# REPORT

# OF

# THE IN-HOUSE GROUP

# TO REVIEW

# THE ROLE OF RESERVE BANK OF INDIA

# IN LAYING DOWN NORMS FOR BANK LENDING

# FOR WORKING CAPITAL PURPOSES

SEPTEMBER 1993

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## I N D E X

# CHAPTER I

## INTRODUCTION AND METHODOLOGY

Following the issue of instructions on July 27, 1992, by Reserve Bank of India (RBI) making it compulsory for banks to strictly comply with the guidelines/instructions on discounting/rediscounting of bills by banks, as also lending under consortium arrangement, a number of associations/chambers/confederations of trade and industry represented about the hardship faced by them on account of lack of adequate credit as well as on account of delay in supply of credit for financing their operations. Even prior to this, trade and industry had been expressing their difficulties in adhering to the lending norms prescribed by RBI for delivery of working capital finance by banks. In the view of trade and industry, the quantitative norms prescribed for holding of inventory/receivables had become outdated and hence needed immediate review. According to them, borrowers were forced to seek finance outside their regular banking arrangement for the following reasons :

(a) Lack of flexibility in the banking system in respect of implementation of lending discipline and lending norms ;

(b) Lack of prompt response on the part of banks in taking decisions on loan proposals ;

(c) Reluctance of regular bank/consortium of banks in sanctioning ad-hoc and/or additional limits ; and

(d) Rigidity in computation of maximum permissible bank finance (MPBF) based on the recommendations of the Tandon Committee.

I.2 The issues raised by trade and industry were discussed on several occasions by RBI separately with banks and industry. In the meeting presided over by the then Governor on November 4, 1992, with high-level representatives from banks, Government of India, trade and industry, it was decided that while financial discipline was necessary, the present set of guidelines on lending discipline and norms would be reviewed in the context of the changing economic scenario. It was, therefore, decided to constitute an In-House Group in RBI, in addition to the two other Committees[1] to be set up, to review the need for continuing to determine the quantum of credit for a borrower based on norms for holding of inventory/receivables as also allocation of credit to industry by fixing maximum permissible bank finance (MPBF) based on the norms prescribed for each industry.

I.3 It was in this context that RBI appointed the In-House Group under the chairpersonship of Ms. I.T.Vaz, Executive Director, on January 5, 1993, with the

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1 The two other Committees referred to are (a) the Working Group to suggest revised method of lending in place of the present cash credit system (Chairman Shri Rashid Jilani, Chairman and Managing Director, Punjab National Bank) and (b) the Committee to review the system of lending under consortium arrangement (Chairman : Shri J.V.Shetty, Chairman and Managing Director, Canara Bank)

following terms of reference

(a) To examine and recommend (in the context of revised economic policies, growth of more diversified financial systems and public preference for disintermediation) the necessity or otherwise of continuing with the process of allocation of credit by fixing the extent of bank credit (MPBF);

(b) To examine and recommend the necessity or otherwise of fixing of norms and lending discipline by RBI (Central Banking Authority) as against fixation of prudential exposure norms.

A copy of the Memorandum constituting the Committee is enclosed as Annexure I.

I.4 The members of the Committee are

1. Shri R.K.Jalan
   Chief Officer
   Reserve Bank of India
   Rural Planning and Credit Department
   Central Office
   Bombay

2. Shri S.J.Thaker
   Chief Officer
   Reserve Bank of India
   Industrial and Export Credit Department
   Central Office
   Bombay

3. Shri D.N.Samarth[@]
   Chief Officer
   Reserve Bank of India
   Financial Institutions Cell
   Central Office
   Bombay

4. Shri J.R.Prabhu[£]
   Additional Chief Officer
   Reserve Bank of India
   Department of Banking Operations
   and Development
   Central Office
   Bombay

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@ Retired from service on March 31, 1993

£ Appointed as Chief Officer with effect from June 1, 1993

5. Shri M.V.Raghavachari
Adviser-in-Charge
Reserve Bank of India
Credit Planning Cell
Central Office
Bombay

6. Shri A.Seshan *
Officer-in-Charge
Reserve Bank of India
Department of Economic Analysis and Policy
Central Office
Bombay

7. Shri S.N.Dalal
Economic Adviser
Reserve Bank of India
Industrial and Export Credit Department
Central Office
Bombay

8. Shri P.K.Biswas — Member-Secretary
Joint Chief Officer
Reserve Bank of India
Industrial and Export Credit Department
Central Office
Bombay

Shri R.N.Verma, Additional Chief Officer, Industrial and Export Credit Department participated in the deliberations as a permanent invitee.

I.5 Methodology The Group met seven times beginning with its first meeting held on March 5, 1993, to discuss the issues involved and the methodology to be adopted to accomplish the task assigned to it. It was felt that in order to examine the issues arising out

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* Dr.A.Vasudevan, Adviser, Department of Economic Analysis & Policy (subsequently appointed as Officer-In-Charge) co-opted in his place.

of the terms of reference in depth it would be necessary to collect data and information about the observance of the present lending discipline by borrowers and whether bank finance for working capital purposes should continue to be determined on the basis of norms for inventory and receivables, as prescribed for different industries from time to time. The Group, therefore, decided to obtain the views of banks, trade and industry as also certain experts in the field.

I.5 In accordance with the above decision, a structured questionnaire was forwarded seeking views of the respondents on the various aspects of the lending discipline as also the extent of compliance by banks with the prescribed discipline. The questionnaire circulated to banks and their responses to it are tabulated in Annexure II.

I.6 Responses brought into sharp focus the fact that borrowers were disturbed about non-availability of adequate credit not because of the norms per se but because of the rigidities in their implementation. The situation was aggravated by the fact that the borrowers had continued to be substantially dependent on bank credit because of reluctance on their part either to plough back profits or to increase their long-term surplus to support build-up of current assets. The Group, therefore, heard the views of some banks and experts in a meeting held with them to deliberate on specific issues. The names of the individuals/institutions/organisations, who submitted their views and/or tendered oral submission before the Group are furnished in Annexure III.

I.7 Acknowledgements The Group is grateful to all those persons and organisations listed in Annexure III for offering valuable suggestions as also for sparing their time for discussion on various issues and for their written responses.

I.8 The Group was ably assisted by Smt.Chitra Chandramouliswaran, Deputy Chief Officer, during some stages of deliberation. The staff of the Policy and Monitoring Division of the Industrial and Export Credit Department provided excellent secretarial assistance and special mention be made about the services rendered by Shri P.P.Gonsalves and Shri P.G.Bagul, Assistant Industrial Credit Officers. Smt.A.D.Kale, Stenographer, bore the brunt of the stenographic and typing work without whose support it would not have been possible to complete the job in time. The Group, therefore, wishes to place on record its appreciation of their contribution.

The Group is greatly indebted to its Member-Secretary, Shri P.K.Biswas, for his dedicated work, invaluable contribution to the deliberations of the Group and the drafting of the Report.

## CHAPTER II

## BACKGROUND

II.1 About two decades back the methodology of bank lending was first systematised to evolve principles of need-based lending by commercial banks and these came to govern the entire banking system in the post-nationalisation period. The Study Group to frame guidelines for follow-up of bank credit constituted by RBI in 1974, under the chairmanship of Shri Prakash Tandon, the then Chairman of Punjab National Bank, visualised that with the development of the economy, the demand for bank borrowings would increase and hence there was a need to change the concept of treating bank finance from 'commodity' to 'resource'. The Study Group, commonly referred to as the Tandon Committee, arrived at the conclusion that bank finance being a 'scarce resource', its use should be made in a planned manner amongst various competing sectors of the economy. To achieve this objective, the Tandon Committee felt that the large and medium industrial units, which had been traditionally obtaining/enjoying a larger share of bank finance, would have to subject themselves to rigorous credit planning in future.

II.2 Dahejia Committee The above idea was in fact an extension and to a certain extent reformulation of the recommendations made earlier by the Dahejia Committee appointed by the National Credit Council in October, 1968. The Dahejia Committee set up to examine "the extent to which

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credit needs of industry and trade are likely to be inflated and how such trends could be checked" observed the shortcomings of the security-cum-guarantee oriented system of lending and recommended that the banking system should resort to financing on the basis of a total study of the borrower's operations rather than on security considerations alone, and this concept was later elaborated by the Tandon Committee.

