash flows of the particular year. Risk free rate of interest is 9%, market return is 14% and relevant company assets beta for the investment is estimated to be 1.5. Net operating after tax cash flows from the project is

- year 1 = ₹ 15 lacs.
- year 2 = ₹ 34 lacs;
- year 3 = ₹ 12 lacs.

Besides, these inflows residual value of ₹ 5 lacs (after all taxes) is also expected at the end of third year. Assuming the principal is repayable at the end of 3 years you are required to estimate APV (Adjusted Present Value) of the investment and decide whether the investment is worth undertaking.

**Solution**

**Base NPV:**

This is applicable if the project is 100% equity financed.

\[ R_f + (R_m - R_f) \beta \]
\[ = 9\% + (14\% - 9\%) \times 1.5 = 16.5\% \]

NPV at Cost of Capital of 16.5\% = ₹ (2.4840) lacs

**Impact of Financing:**

Annual Interest ₹ 25.00 lacs \times 0.12 = ₹ 3.00 lacs

Annual Tax Saving = ₹ 3.00 lacs \times 0.40 = ₹ 1.20 lacs

Present Value of Tax Shield

= ₹ 1.20 lacs \times 3 \text{ year annuity factor of 12}\% 

= ₹ 1.20 lacs \times 2.4018

= Rs. 2.882 lacs

**Adjusted Present Value**

<table>
<thead>
<tr>
<th></th>
<th>₹ lac</th>
</tr>
</thead>
<tbody>
<tr>
<td>Base NPV</td>
<td>(2.484)</td>
</tr>
<tr>
<td>Present Value of Impact of Financing</td>
<td>2.882</td>
</tr>
<tr>
<td></td>
<td>0.398</td>
</tr>
</tbody>
</table>

The project is therefore marginally acceptable on the basis of APV.

**4.5.3 Bankability of Project**

Bankability means the repayment capacity of the borrower. Bankability is measured by way of:

– Debt Service Coverage Ratio

– Interest Service Coverage Ratio

**4.5.4 Risk Analysis**

Under this the following risks may be covered:

– Construction Risk:

– Post construction Risk:

**4.5.4.1 Construction Risk**

Construction carries the risk that the project will not be completed on time, within budget or at all because of technical, labour, and other construction difficulties.

– Delay in repayment

– Loss of sale contract
Construction Risk Mitigants:

- Past track record of the construction agencies
  - Minimum Net worth
  - Minimum Turn Over
  - Successful past experience
- Obtaining completion guarantees requiring the sponsors to pay all debts and liquidated damages if completion does not occur by the required date.
- Ensuring that sponsors have a significant financial interest in the success of the project so that they remain committed to it by insisting that sponsors inject equity into the project.
- Requiring the project to be developed under fixed-price, fixed-time turnkey contracts by reputable and financially sound contractors whose performance is secured by performance bonds or guaranteed by third parties.
- Obtaining independent experts' reports on the design and construction of the project.
- Phased draw-down
- Contingent on completion of milestone
- Milestones to be verified by:
  - Independent consultant
  - Government bodies
  - Other bodies

4.5.4.2 Post Construction Risk

- The risk here is that for a mining project, rail project, power station or toll road, there are inadequate inputs that can be processed or serviced to produce an adequate return.
- For example, there is the risk that there are insufficient reserves for a mine, passengers for a railway, fuel for a power station or vehicles for a toll road.

Post Construction Risk Mitigants:

- Experts' reports as to the existence of the inputs (e.g. detailed reservoir and engineering reports which classify and quantify the reserves for a mining project) or estimates of public users of the project based on surveys and other empirical evidence (e.g. the number of passengers who will use a railway);
- Requiring long term supply contracts for inputs to be entered into as protection against shortages or price fluctuations (e.g. fuel supply agreements for a power station);
- Obtaining guarantees that there will be a minimum level of inputs (e.g. from government that a certain number of vehicles will use a toll road);
“Take or pay” off-take contacts which require the purchaser to make minimum payments even if the product cannot be delivered.

- Affect the cash-flow of the project by increasing the operating costs or affecting the project’s capacity to continue to generate the quantity and quality of the planned output over the life of the project.
- Operating risks include, for example, the level of experience and resources of the operator, inefficiencies in operations or shortages in the supply of skilled labour.

Before lending:
- To be operated by a reputable and financially sound operator whose performance is secured by performance bonds.