II.3 Tandon Committee   The Tandon Committee, in its final Report (submitted in 1975), recommended radical changes in the system of bank lending by emphasising the need to shift away from the erstwhile security-oriented system of lending to a production-oriented system of lending to industry. Important recommendations of the Committee were as under

(a) The Committee suggested norms for inventory & receivables (Current Assets) in respect of 15 major industries for the purpose of assessment and sanction of short-term bank credit for financing working capital needs of industrial units with aggregate credit limits in excess of Rs.10 lakh from the banking system (Note : Norms are being reviewed periodically by RBI as explained later, and as on date norms have been evolved for 53 industries).

(b) The Committee suggested three methods to assess MPBF. These three methods of lending envisaged different levels of contribution from the long-term funds of the borrowing units with a view to progressively reduce dependence on short-term bank borrowings. It was recommended that starting with the first method of lending there should be a gradual move towards adoption of the third method of lending, which envisaged a comparatively higher contribution from the net working capital of the borrowing units. (Note Though the Committee recommended three methods of lending, RBI did not accept (and has so far not accepted) the recommendation to adopt the third method of lending for assessment of the maximum permissible bank finance. The three alternatives in the words of the Tandon Committee are : (i) First Method of Lending Bank can work out the working capital gap, i.e., total current assets less current liabilities other than bank borrowings 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; (ii) Second Method of Lending : Borrowers to provide for a minimum of 25 per cent 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 and the bank will provide the balance. Total current liabilities inclusive of bank borrowings will not exceed 75 per cent of current assets ; and (iii) Third Method of Lending : Same as (ii) above, but excluding core current assets from total current assets on the theory that core current assets should be financed out of long-term funds, i.e., owned funds plus term borrowing).

(c) The Committee suggested annual review of the accounts to appraise the performance and assess the working capital needs for the next year.

(d) In order to ensure planned and proper end-use of funds as also prudent deployment of scarce resources, it was recommended that the financing should be placed on a quarterly budgeting-reporting system for operational purposes.

II.4 Norms for inventory and receivables It may be observed that the Tandon Committee, while recognising that the norms recommended by it should be applied flexibly and not rigidly, i.e., the application of the quantitative norms must be responsive to the changes in economic environment and within an industry, was not convinced by arguments that the uncertainties could be regarded as a justification for not laying down norms. The Committee on the contrary emphasised that there was considerable scope for economy in the utilisation of bank finance, if borrowers were careful in their inventory management and up-to-date in collection of debts.

II.5 Current Ratio The Tandon Committee observed that the large sector had all along been enjoying longer trade credit from suppliers besides bank finance. In fact, the expansion of bank credit had been in favour of the large industrial sector at the aggregate level. The Committee further noted that such expansion in bank credit, however, had not been accompanied by a corresponding increase in production. On the other hand, because of too much dependence of this sector on bank finance, the current ratio in most cases had all along been very low. It was to correct this situation and obtain a large multiplier for bank finance, the Committee proposed three 'methods of lending', which would gradually push the current ratio to a higher level.

II.6 Committee of Direction In August, 1975, RBI issued guidelines/instructions to commercial banks on the basis of the recommendations made by the Tandon Committee. For effective implementation of the guidelines/instructions as also to deliberate on the issues arising out of it, a Standing Committee called as Committee of Direction was constituted in RBI in April, 1975. This Committee, which is functional as on date, has reviewed on an on-going basis the norms for inventory and receivables for different industries besides other aspects of lending discipline/guidelines. Accordingly, norms have been revised from time to time and/or new norms have been evolved, as a result of which there are prescribed norms for inventory and receivables for 53 industries as on date (as against 15 industries in 1975).

II.7 Chore Committee On a review of the progress made by banks in implementing the guidelines issued by RBI on the basis of the recommendations made by the Tandon Committee, it was observed that the same had not been fully implemented for various reasons. Further, the flexibility and graduality that formed the keynote in the proposed norms and financial discipline were not taken in the right spirit but used as pretensions to circumvent the very norms and discipline. Even, till 1979 borrowers were not required to move over to the Second Method of Lending. Since the progress achieved in the implementation of these guidelines was slow, the RBI decided to re-examine the issue by appointing on April 4, 1979, a Working Group under the chairmanship of Shri K.B.Chore, the then Additional Chief Officer, RBI, to review the system of cash credit. In its Report, submitted on August 31, 1979, the Chore Committee retained the basic structure of the system recommended by the Tandon Committee, but modified several of its recommendations. The major recommendations of the Chore Committee were as under

(a) The existing system of extending credit by way of a combination of cash credit, loan and bill should be retained subject to, wherever possible, the use of cash credit being supplanted by loans and bills.

(b) There was need for reducing the over-dependence of the medium and large borrowers on bank finance and, therefore, a gradual reduction of borrowing units' dependence on bank finance for build-up of current assets would be imperative.

(c) Borrowing units not in a position to comply with the Second Method of Lending be sanctioned working capital term loan at higher rate of interest for their excess borrowings over and above the MPBF arrived at on the basis of the Second Method of Lending.

(d) The lending norms should be continued to be made applicable for borrowing units enjoying limits of Rs.10 lakh and above (except sick units) and units with limits of Rupees 50 lakh and above were to be brought under the Second Method of Lending (unless specifically exempted).

(e) The recommendation of the Tandon Committee relating to the style of credit in terms of which differential rates of interest were to be charged for the demand loan and cash credit components be discontinued.

(f) The statements under the Information System should be simplified and rationalised and made applicable to all borrowers having aggregate working capital limits of Rs.50 lakh and above.

(g) Considerable emphasis was laid on regular annual review of accounts as an inherent part of the financial discipline for continuance of the cash credit system.

II.8 Method of Lending and Working Capital Term Loan :

The Chore Committee observed that the borrowers would not switch over to the Second Method of Lending (minimum Current Ratio 1.33:1) on their own, and some amount of compulsion was necessary to put them on the desired track. It, therefore, suggested that the borrowers should be brought immediately under the Second Method of Lending and their excess borrowings, if any, should be segregated and treated as a working capital term loan, which should be repayable in instalments. The Committee further recommended that higher interest rate (2 per cent over that applicable on the cash credit limits) for such working capital term loan be charged in order to ensure that such term loans were repaid in time.

II.9 Ad-hoc Limits : The Chore Committee, like its predecessor Tandon Committee, desired borrowers to plan and budget their requirements of working capital finance in advance and did not favour intermittent increases in limits. The Chore Committee, therefore, recommended imposition of a penal interest rate of 2 per cent for ad-hoc increases.

II.10 Peak Level and Non-Peak Level Requirements : The Chore Committee recommended that there should be separate limits for peak level and non-peak level requirements to meet the varying credit needs due to seasonality of an industry. This method of fixing two limits, the Committee felt, would reduce the gap between the sanctioned limit and its utilisation and would thus ensure better control of accounts.

II.11 Bill Culture Both the Tandon Committee and the Chore Committee laid much emphasis on the bill system of financing and developing a regular bill market on the lines of the one in the United Kingdom. The Chore Committee, went a step further by highlighting the importance of the drawee bill system of financing and recommending that 50 per cent of the cash credit limit against raw materials should be by way of drawee bills only.

II.12 <u>Information System</u> The Chore Committee improved upon the information system recommended by the Tandon Committee as also simplified the system. Under the revised system, borrowers were required to submit quarterly statements in Form I indicating their requirement of funds in the next quarter well in advance so that the banks could fix the operative limits within the overall limits sanctioned. Quarterly performance data in Form II and the profitability and funds flow figures in Form III were to be submitted within six weeks after the end of the quarter and two months after the end of the half year respectively. The Chore Committee recommended imposition of a penalty of 1 per cent interest on the entire borrowings till the time the statement was submitted with the objective of ensuring that borrowers submitted these statements in time.

II.13 In keeping with the above developments, the scope of the Credit Authorisation Scheme (CAS), introduced first in November, 1965, was enlarged and prior authorisation of credit limit by RBI was based on clearly enunciated quantitative criteria with a view to preventing excessive credit allocation to favoured customers or groups. The redefined objectives of CAS were

(a) To ensure that additional bank credit is in conformity with the approved purposes and priorities and that the bigger borrowers do not pre-empt scarce resources ;

(b) To enforce financial discipline on the larger borrowers, where necessary, on uniform principles ;

(c) Where a borrower is financed by more than one bank, to ensure that the customer's proposal is assessed in the light of the information available with all the banks and

(d) To bring about improvement in the techniques of credit appraisal by banks and their system of follow-up.

Thus, by broad-basing the objectives of CAS, an attempt was made to enlarge its scope with a view to ensuring a greater degree of credit discipline on the part of the banks as well as borrowers.

II.14 Marathe Committee Though the CAS had been periodically reviewed and changes effected together with raising of the cut-off limit (beyond which prior authorisation was necessary), RBI appointed in November, 1982, a Committee to make an independent review of the Scheme under the chairmanship of Shri S.S.Marathe (former Secretary to Government of India, Ministry of Industry). These recommendations, as accepted by RBI, which were communicated to banks in November, 1983, widened further the discretion vested in banks for release of credit facilities to CAS borrowers by permitting banks to release 50 per cent of the additional limits for which authorisation was sought (75 per cent in the case of predominantly

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export-oriented unit) subject to the credit proposals satisfying the basic financial discipline. However, it was also recommended that, if the RBI was not satisfied that the credit limit sanctioned was need-based, the bank could be directed to recall the amount released partially or wholly. The Scheme, popularly known as 'Fast Track', was further liberalised in July, 1987, by permitting banks to release 100 per cent of the additional working capital limits. A further review in 1988 revealed that a large majority of borrowers covered under CAS were complying with the norms for inventory/receivables and submission of Quarterly Information System as also in adhering to the minimum Current Ratio. The Scheme of prior authorisation (CAS) was thus withdrawn with effect from October 8, 1988, and banks were advised to merely report sanction of working capital limits in excess of Rs.5 crore and term loans where the share of the banking system exceeded Rs.2 crore, for post-sanction scrutiny under the Credit Monitoring Arrangement (CMA). The said cut-off points for reporting under CMA were enhanced in December, 1992, to Rs.10 crore and Rs.5 crore respectively. While CAS was rechristened as CMA, the basic financial discipline envisaged under CAS, as indicated below, continued and banks could extend finance subject to ensuring the following financial discipline

(a) Projection of current assets in accordance with the norms for inventory/receivables evolved for the industry or based on past trend, where no norms have been fixed, and whichever are lower. (Where such projections are not possible, assessment of MPBF is done on the basis of cash budget).

(b) Maintenance of a minimum Current Ratio of at least 1:1 for borrowers enjoying working capital limits of Rs.10 lakh and upto Rs.50 lakh and 1.33:1 for borrowers enjoying working capital limits of Rs.50 lakh and more except in the case of sick/weak units and in respect of export receivables.

(c) Submission of data under the Quarterly Information System within the prescribed period failing which penal interest of at least 1 per cent to be levied on all outstandings in the working capital limits for a whole quarter.

(d) Annual review of borrowal accounts, even if enhancement in limits is not involved.

II.15 Deviations from norms not exceeding 20 per cent of the standard norms for the industry and/or past trend, as the case may be, are also permissible, where the bank is satisfied that such deviation is necessitated subject to a time-bound programme being chalked out to ensure adherence to the norms within a short period. In order to meet unforeseen contingencies of borrowers, banks can also sanction ad-hoc limits not exceeding 3 months. In case such credit is required beyond 3 months, banks should reassess the limits of a borrower by calling for fresh data. Such ad-hoc limits for inland sales, other than by way of bills, attracts a penal interest of 1 per cent above the normal lending rate.

II.16 Since withdrawal of CAS in October, 1988, additions/amendments/changes/deletions have been made by RBI mostly in the lending discipline/guidelines for sanction/disbursement/monitoring of working capital

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finance by banks, and more often based on the recommendations made by the Committee of Direction. Two major changes are summarised below

(a) Commitment Charge    With a view to bringing about discipline in the availment of bank finance by borrowing units and to facilitate better management of funds by banks, RBI advised banks to levy effective January 1, 1991, a minimum commitment charge of one per cent per annum on the unutilised portion of quarterly operative limits, subject to a tolerance level of 15 per cent of such limits. The measure is applicable in respect of borrowing units with working capital limits of Rs.1 crore and above.

(b) Bill Culture    On the recommendations of the RBI, Government of India exempted certain categories of bills from the incidence of stamp duty. Borrowing units availing of discretionary inland bill limits are exempt from the additional interest of one per cent over the normal rate of interest. To ensure better compliance with bill discipline, effective January 1, 1991, interest at 2 percentage points above the relevant rate of interest charged for cash credit limits is being levied by banks on that portion of the book-debt finance, which is in excess of the prescribed norm of 75 per cent of limits sanctioned to borrowing units under CMA for financing inland credit sales.

II.17 Recent Changes    A series of measures beginning 1965 as also several studies have been undertaken by RBI to ensure that the productive needs of the industrial sector were met by the banking system within the overall policy of ensuring the financial discipline that bank credit would not be used for the purpose of speculation and/or hoarding activities. The modifications were made in the guidelines by RBI from time to time in tune with the exigencies of the economic situation. With the on-going process of liberalisation of the economy, set in motion since July, 1991, more powers have been delegated to banks for sanction of working capital limits to the industrial units leading to better manoeuverability for banks. Some of the recent relaxations, as indicated hereinunder, are pertinent from the point of view of the terms of reference of the Group.

(a) Deviation from norms for inventory and receivables: In view of the current demand recession in certain sectors of the economy banks have been advised that they can permit/allow deviation in norms/past trend not exceeding 20 per cent of the standard norms for the industry and/or past trend, as the case may be, in respect of any of the items of inventory/receivables subject to the bank being fully satisfied that such deviation is warranted and the levels are brought within the prescribed norms as soon as the situation permits. Industries requiring a review of norms can also be permitted such deviation and the matter thereafter referred to RBI for further examination.

(b) Reporting to RBI On a review of the reporting of CMA proposals to RBI for post-sanction scrutiny, the cut-off limits for reporting were revised. Working capital limits of Rs.10 crore and more and term loans, where the share of the banking system is Rs.5 crore and more, need be reported at present (circular dated December 10, 1992) as against working capital limits of Rs.5 crore and term loans of Rs.2 crore earlier.

(c) Treatment of instalments of term loans At present instalments of term loan falling due for repayment within the next twelve months are treated as items of current liabilities while calculating MPBF. Trade and industry have represented that these instalments are repaid out of cash generated during the year and hence reckoning the same as resources right from the beginning of the year only reduces the quantum of bank credit. The matter has been examined and it has been decided that henceforth only one-third of such term loan instalments payable within the next twelve months would be treated as items of current liabilities.

(d) Treatment of subsidy receivables Banks have been permitted as a temporary measure to finance subsidy receivables under the normal retention price scheme by the fertiliser industry for a period upto four months. The availability of the concession has been extended up to end of December, 1993. Banks have also been advised to reassess the working capital limits of units engaged in the manufacture of decontrolled fertilisers based on the revised projections for the free market sale prices of these components.

(e) Export Credit : The success of the current policy framework is crucially dependent on the ability of the country to increase exports. With a view to ensuring that exporters obtain adequate bank credit in time, banks have been advised recently as under :

(i) Banks should endeavour to reach a level of export credit disbursement equivalent to 10 per cent of each bank's net bank credit by June, 1993. Banks have been further advised to continue to adhere to the stipulated target for export credit during 1993-94 (July-June).

(ii) Additional credit needs of exporters arising out of firm orders/confirmed letters of credit not taken into account while fixing the regular credit limits of borrowers should be met in full even if sanction of such additional credit exceeds MPBF.

(iii) Export units having exports of not less than 25 per cent of their total turnover during the previous accounting year, will henceforth not be subject to the Second Method of Lending in assessing MPBF provided their aggregate working capital limits from the banking system are less than Rs.1 crore.

(f) Small Scale Industry Sector : For the credit requirements of village industries, tiny industries and other SSI units having aggregate fund-based working capital credit limits up to Rupees 50 lakh from the banking system, the norms for inventory and receivables as also the First Method of Lending will not apply. Instead such units may be provided working capital limits computed on the basis of a minimum of 20 per cent of their projected turnover for new as well as existing units.

(g) Borrowing units marketing/trading exclusively in products and merchandise manufactured by village, tiny and SSI units are subject to the First Method of Lending while assessing their MPBF provided dues of the said village, tiny and SSI units have been settled by such borrowers within a maximum period of 30 days from the date of supply. This relaxation is also available to that portion of marketing business related to the products manufactured by village, tiny and small scale industries in respect of cases, where borrowing units also market products manufactured by medium and large industries and/or have manufacturing activity of their own.