During the loan period:
- Provision of detailed reports on the operations of the project
- Controlling cash-flows by requiring the proceeds of the sale of product to be paid into a tightly regulated proceeds account to ensure that funds are used for approved operating costs only.

- Market risk is the risk that a buyer cannot be found for the product at a price sufficient to provide adequate cash-flow to service the debt.

- Risk Mitigants:
  - The best mechanism for minimizing market risk before lending takes place is an acceptable forward sales contact entered with a financially sound purchaser.

- Uncertainty Analysis: Uncertainty is captured by way of:
  - Sensitivity Analysis
  - Scenario Analysis
  - Simulation
  - Decision Tree Analysis
  - Real Option Analysis

For projects where completion uncertainty is not there, we can use Sensitivity Analysis or Simulation Analysis. However, if the project has uncertainty, we have to use Decision Tree Analysis and Real Option analysis along with the above methods.

5. WORKING CAPITAL MANAGEMENT

Before we discuss the assessment of working capital, let us first understand the meaning and implication of the term “working capital”. “Working Capital” consists of two words “Working” and “Capital”. As the name suggests, the meaning of working capital is the capital or fund required for
working of the business. It is the fund required for day-to-day operations of the company. So in order to understand the requirement of working capital, we need to understand why we require funds for day-to-day operations.

Day-to-day operations mean purchasing goods and services and processing the same for production of goods and services and then selling the same. As we have discussed in the paper of Financial Management, first the organization has to purchase goods and services, then it processes the same, offer that it sells and then it collects the payment.

Hence, organisation incurs expenses for the first and second stage. However, it collects cash in the fourth stage. So expenses incurred in the first and second stage need to be funded which requires working capital. Let us explain with the help of a simple example of a trading company.

**Example**

On 12th April 2013, a trader purchases material worth ₹ 25 lacs. It has incurred expenses on 12th April 2013. It has to make the payment if the supplier is not giving any credit. So if it does not get credit from the market, it requires working capital.

Next, if it sells on 12th April 2013, it gets cash on the same day and from this it can make the payment. So even though a person is purchasing raw material on cash basis and if he sells on cash basis, depending on the time of payment, he may not require working capital. If the customer sells on 15th April 2013 for one month credit, it would get the cash on 15th May 2013 and if it has to make the payment on 12th April 2013, it requires working capital for a longer period.

From the example, it is clear that the working capital requirement arises due to incurring expenses and making the payment on account of expenses before realization of cash from sales. After understanding the meaning of working capital, we shall now bring the definition of working capital.

### 5.1 Gross Working Capital Concept

According to this concept, a company's investment in total current assets signifies the Working Capital. So, Gross working capital is equal to total current assets.

The Gross Working Capital can be ascertained as follows:

<table>
<thead>
<tr>
<th>Current assets</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Current investments</td>
<td>XXX</td>
</tr>
<tr>
<td>(b) Inventories</td>
<td>XXX</td>
</tr>
<tr>
<td>(c) Trade receivables</td>
<td>XXX</td>
</tr>
</tbody>
</table>

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5.2 Net Working Capital Concept

According to this concept current assets minus current liabilities is known as Working Capital. If nothing is given generally it is taken as net working capital.

However, it may be noted that Net Working Capital means that part of Working Capital gap which is financed with long term funds.


The Net Working Capital are ascertained as follows:

<table>
<thead>
<tr>
<th>Current assets</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Current investments</td>
<td>XXX</td>
</tr>
<tr>
<td>(b) Inventories</td>
<td>XXX</td>
</tr>
<tr>
<td>(c) Trade receivables</td>
<td>XXX</td>
</tr>
<tr>
<td>(d) Cash and cash equivalents</td>
<td>XXX</td>
</tr>
<tr>
<td>(e) Short-term loans and advances</td>
<td>XXX</td>
</tr>
<tr>
<td>(f) Other current assets</td>
<td>XXX</td>
</tr>
<tr>
<td>Gross Working Capital</td>
<td>XXX</td>
</tr>
</tbody>
</table>

Less: Current liabilities

<table>
<thead>
<tr>
<th>Current liabilities</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>(a) Short-term borrowings</td>
<td>XXX</td>
</tr>
<tr>
<td>(b) Trade payables</td>
<td>XXX</td>
</tr>
<tr>
<td>(c) Other current liabilities</td>
<td>XXX</td>
</tr>
<tr>
<td>(d) Short-term provisions</td>
<td>XXX</td>
</tr>
<tr>
<td>Net Working Capital</td>
<td>XXX</td>
</tr>
</tbody>
</table>
5.3 Positive and Negative Working Capital

When current assets exceed current liabilities, a positive Working Capital is created, and when current assets are less than current liabilities, a negative Working capital occurs. The chronic negative working capital situation will lead to closure of business and the enterprise is said to be 'technically insolvent'.