# CHAPTER III

## LENDING NORMS AND GUIDELINES - DIFFERENT VIEWS

III.1 As mentioned earlier, the Group examined a wide cross-section of views presented to it. It was observed that among the banks there was a clear divide in their views. Almost all the Indian banks suggested continuation of prescribed quantitative norms with certain flexibilities, while most of the foreign banks operating in India advocated removal of such norms altogether for the purpose of arriving at permissible bank finance. Foreign banks have also suggested that each individual bank could devise its own credit assessment and/or appraisal method. The Indian banks on the other hand, have been appreciative of the usefulness of the lending norms and guidelines in bringing about orderliness, discipline and qualitative improvement in bank lending. They have, therefore, suggested marginal modifications and relaxations in respect of operational aspects. The Group further observed from the data/information received in response to the questionnaire circulated among all banks that the average level of compliance with the basic lending discipline had been around 85 per cent and the utilisation of credit by borrowers revealed that only about 10 per cent of the borrowers had felt that the limits sanctioned were inadequate and had not been sanctioned ad-hoc limits for holding higher levels of inventory/receivables. However, the data/information also revealed that banks had taken as long as 90 days or more in some cases for sanctioning/deciding loan applications/proposals and, by and large, the

Indian banks had taken more time than the foreign banks operating in India.

III.2 During the direct interaction with the Group some banks took the view that the present system had inculcated a feeling on borrowers that they should get credit as a matter of right and borrowers laid emphasis on their financial needs in disregard to their credit standing. Borrowers had come to assume that they were entitled to borrow 75 per cent to 80 per cent of their current assets from banks irrespective of their creditworthiness, source of repayment and ability to repay. Besides, the system has introduced permanency to working capital borrowings in as much as borrowers assumed that working capital borrowings would never have to be repaid. Lending in the form of cash credit with no repayment plan has on the one hand made the borrowers complacent but, on the other, put the resource planning of banks in disarray.

III.3 Most of the individuals/experts, who forwarded/presented their suggestions, were of the view that while the existing norms and guidelines had contributed in the past for development of the banking system, these had outlived their utility in the current context of liberalisation of economic policy. They felt that in due course the application of norms for capital adequacy, income recognition and prudential exposure would compel banks to devise their own internal guidelines and mechanisms that would help to ensure that the credit disbursed would be optimal and efficiently utilised.

III.4 Trade and industry have strongly advocated more flexibility in the lending guidelines. They have opined as under

The lending discipline evolved on the basis of recommendations of the Tandon/Chore Committee, as modified from time to time, had become outdated in the fast changing socio-economic environment. In their opinion, even if quantitative norms are to be used as a guiding principle for determining the reasonable level of build-up of current assets for an industry, no separate sub-norms should be fixed for each item of current assets. The norms, therefore, should be flexible taking into account the economic performance of the industry and the economic parameters under which it operates and which, to a large extent, fluctuate with changes in Government policies. Besides, they have argued that the existing guidelines on computation of MPBF discriminate against an efficient borrower. As the borrower's entitlement to MPBF is based on historical data, a borrower, who has efficiently controlled his inventory and receivable levels, suffers as against the borrower, who has consistently/persistently been inefficient in managing inventory/receivables.

III.5 Since the views expressed before the Group and/or available to the Group were widely different, these are summarised below for better appreciation.

III.6 <u>Views against</u> Various shortcomings of the present system, as expressed to the Group, are

(a) Under the existing system, credit limits are fixed on the basis of future plans/projections made by borrowers of their business. Funds are withdrawn from cash credit accounts and ultimately sale proceeds are credited to these accounts. Thus withdrawal of fund to deposit of sale proceeds completes one circle with a certain time interval and this 'time interval' varies from borrower to borrower due to varying nature of production process and sale of ultimate products. In practice, the equilibrium between borrowings and repayments is often disturbed as and when borrowing units face a situation of more credit sales than cash sales of their products and to that extent fail to plough back sale proceeds to the cash credit accounts. The present system of inventory norms does not take into account such contingencies. Further, the time now taken to revise the inventory norms taking into account changes in trade conditions is long due to the cumbersome and slow process involved in revision of the norms.

(b) At present, bank finance is intended to cover the gap between a borrower's holding of current assets and his other current liabilities (viz., sundry creditors). It is, moreover, intended that if a borrower could manage with a lower amount of bank finance, he should not be allowed to pre-empt a larger amount. The whole idea of borrowers reducing their dependence on working capital finance from banks as they grow, appears to be excessively utopian.

(c) Borrowing units have been often found to draw funds from their cash credit accounts and utilise the same for purposes other than inventory and receivables, viz., modernisation of existing plants and machinery. This quite often disturbs the equilibrium between the borrowings and repayments cycle as the borrowing units are not able to generate surplus within a short period so as to put the same through the cash credit accounts and to that extent the process of circulation gets disturbed distorting the basic purpose of the cash credit system.

(d) As inventory is cyclical in nature, some amount would always remain outstanding in any cash credit account. Thus, though the cash credit system is theoretically short-term by definition, in practice it becomes a perpetual long-term credit.

(e) Leaving aside difficulties in making any accurate forecast on the uncertainties in the economic system, borrowers have not been able to assess their credit needs precisely on account of -

- imperfect projection technique,
- non-availability in time of past results,
- equal projection for other current assets and other current liabilities, particularly, in the absence of norms for 'sundry creditors' under other current liabilities, and
- absence of consideration of inflation indexing factors while assessing the values of inputs and outputs.

The resultant effect is either under-financing or over-financing.

(f) The gap between the sanctioned credit limit and its utilisation continues to cause anxiety, in spite of introduction of a levy of commitment charge.

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This implies that the banks are perhaps forced to provide for such funds so as to be able to meet the needs of their borrowers according to their credit limits. This results in serious strain on the management of funds in banks and also causes loss to the economy on account of not being able to use such scarce resources for other productive purposes. The matter is further complicated in case of those borrowers whose drawing power is less than the credit limit. Lastly, the secular and sustained nature of the gap between credit limit and credit utilisation in certain cases and which does not show a reverse trend, has become a source of concern.

(g) Speed of decision making in banks leaves a lot to be desired. Consequently, borrowers are sometimes forced to seek ad-hoc limits pending sanction of their regular limits sought for. Quite often, the approach of both banks and borrowers towards computation of MPBF is mechanical and ritualistic ignoring the fundamental aspects of capacity utilisation.

(h) The follow-up mechanism appears to be rigid. The delay in submission of QIS I and II under the quarterly information system by the borrowers and the consequential problem in follow-up tend to remove much of the advantages of the system.

III.7 Views for :

(a) Some views were expressed about the historic role of the lending norms, lending guidelines, Credit Authorisation Scheme, etc., in bringing about uniformity, objectivity and discipline in use of bank finance besides transforming the security-oriented approach of banks to production-oriented/need-based approach.

(b) Data and information received from banks also reveal that the average level of compliance of banks with the basic lending discipline (viz., inventory norms, method of lending, quarterly information system and annual review of accounts) has reached around 85 per cent implying that these norms have not posed any difficulty for a vast majority of borrowers. The norms were by and large, well thoughtout and continue to be relevant. The adoption of these norms (which are denominated in terms of months'/weeks'/days' level of inventory/receivables) ensures maintenance of optimum level of liquidity and profitability for borrowers.

(c) In the absence of norms, there may be a shift of bank finance in favour of large borrowers, who otherwise command relatively better credit ratings in the market. As large borrowers have direct access to resources of the non-bank sector (viz., household sector, trade credit, non-banking financial companies, etc.), dispensing with the existing norms could lead to a bias towards them. Besides, in the absence of norms as well as classification of current assets and current liabilities, inter-corporate credit flow or flows from sectors other than banks may assume large dimensions as to become a serious constraint to healthy and efficient development of the credit market.

III.8 Analysis of the data and information and views of the Group have been indicated in Chapter IV.

# CHAPTER IV

## OBSERVATIONS AND RECOMMENDATIONS

IV.1 Liberalisation and Industrial Finance : Banking in India, till recently, had been subject to a large range of regulations. While regulations per se can not be termed unnecessary, and have a rationale of their own, excessive regulations had resulted in distortions, rigidity, loss of innovativeness, inefficiencies and have not left much scope for operation of market forces in banking and financial services, as evidenced from, (a) diversification of business by financial intermediaries; (b) rapid growth of the non-banking financial intermediaries; and (c) faster growth of the secondary banking sector. Too many regulations perhaps have also resulted in a tendency on the part of the banks to circumvent and/or to overstep the regulatory directives.

IV.2 The Group felt that quantitative controls over the availability of credit, though at times useful in the short run or to meet emergency situations, can not work in the long run, since such controls are not very effective in practice. When borrowers cannot obtain funds from banks, they often have recourse to other agencies outside the banking system by offering higher rates of interest. As bank lending became tighter, borrowers turned to these 'spill over' sources. It had become increasingly apparent that effectiveness in monetary policy required a shift from direct monetary control measures to more indirect measures for achievement of the objective.

IV.3 In the present context, liberalisation of the financial system has to, therefore, firmly address to the deficiencies/distortions brought about by the quantitative restrictions and regulated policy-framework. This can be rendered possible not only by monetary policy measures relating to reserve requirements and interest rate, but also by other measures that resolve the problems within the banking system and improve competitive efficiency. Norms for capital adequacy, income recognition and prudential exposure would help to bring about improvement in the quality of assets held by banks. In short, these would mean, (a) phased removal of regulatory norms with simultaneous implementation of prudential norms, (b) gradual shift from the administered interest rates to rates determined by market forces, (c) larger access to money and capital markets, and (d) more efficient service to be provided by the banking system.

IV.4 The Group noted the fact that various prudential norms (viz., capital adequacy, income recognition, etc.) for banks would become universally applicable in an uniform manner only after March 31, 1996. In the interregnum, i.e., during the transition from regulated banking to market-oriented banking, RBI as the monetary-cum-supervisory authority has to play a pivotal role. This is, particularly, so in the context of the current high level of non-performing assets with the banks, which if allowed to continue, could eventually lead to systemic risks. The

Group, therefore, is of the view that total elimination of controls should be preceded by a thorough cleansing of the asset portfolio of banks and a dedicated application of prudential regulations. This process would be facilitated, if interest rates are determined in response to market forces in the financial markets. RBI will need to devise a sound market intelligence system to gain insight into the working and behavioral responses of markets which would be useful in formulation of monetary policy responses. Policy measures regarding prudential practices should focus not only on banks but also on the different segments of the financial system, especially the non-banking financial intermediaries, so that financial disintermediation does not take place on account of controls regulating operation of banks while no controls or less controls are exercised on non-banking financial intermediaries.

IV.5 <u>Inventory Norms</u> As mentioned earlier, the norms for inventory and receivables represent the maximum levels for holding of inventory and receivables in each industry for the purpose of sanctioning short-term bank borrowings to supplement the own resources of the borrowing units to hold an accepted level of current assets. If, however, a borrowing unit had managed with lower levels of inventory and receivables in the past, banks have to finance the level of current assets on the basis of such reduced levels of holding unless warranted otherwise.

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Deviations from the norms are, however, permitted under certain circumstances for short duration. The applicability of these norms is confined to borrowing units with aggregate fund-based credit limits in excess of Rupees 10 lakh from the banking system. Norms for various items of inventory and receivables are denominated in terms of months' level as under

| | |
|---|---|
| Raw materials | Number of months consumption of raw materials |
| Spares | Number of months consumption of spares |
| Stocks-in-Process | Number of months cost of production |
| Finished Goods | Number of months cost of sales |
| Receivables | Number of months sales |

The Group also noted that with the objectives of increasing credit flow from the banking system to the small scale industry (SSI) sector and reducing time now taken for sanction and/or disbursal of bank finance, banks had been advised recently as under

> "For the credit requirements of village industries, tiny industries and other SSI units having aggregate fund-based working capital credit limits up to Rupees 50 lakh from the banking system, the norms for inventory and receivables as also the First Method of Lending will not apply. Instead such units may be provided working capital limits computed on the basis of a minimum of 20 per cent of their projected turnover for new as well as existing units."

IV.6 The Group observed that norms, based as they are on the principle that bank finance should not be used to hold current assets beyond a reasonable level, would be in the interest of the borrowing units since larger borrowings would mean higher interest costs and thereby reduced profits. The norms thus evolved are the maximum permissible holding levels of inventory and receivables required by borrowing units for transactions/processing in normal situations and/or for meeting contingencies. Further, these norms vary from one industry to another commensurate with the varying needs of each industry because of difference in production/processing cycle. The Group also noted that in developed countires too, bank finance supports build-up of inventory in varying manner from industry to industry. There is always an attempt in developed countries to minimise the level of inventory. In Japan, for example, the levels of inventory are so minimal that these are kept within hours/days of consumption (inputs just-in-time) by units on their own so as to be able to bring down costs. As such, the norms per se are not ill-designed, and perhaps as cost of holding inventory will increase, units in India too, will attempt economising on this count by reducing their levels of inventory. The Group also observed that the norms were essentially meant originally to be in the nature of broad guidelines regarding the desirable levels of holdings of inventory and receivables and it was expected that their application would be made with a degree of flexibility. In the past, however, rigid application of these norms in practice had caused problems

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since often banks, particularly, at field-level tended to consider the norms as directives rather than as guidelines, and to ignore the guidelines on deviations from norms.

IV.7 Based on these considerations, the Group recommends the following amendments/changes in the extant guidelines

(a) In future it will be desirable on the part of each financing bank/consortium or syndicate of banks to decide the levels of individual items of inventory and receivables that could be supported with short-term bank finance. While doing so, banks/consortia/syndicates should carefully study the varying needs of each industry because of differences in production/processing cycle and seasonality in availability of raw materials as well as in sale of finished products. Considering, however, the near unanimous view of banks, and the fact that some banks may not possess the resources and/or expertise to decide on norms for various industries, RBI would continue to evolve and/or review as well as to advise banks the overall levels of inventory and receivables for each industry for their guidance. These overall levels of inventory and receivables should be used by banks as broad indicators and banks/consortia/syndicates must take into account other relevant factors while deciding credit limits for individual borrowers in different industries. Deviations from these indicators should be decided by banks/consortia/syndicates on merits of individual cases.

(b) Banks may consider evolving criteria necessary for projection of figures relating to 'Other Current

Liabilities', especially, the item of 'sundry creditors (goods)'.

(c) Considering the need for reducing time now taken for assessing credit needs of individual borrowers, applicability of norms for inventory and receivables will be confined to borrowing units with aggregate fund-based credit limits of Rupee One crore and above from the banking system. Pursuant to this recommendation the Group further recommends that for assessing the working capital requirements of village industries, tiny industries and other SSI units having fund-based working capital credit limits up to Rupees One crore from the banking system, banks may consider providing working capital finance computed on the basis of a minimum 20 per cent of their projected turnover.

IV.8 <u>Method of Lending/Current Ratio</u> At present under the First Method of Lending banks can provide working capital finance upto a maximum of 75 per cent of the working capital gap (Current Assets less Current Liabilities other than short-term bank borrowings) and the balance should be contributed by the borrowing units out of their long-term funds (i.e., surplus available after use of owned funds and term borrowings for fixed assets and non-current assets). Thus, under the First Method of Lending the borrower's contribution is at least 25 per cent of the working capital gap in order to ensure a minimum current ratio of 1:1. Under the Second Method of Lending a bank can finance the working capital gap less borrower's contribution from long-term funds to the extent of at least 25 per cent of total current assets (as shown below) and under the Second Method a minimum current ratio of at least 1.33   1 is ensured

| | | |
|---|---|---|
| Current Assets (inventory and receivables as per norms or past trend plus other current assets) | : | A |
| Current Liabilities (other than short-term bank borrowings) | | B |
| Working Capital Gap | | (A-B) or C |
| Minimum Net Working Capital under the Second Method of Lending (i.e., 25 per cent of Current Assets) | | 0.25 A<br>or<br>D |
| Actual/Projected Net Working Capital (i.e., borrower's contribution from long-term funds) | | E |
| Maximum Permissible Bank Finance (MPBF) | | (C-D)<br>or<br>(C-E),<br>whichever is less |

Projections in respect of the operating and balance sheet data for the purpose of assessment of the MPBF are made on the basis of the current prices (i.e., anticipated cost escalation is not built into the projections). Currently borrowing units with fund-based working capital limits of Rs.50 lakh and above are brought under the Second Method of Lending, i.e., they are required to comply with the minimum current ratio of 1.33 : 1, unless otherwise exempted as under

(a) In the case of borrowing units engaged in export activities, it has been stipulated that they need not bring in any contribution from their long-term surplus towards financing that portion of current assets as is represented by export receivables, as such units, which are substantially export oriented, may not be able to always maintain an overall current ratio of 1.33 1.