5.4 Factors Determining Working Capital Requirement

There is no set of universally applicable rules to ascertain working capital needs of a business organization. The factors which influence the need level are discussed below:

1. Time span required for conversion of raw materials into finished goods is a block period. The period, in reality, extends a little before and after the WIP. This cycle determines the need for working capital.

2. Credit policy of the business organization includes to whom, when and to what extent credit may be allowed. Amount of money locked-up in account receivables has its impact on working capital.

3. If we look at the balance sheet of any trading organization, we find that major quantum of the resources is deployed on current assets, particularly stock -in-trade. In contrast, service organizations need lesser working capital than trading and financial organizations. So working capital requirement depends on the nature of business.

4. Economic boom or recession etc., have their influence on the transactions and, consequently, on the quantum of working capital required.

5. If demand for a product is seasonal, then also manufacturing operation has to be conducted during the whole year resulting in working capital blockage during off season.

6. Operational level determines working capital demand during a given period. Higher the scale, higher will be the need for working capital.

7. It depends on the policy of the firm at which level of Stock turnover ratio they feel comfortable.

8. Creditworthiness is the precondition for assured accessibility to credit. Accessibility in banks depends on the flow of credit i.e., the level of working capital.

9. In case of newly established concerns, the materials are required to be purchased in cash and the sales are to be made on credit basis. But the established companies can negotiate for credit terms with suppliers and sell the product at shorter credit period to customers. Therefore, it requires less working capital than concerns with lesser business standing.


11. In a buyers' market i.e. the market with fierce competition, the companies are forced to sell on credit, with liberal credit and collection policies. But if the sellers' market prevails, quick disposal of
stocks, high percentage of cash sales, strict credit and collection policies etc. reduce the need for working capital.

12. Political stability brings in stability in money market and trading world. Things mostly go smooth. Risk ventures are possible with enhanced need for working capital finance. Similarly, availability of local infrastructural facilities like road, transport, storage and market etc., also influence business and working capital needs.

5.5 Assessment of Working Capital from the bank’s point of view

After understanding the fundamental concept of the working capital and the meaning of different terminology of working capital, it is now easy to find out the step by step process of assessment of working capital.

1. Step 1: Understanding the meaning of ‘assessment’: In financial parlance, assessment means determination of quantum. So assessment of working capital means how much working capital is required by the company. When we are talking about the word ‘assessment’ from the bank’s point of view, we mean the amount bank would sanction as working capital limit. Henceforth, we shall talk of assessment from the bank’s point of view only.

2. Step 2: Assessment means future requirement of fund. So assessment would be carried out on the basis of future financials. When we talk about the future we are talking about the current running year (estimate) and the next year (projected). So assessment would be carried out either on the basis of estimated figure or projected figure. However actual is required to find out the present position of the borrower and the validation of the projection.

3. Step 3: Determination of assessment methodology. In India, fund based working capital assessment is carried out by three methods:

a) Turn Over Method

Under this method, the sales are estimated or projected. Based on the projected or estimated sales, 25% of the projected sales is the working capital requirement. The underlying assumption of this method is that working capital cycle of the borrower is 90 days and in a year it would be rotated four times. Accordingly, working capital requirement (not the limit) is 25% of sales. TurnOver method also says that 5% of the sales would be the net working capital. The limit would be 20% of the sales. This is also called Nayek Committee method of assessment of fund based working capital. This is explained with the help of an example:

Example

The actual sales of a company for the FY 2012-13 are ₹ 150 lacs and the actual bank borrowing for working capital as on March 31, 2013 is 25 lacs. The company has estimated sales of ₹ 200 lacs for the
FY 2013-14 and the bank has accepted that estimate. Now, the working capital requirement of the company is ₹ 50 lacs i.e. 25% of ₹ 200 lacs. The minimum margin money is 5% of sales i.e. ₹ 10 lacs. We now shall look at the audited (provisional) figure of March 31, 2013. We find that as on March 31, 2013, the current asset is ₹ 40 lacs and the current liability as on that date is ₹ 33 lacs, the company is having actual net working capital of ₹ 7 lacs. The fund- based working capital limit would be ₹ 40 lacs provided the company brings in additional ₹ 3 lacs [ ₹ 10 lacs – ₹ 7 lacs ]. If the company brings in additional ₹ 3 lacs, the fundbased working limit would be increased from ₹ 25 lacs to ₹ 40 lacs.