(b) Additional credit needs of exporters arising out of firm orders/confirmed letters of credit (and which were not taken into account while fixing the regular credit limits of borrowers) should be met in full even if sanction of such additional credit limits exceeds MPBF.

(c) Export units having export of not less than 25 per cent of their total turn-over during the previous accounting year, are not subject to the Second Method of Lending in assessing MPBF provided their aggregate working capital limits from the banking system are less than Rs. one crore.

(d) Borrowing units marketing/trading exclusively (100 per cent) the products and merchandise manufactured by village, tiny and SSI units are subject to the First Method of Lending while assessing their MPBF provided dues of the said village, tiny and SSI units have been settled by such borrowers within a maximum period of 30 days from the date of supply. This relaxation is also available to that portion of marketing business related to the products manufactured by village, tiny and SSI industries in respect of cases, where borrowing units also market products manufactured by medium and large industries and/or have manufacturing activity of their own

(e) Credit limits of the borrowing units in the sugar industry are determined on the basis of a current ratio of 1:1 (valid upto September 30, 1994).

(f) Sick/weak units under rehabilitation are exempt from the Second Method of Lending.

IV.9 The Group observed that borrowing units in India were excessively dependent on the banks for financing their working capital requirements. The proportion of long-term funds financing working capital is much less in India compared to that abroad. Many units are also unable to maintain the stipulated minimum current ratio. Sometimes even the quantum of short-term bank borrowings is more than the net worth of the borrowers, particularly, in case of partnership and proprietory concerns. The recently (July 22, 1993) published data by the Industrial Credit and Investment Corporation of India Limited (ICICI) for a sample of 615 public limited companies on its portfolio reveal that the borrowing units have not been able to maintain current ratio of 1.33:1 as shown below

(Amount in Rs. crore)

| | 1987-88 | 1988-89 | 1989-90 | 1990-91 | 1991-92 |
|---|---|---|---|---|---|
| Current Assets | 21110 | 26001 | 32214 | 37879 | 46411 |
| Current Liabilities | 17675 | 22382 | 27198 | 31700 | 38821 |
| Current Ratio | 1.19 | 1.16 | 1.18 | 1.19 | 1.20 |
| Current Liabilities(other than short-term bank borrowings) | 13550 | 16702 | 20470 | 23875 | 29532 |
| Working Capital Gap | 7560 | 9299 | 11744 | 14004 | 16879 |
| 25 per cent of Current Assets | 5278 | 6500 | 8054 | 9470 | 11603 |
| MPBF(on the basis of Working Capital Gap less 25 per cent of Current Assets) | 2282 | 2799 | 3690 | 4534 | 5276 |
| Short-term Bank Borrowings for Working Capital | 4125 | 5680 | 6728 | 7825 | 9289 |

Actual bank borrowings, as may be observed from the above figures, were higher than the MPBF, though it could be possible that the sample of 615 companies includes categories, which are exempt from the Second Method of Lending.

IV.10 It is common knowledge that higher the current ratio, better is the ability of a borrowing unit to tide over adverse situation. As such it will be preferable to move over to a higher current ratio of 1.5:1. However, considering the present position (as revealed by the data) in this regard the Group observes that the borrowing units will not be in a position to achieve in the near term the higher current ratio of 1.5:1. The issue is also related to the 'System of Lending' and consequent accounting procedure for classification of current assets. The Group, therefore, does not recommend any change in the extant guidelines except that in future the applicability of the Second Method of Lending be restricted to those borrowing units with aggregate fund-based credit limits of Rs.One crore and above from the banking system. The Group also recommends continuation of the existing selective exemptions from the application of the Second Method of Lending.

IV.11 <u>Slip back in Current Ratio</u> The Tandon Committee felt that lending up to 75 per cent of the working capital gap as in the First Method of Lending was liberal but in its view this should be considered as the upper limit. It recommended that starting with the First Method of Lending banks should gradually reach the ideal of the Third Method.

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To that extent it had stated that the existing current ratio should not be impaired and if the credit needs of borrowers increased in future, they should not be allowed to slip back from a higher category to a lower category.

IV.12 RBI in consultation with the Committee of Direction considered the issue in 1978 based on the representation that rigid adherence to the above concept might cause hardship under certain circumstances. Accordingly, banks were advised on July 17, 1978, that they might, as a special case, consider permitting relaxation to the industrial units, which had good past performance record and which had built up a sound current ratio over a period of time, for the following purposes

(a) for undertaking either an expansion of existing capacity or for diversification;

(b) for fuller utilisation of existing plant capacity;

(c) for meeting a substantial increase in the unit's working capital requirements on account of abnormal price rise;

(d) for investment in allied concerns with the concurrence of the bank, if such an investment is considered necessary in the business interests of the borrowing unit, i.e., for procuring supply of raw materials, etc.

(e) for bringing about a reduction in the level of deposits accepted from the public for complying with statutory requirements and

(f) for repayment of the instalments due under foreign currency loans and other term loans.

While permitting relaxation in the circumstances stated above, banks should ensure that the current ratio of at least 1.33:1 was maintained, i.e., the relaxation should not result in reducing the borrowing unit's contribution from the long term sources below a minimum of 25 per cent of its current assets. In case of the borrowing units, who were in the First Method stage, they should not normally be allowed to expand their activities without bringing in additional equity or raising term loans so as to ensure that their financial structure was not weakened as a result of expansion.

IV.13 The matter was further reviewed during 1991 while considering policy guidelines relating to 'Group Approach' and banks were advised inter alia on November 22, 1991, as under

(a) No amount lent to a healthier unit of a 'Group' for its working capital requirements is transferred to another unit within the 'Group' by reducing the current ratio of the transferer unit to a level which is below 1.33:1 and

(b) Subject to maintenance of a minimum current ratio of 1.33:1, funds from cash-rich units of a 'Group' should flow to the weaker units of the 'Group' to help their revival/rehabilitation.

IV.14 The In-House Group observed that trade and industry was of the view (as they had been in the past) that the extant guidelines had caused hardship, particularly, to

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those units which had been able to maintain current ratio higher than 1.33:1 in the past. The Group, however, observed from the extant guidelines that banks had been bestowed with the power to use discretion in deciding a slip back in current ratio and non-exercise of such power was no reason to change the extant guidelines. At the most, it needed clarification whether the word, 'diversification', meant inclusion of 'new units to be set up'. The Group felt that the word, 'diversification', should include 'new units to be set up' and, therefore, recommends continuation of the extant guidelines together with the above clarification.

IV.15 <u>System of Lending</u> The Group is aware that a Working Group (Chairman Shri Rashid Jilani, Chairman and Managing Director, Punjab National Bank) has been constituted by the Indian Banks' Association at the instance of RBI to suggest revised method of lending in place of the existing cash credit system. The Group, therefore, has not made any recommendation in this regard.

IV.16 <u>Review of Accounts</u> In terms of current guidelines, banks are required to review all the borrowal accounts enjoying working capital credit limits of Rs.10 lakh and over from the banking system at least once a year. Since the objective of such a review is not only to verify the continued viability of the borrowers but also to assess the need-based character of their limits, the Group recommends continuation of the extant guidelines in this regard.

IV.17 Ad-hoc limits In terms of existing guidelines banks may sanction ad-hoc limits to borrowers for temporary periods and RBI has suggested that such temporary period may not exceed three months. The rationale behind the suggestion is that where the ad-hoc credit is required for a period beyond three months, banks should reappraise the credit needs of the borrower and fix appropriate limits for meeting the need-based requirements. Except in the case of ad-hoc export credit limits and bills limit, banks may charge a penal rate of interest of one per cent above the normal lending rate.

IV.18 The Group observed that in the context of the relaxations made recently in the extant guidelines (as elaborated in Chapter II), such restrictions on banks for sanction of ad-hoc limits were not necessary. The Group, therefore, recommends modification of these guidelines including charging of penal rate of interest and suggests that both quantum and period of ad-hoc limits be henceforth decided by financing bank/consortium/syndicate.

IV.19 Quarterly Information System : In terms of the existing guidelines banks must ensure that the borrowers enjoying working capital limits of Rs.50 lakh and over from the banking system comply with this requirement. These guidelines have also specified role of banks, either as a sole banker or under multiple banking arrangement or as a leader/member-bank in a consortium in enforcing this discipline. Banks have also been advised to invariably charge penal interest of at least one per cent per annum for a period of one quarter on the outstandings under various working capital limits sanctioned to a borrower, who fails to submit any of the statements within the prescribed time (viz., Form I to be submitted in the week preceding the commencement of the quarter to which the statement relates, Form II within six weeks from the close of the quarter to which the statement relates and Form III within two months from the close of the half-year). Further, banks should not show any latitude in implementing these instructions and should ensure that penal interest is charged to all defaulters. Where the default is of a serious or persistent nature, banks may charge, at their discretion, a rate higher than the aforementioned minimum penal rate of one per cent per annum and may also consider freezing the operations in the account after giving due notice to the concerned borrower. Exemptions are, however, available to sick industrial units, which remain closed and to borrowers, who are not able to submit statements in time on account of political disturbances, riots, natural calamities, etc., on merit of each case.

IV.20 While views had been expressed by the trade and industry against observance of this discipline, the Group was of the view that it was essential to continue with the extant guidelines on the information system. The system, particularly, QIS I and II, which provide for quarterly projections and the results of the previous quarter, enable banks/consortia to fix quarterly operating limits. The Group also realised that the information system, if

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fine-tuned, had the potential for developing into a major instrument of credit management in banks. The Group observed that some of the recalcitrant borrowers preferred to pay the penal rate of interest of one per cent rather than comply with the discipline, as, at present, the actual penal rate/s applied to any borrower was not to exceed an overall ceiling of 2 per cent.

IV.21 The Group, therefore, recommends continuation of the current guidelines as also exemptions thereof except that in future compliance with the Quarterly Information System would be confined to borrowers enjoying working capital limits of Rupees One crore and above from the banking system. With a view to make QIS an essential tool of credit management, it further recommends that banks/ consortia/syndicates may consider charging of higher rate of interest on the entire credit limits of a borrower for failure to submit these returns in time for two consecutive quarters.

IV.22 <u>Commitment charge on unutilised portion of credit limits</u> In terms of current guidelines banks are directed to levy a minimum commitment charge of one per cent per annum on the unutilised portion of the working capital limits, subject to a tolerance level of 15 per cent of such limits. The measure is applicable in respect of borrowing units with fund-based working capital limits of Rupees One crore and above and the commitment charge of one per cent per annum is exclusive of the overall ceiling of 2 per cent of penal/additional interest stipulated by RBI. The charge, however, is not levied on the following limits:

(a) Drawings in excess of the operative limit ;

(b) Working capital limits sanctioned to sick/weak units ;

(c) Limits sanctioned for export credit as well as against export incentives ;

(d) Inland bill limits, extended by way of bills purchased/discounted or overdraft/cash credit limit/sub-limit against bills for collection ; and

(e) Credit limits granted to commercial banks, financial institutions and co-operative banks including land development banks.

IV.23 The Group observed that the measure was introduced with the twin objectives of (i) bringing about discipline in the availment of bank finance by the borrowers and (ii) encouraging better management of funds. The Group further observed from available data and information that the gap between credit limit and its utilisation ranged between 22 per cent and 32 per cent during the eleven years (1979 to 1989) as of last Friday in the month of June, with the cluster between 25 per cent and 32 per cent. The latest available annual position showed the gap to be about 27 per cent, as shown below

Outstanding credit of scheduled commercial banks under cash credit accounts (amount in Rs. crore)

| Year (as on the last Friday of June) | Credit limit | Credit utilis-tion | Gap in percentage |
|---|---|---|---|
| 1979 | 10691 | 7505 | 29.80 |
| 1980 | 11299 | 7829 | 30.71 |
| 1981 | 12753 | 8706 | 31.73 |
| 1982 | 14527 | 10888 | 25.05 |
| 1983 | 18000 | 13214 | 26.59 |
| 1984 | 16892 | 12672 | 24.98 |
| 1985 | 18643 | 13941 | 25.22 |
| 1986 | 17773 | 13861 | 22.01 |
| 1987 | 23555 | 18176 | 22.84 |
| 1988 | 26009 | 19619 | 24.57 |
| 1989 | 31170 | 22650 | 27.33 |

( Note Upto June, 1983, data relate to accounts with credit limits over Rs.10,000 and from June, 1984, onwards, to accounts with limits over Rs.25,000)

(Source Basic Statistical Returns)

The data indicate that the banks had and perhaps still have to keep provision of such amount to meet the needs of their borrowers according to their credit limits. This situation not only implies serious strain for credit management, but also causes indirectly loss to the banks for being not able to put this amount of fund to alternative use. Over-estimation of credit limit or under-utilisation of it could be on account of no cost or very nominal cost involved and/or delay in revising regular as well as operative limits.

IV.24 One solution to overcome this problem and improve the percentage of utilisation of sanctioned credit limit could be introduction of a loan system of financing. However, for reasons stated earlier (paragraph IV.15), the Group has not made any recommendation to this effect. Subject to that observation, the Group recommends that banks may consider adoption of 'Cash Flow' approach to assess working capital needs as an additional information together with the existing 'Funds Flow' concept, so as to be able to reduce, if not eliminate, the gap between sanctioned credit limits and utilisation thereof, the rationale being, that under the funds flow concept, 'time lag' between actual 'outflow' and 'inflow', not necessarily always in the same order, is not considered (e.g., instalment of term loan instalments). Further, adoption of cash flow approach as an additional information will enable banks to fix more realistically the 'peak' and 'non-peak' credit limits. Lastly, adoption of 'cash flow approach' will facilitate switching over to a 'loan system' at a later date.

IV.25 The Group, therefore, recommends not only continuation of the current guidelines for levy of commitment charge, but also introduction of a 'Cash Flow' approach by modifying/adding to the existing CMA Data Base and QIS Forms.

IV.26 <u>Bill Culture</u> In terms of existing guidelines banks are required to charge interest at two percentage points above the relevant cash credit interest rate on the portion of the book-debt finance which is in excess of the prescribed norm of 75 per cent of the limits sanctioned to borrowers for financing inland credit sales. The said directive is applicable to all borrowers enjoying working capital **limits** (fund-based) of Rs.5 crore and above. Further, the prescribed additional interest is in addition to the overall ceiling of 2 per cent of penal/additional interest stipulated by RBI.

IV.27 The Group observed that over the years the share of outstanding bank credit for inland bills purchased and discounted to total outstanding bank credit had registered a downward trend and of late the percentage had stabilised around five as against the desired level of 25 per cent as evidenced by the data shown below

Outstanding total credit and inland bills purchased and discounted of all scheduled banks (Amount in Rs. crore)

| Year (as on last Friday of March) | Total bank credit | Inland bills purchased and discounted | Percentage of credit for bills to total bank credit |
|---|---|---|---|
| 1975-76 | 11,829 | 1,852 | 15.66 |
| 1980-81 | 27,265 | 2,283 | 8.37 |
| 1986-87 | 59,945 | 3,808 | 6.35 |
| 1988-89 | 91,875 | 4,368 | 4.59 |
| 1989-90 | 109,775 | 5,041 | 4.59 |
| 1990-91 | 125,575 | 5,941 | 4.73 |

The Group observed that the objective behind the existing guidelines was to encourage bill culture as well as to reduce dependence on bank finance against book-debts. The Group further observed that there was a general tendency among buyers, particularly, large industries (in both private and public sectors) and Government Departments, to delay payments due to the sellers. Not only this aggravates the working capital management, if not shortage of working capital, for the sellers (particularly, if a seller happens to be a small industrial unit), but it also amounts to extortion of informal credit by buyers without paying any price for the same. The Group, therefore, recommends continuation of the extant guidelines on bill culture.

IV.28 Credit Monitoring Arrangement : At present banks are required to report to RBI for post-sanction scrutiny under the Credit Monitoring Arrangement(CMA) sanction of working capital credit limits (including those falling under the exempted categories) of Rs.10 crore and above as also additional limits, which would take the total credit of the borrower from the banking system as a whole to Rs.10 crore or more. The relative papers are required to be sent to RBI in a manner so as to reach it within 15 days from the date of sanction/renewal by the Boards of Directors/competent authority. Such reports should be accompanied by data in the prescribed forms, a copy of the latest audited balance sheet of the borrower together with the copy of the note put up to the Board/competent authority explaining the reasonableness of the assessment of the working capital needs and justification for the limits or additional limits, as the case may be.