(b) Maximum Permissible Bank Finance Method (MPBF)

Under this method, the borrower has to submit the data as per a specified format called Credit Monitoring Arrangement (CMA). As per this format, borrower has to fill up six forms called CMA form.

Form I of CMA forms requires that borrower provide details of the borrowing as on the date of the application.

Form II deals with the P&L.

Form III deals with the balance sheet.

In Form II and Form III, borrower has to provide four years’ data, i.e. last two years’ actual (audited/provisional), current year estimate and next year’s projections.

While filling up Form II and Form III the borrower needs to adjust certain thing from the audited financials. These are given below:

1. The total sale value has to be segregated into domestic and export sales, with excise to be shown separately in Form II.

2. The consumption of raw material has to be segregated into import and inland part in Form II.

3. With the bank borrowing for working capital, bill discounting amount (which would appear as contingent liability on the borrower’s balance sheet) would be added in the liability side under the head bank borrowing for working capital and in the asset side under the head receivable.

4. The current maturity of term loan would appear under the head current liability.

5. The unsecured loan would appear as term liability if it is payable more than 1 year and if it is not subordinate. In case it is subordinate, it may be treated as quasi- equity.

6. The receivable would have to be shown separately as export and domestic receivable. Receivable of more than 3 months and in some cases more than 6 months would be shown under the head current asset.

7. Loans and advances not related to production i.e. loans and advances to group companies would not be treated as current asset; it would be put under non- current asset.
8. Investment would be put under non-current asset.

9. Once Form III has been filled up, forms IV, Form V and Form VI would be automatically generated. Form III is the balance sheet of the borrower.

10. Form IV deals with the current asset and other current liability part. In this form, we have the amount as well as the holding level of Inventory, receivable and creditor.

11. Form V deals with assessment.

12. Form VI deals with the fund flow statement showing the sources and uses of fund.

Rules for making projections

The current asset is projected in a manner so that holding level of inventory, receivable and other current asset should not go up. The other current liability is projected in a manner so that the holding level of the creditor and other current is not going down. In case there is a deviation, it needs to be properly explained.

Once the projection is made, the assessment is carried out mainly by two methods namely Method I and Method II.

Under Method I, the limit has been arrived at by using the following sequence:

1. Estimated Current Asset: ₹ 100 lacs
2. Estimated Other Current Liability: ₹ 30 lacs
3. Estimated Working Capital Gap: ₹ 70 lacs

* lacs*25% i.e. ₹ 17.5 lacs
5. Estimated net working capital is ₹ 18 lacs
6. MPBF is minimum of [3-4, or 3-5] i.e. 52 lacs

Under method II, the calculation is carried out in the following sequence:

1. Estimated Current Asset: ₹ 100 lacs
2. Estimated Other Current Liability: ₹ 30 lacs
3. Estimated Working Capital Gap: ₹ 70 lacs
4. Minimum Net Working Capital (25% of Current Asset): ₹ 100 lacs

* lacs*25% i.e. ₹ 25 lacs
5. Estimated net working capital is ₹ 25 lacs
6. MPBF is minimum of [3-4, or 3-5] i.e. 45 lacs

(c) Cash Budget Method

This is the most complex but most scientific method. In this method, the next two years’ cash budget is forecasted under revenue account and capital account. The revenue deficit amount would be bridged by the capital account surplus and the remaining amount is the fund based limit. In the case of seasonal industry, this is the best method of assessment of fund based working capital. Besides, for construction and software the RBI is advising the banks to follow cash budget method of assessment.

Please note that if the assessment is carried out as per turnover or cash budget method, filling up of CMA form is not required by the borrower. In the case of cash budget, the borrower has to prepare a cash budget for the next 12 months.

6. REVERSE MORTGAGE

A Reverse Mortgage is meant for asset rich but cash poor senior citizens. A reverse mortgage is a loan available to homeowners, 60 year or older, that allows them to convert part of the equity in their homes into cash. A reverse mortgage is a type of mortgage in which an owner of a house can borrow money against the value of his home. The owner can receive money in the form of fixed monthly payment or a line of credit.

In India it is the National Housing Bank (NHB), who formulated the basic structure of this financial product. In a regular mortgage, the borrower takes loan from the bank and gives his property to the bank against collateral. Thereafter, he returns the loan amount by paying the principal and interest amount to the bank at regular intervals, say monthly.

However, reverse mortgage works in a different way. Here, the homeowner gives his property to the bank and receives payment based on the percentage of the value of the home. Payment may be received either in lumpsum cash, regular monthly cash payment, a line of credit (where the homeowner decides when and how much to borrow), or a combination of these options.

Further, throughout the life of the reverse mortgage, one can keep title to his home, which acts as a collateral for the loan.

The payout is generally for a fixed term of 15-20 years, after which the borrower or legal heirs (on death) can release the house by either repaying the loan or the company settles the amount by selling the house. Any excess in the process is paid to borrower or legal heirs as the case may be.

Now, let us understand who can opt for Reverse Mortgage. Only a senior citizen (60 years or above) who owns a residential property can opt for this product. If a couple is opting for the loan jointly, one of them should be a senior citizen and the other at least 55 years old. Further, while calculating the amount, the bank considers the following factors:
(i) Age,
(ii) Value of the property,
(iii) Current interest rates and the specific plan chosen.
(iv) Also, the residual life of the property should be at least 20 years.

The maximum monthly payment under Reverse Mortgage Loan (RML) is capped at Rs.50,000, and the maximum lump sum payment will be 50% of the total eligible amount of loan with a cap of Rs.15 lakh. Moreover, the borrower will have to continue paying all the taxes related to the house, insure it and take proper maintenance of the property.

The valuation of property is generally done at periodic intervals by the bank. Currently, big nationalized banks and some private banks offer reverse mortgage loans. Interest rate on these loans is usually in the range of 2.75-3% above the base rate.

There are two variants of RML available

(i) Regular RML
(ii) and, reverse mortgage loan-enabled annuity (RMLeA).

### 6.1 Regular RML

In case of regular RML, the homeowner will either get a lump sum amount or instalments depending on its frequency. It is similar to loan against property, the difference being that in RML, there is no need to pay back the money at the end of the tenure. For example, if the tenure of the loan is 20 years, the bank will stop paying money at the end of the tenure. There is no need to repay the loan amount during the lifetime or until one lives in the house.

RMLeA is a reverse mortgage backed with annuities and hence it works like a pension product that pays for lifetime. If you opt for RMLeA, you will get the money from a life insurer as the lender gives the loan amount to an insurance company. The insurer then annuitises the corpus and gives you pension money for the rest of your life.

### 6.2 RMLeA and its superiority to RML

In a regular RML, lender will make a payout till the end of the tenure.

In RMLeA, the actual loan to be disbursed is comparatively lower at 60-75% depending on the borrower's age. Here, the lender makes a one-time payment to an insurer. The insurer works out a monthly payment based on actuarial calculation that it will pay for life. Generally, annuities are offered at an interest rate of 6% a year. The payout in RMLeA is much higher than RML.
6.3 Risks associated with Reverse Mortgage

The main risks associated with Reverse Mortgage for lenders are as follows:

(1) If the person lives for longer life, then for bank it would be quite difficult to source long term funds to match with asset’s value.

(2) Drop in the value of assets is another major risk.

(3) Interest Rate Risk is also a major risk as spread may become narrow.

(4) Legal risk is also attached with property as property may not be put to sale due to any legal reasons.

6.4 Reasons for failure of Reverse Mortgage to takeoff in India

(1) Tendency of Indians to treat their property as family heritage and the property is sold only as a last resort.

(2) Property owners also seen as an important people in the society.

(3) Senior Citizens who own property are assured of love and respect from their kins.

(4) There is no guarantee of life time income which most senior citizens consider in their retired life.

(5) As soon the term of the loan is over, the liability of repayment arises. Therefore, if someone who sustained the entire term of say, 20 years, he runs the risk of losing the house if he is not able to repay the loan.

(6) There is lack of awareness among the people regarding Reverse Mortgage Loans.