IV.29 The Group observed that RBI at present scrutinised 50 per cent of such proposals/sanctions, as against 100 per cent scrutiny till January 7, 1991, as banks had been found to comply with the guidelines in respect of 80 to 85 per cent of cases. With complete adoption of norms for capital adequacy and income recognition, it would be incumbent on banks to devise their own methods of credit and risk appraisals, pricing, etc. Performance indicators for banks so far in this fiscal year clearly indicate that banks have started to do so. In view of the fact that banks have made progress in this regard, there is need to discontinue the process of post-sanction scrutiny. The exact time of effecting/implementing this suggestion will depend on (a) the ability of the banking system to function smoothly in a market-oriented situation and (b) the implementation of a standardised regular reporting system. The Group, therefore, recommends that the position may be reviewed say, after two years, i.e., as at the end of September, 1995, when the impact of the proposed liberalisation in the adoption of banking norms, etc., would be discernible.

IV.30 <u>Credit Monitoring Arrangement - Term Loans</u> In terms of existing guidelines banks are required to report to RBI for post-sanction scrutiny sanction of term credit in which the share of the banking system exceeds Rs.5 crore (including term loans/DPGs). The Group observed that the extant guidelines on sanction of term finance by banks had been considerably amended in the month of August, 1993, as a result of which banks could now sanction individually term loan upto Rs.50 crore or their prudential exposure limits, whichever was less. Further, the restriction on participation of commercial banks to the extent of 25 per cent of the total term loan assistance, when loans were sanctioned in participation with all-India financial institutions, had been removed, though collectively banking system was not permitted to sanction term loan beyond Rs.200 crore.

IV.31 While these relaxations are accompanied by observance of certain discipline and prudential norms on the part of the banks, the Group felt that there would be merit from the policy angle to continue with the current practice of reporting sanction of term loans by banks to RBI for the purpose of post-sanction scrutiny, till evolution of a standardised regular reporting system and impact of liberalisation was reviewed, as stated in paragraph IV.29.

IV.32 <u>Reporting to Reserve Bank of India</u> Banks are at present required to submit periodically returns in prescribed forms indicating (i) compliance with the requirements prescribed by the Tandon, Chore and Marathe Committees, (half-yearly), (ii) statistical data - Form 'A' (quarterly) showing limits sanctioned and balances outstanding in borrowal accounts of parties having aggregate credit limit of Rs.5 crore and above from the banking system, and (iii) monthly statement of borrowal accounts with aggregate fund-based limits of Rs.10 crore and above from the banking system.

IV.33 There is no doubt that the existing communication network needs to be improved right from the stage of submission of data and information by borrowers to banks and onward submission by banks to RBI. Standardisation of the communication system will be crucial for RBI for (i) formulating industrial sector credit policy, (ii) appraising/assessing credit needs of the industrial sector, (iii) monitoring flow of credit to this sector and (iv) evaluating the performance of the banks as well as industry. This aspect assumes much greater significance in the context of the eventual discontinuation of the Credit Monitoring Arrangement. With that objective in mind, the Group felt the matter needed to be discussed with banks so as to evolve a suitable Management Information System for industrial credit, which would serve the purpose of RBI and be also simple enough for implementation. The Group, therefore, recommends that the Committee of Direction be requested to review the position.

IV.34 <u>Committee of Direction</u> : The period of transition from regulated/semi-regulated banking to market-oriented banking is always fraught with risk, if it is not properly steered. It is, therefore, necessary to continue with the Standing Committee so that issues/problems faced during the period of the implementation of the amendments to the guidelines emerging from the recommendations of this Group, as also out of the Shetty Committee and the

Jilani Committee, are addressed to in time. The Group further recommends that the Committee of Direction should meet once every quarter to review the scenario and direction of the liberalisation process.

## CHAPTER V

## SUMMARY OF RECOMMENDATIONS AND CONCLUSIONS

V.1 The Group observed that existence of excessive regulations and their rigid implementation at the grass-root level had led to borrowers not obtaining adequate bank finance to meet their working capital needs and consequently seeking finance from other than banking sector. Further, the reform and/or restructuring of the financial sector that have been set in motion, would release a large quantum of lendable resources to the banking system. Moreover, in the context of banks being required to comply with norms for capital adequacy, income recognition and prudential exposure, there would be no need to prescribe specific norms for inventory and receivables. The Group, therefore, observed that in future RBI might confine itself to indicate broad guidelines for build-up of overall level of current assets. The Group has, therefore, made the following recommendations amending and/or modifying the basic lending discipline so as to impart desired flexibility in their implementation by banks.

V.2 Norms for inventory and receivables As against the present practice of RBI deciding norms for each item of inventory and receivables for different industries, henceforth banks would decide the maximum levels of holding of each item of inventory and receivables for build-up of current assets that could be supported by bank finance. While exercising such judgement, banks should take into account the production/processing cycle for that industry and other relevant financial indicators/factors.

V.3 Applicability of norms for inventory and receivables :

The foregoing recommendation will be applicable in the case of borrowers having aggregate fund-based working capital limits of Rupees One crore and above (as against Rupees 10 lakh and above now) from the banking system.

V.4 Working capital finance to borrowal units having limits up to Rupees One crore Banks may consider providing working capital finance to all borrowing units having fund-based working capital credit limits up to Rupees One crore (as against Rupees 50 lakh now to village, tiny and other SSI units) from the banking system, computed on the basis of a minimum 20 per cent of their projected turnover.

V.5 Realistic assessment of 'Other Current Liabilities' Banks may consider evolving criteria necessary for projection of figures relating to 'Other Current Liabilities', especially, the item of 'Sundry Creditors (Goods)'.

V.6 Development of expertise in assessing norms for inventory and receivables : In order to assist banks which may not possess the resources and/or expertise to arrive at such norms for various industries, RBI will continue to advise banks the overall levels of inventory and receivables for different industries and which may be used as broad indicators by banks.

V.7 Current Ratio : Though the Group felt that it would be better to move over to a minimum current ratio of 1.5:1, as against the existing prescribed minimum of 1.33:1 under

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the Second Method of Lending, the Group also observed that it would not be easy for existing borrowing units to have a higher current ratio in the near term. The Group has, therefore, recommended that banks may continue to finance the working capital gap less borrower's contribution from long-term funds/surplus to the extent of at least 25 per cent of total current assets (leading thus to a minimum current ratio of 1.33:1).

V.8 Applicability of the Second Method of Lending : Banks may henceforth assess MPBF of all borrowing units having aggregate working capital limits of Rupees One crore and above from the banking system as against Rupees 50 lakh and above hitherto under the Second Method of Lending.

V.9 Exemption from the applicability of the Second Method of of Lending

(a) As hitherto, borrowing units, engaged in export activities, need not bring in any contribution from their long-term surplus towards financing that portion of current assets as is represented by export receivables for the purpose of assessment of MPBF.

(b) Banks will meet in full, as is being done now, the additional credit needs of exporters arising out of firm orders/confirmed letters of credit (and which were not taken into account while fixing the regular credit limits of borrowers), even if sanction of such additional credit limits exceeds MPBF.

(c) Banks will continue to use the First Method of Lending while assessing the MPBF of borrowing units marketing/trading exclusively the products and merchandise manufactured by village, tiny and SSI units provided dues of the said village, tiny and SSI units have been settled by such borrowers within a maximum period of 30 days from the date of supply. The manner in which this relaxation is currently available to borrowers marketing products manufactured by SSI as well as large sectors will also continue.

(d) Sick/weak units under rehabilitation will continue to be exempt from the Second Method of Lending.

(e) Credit limits of the borrowing units in the sugar industry will be determined on the basis of a current ratio of 1:1 (as against the prescribed minimum of 1.33:1) up to September 30, 1994.

V.10 Slip back in Current Ratio The present regulations imposed on banks for not permitting slip back in current ratio except for certain specific purposes will continue. The Group, however, recommends broadening the meaning of the word, 'diversification' and accordingly, in future 'diversification' will also include establishment of new units.

V.11 System of Lending In view of the constitution of the Working Group to suggest revised method of lending in place of the present cash credit system, the Group has refrained from making any recommendation in this regard.

V.12 Review of Accounts Banks should continue to review all working capital borrowal accounts of Rupees 10 lakh and above at least once every year.

V.13 Ad-hoc Limits Consistent with its recommendation of completely delegating power to banks for assessment of working capital credit requirements of borrowing units (by dispensing with the prescribed norms for inventory and receivables), it is recommended that banks may henceforth freely sanction ad-hoc and/or additional limits on merits of each case. The Group further recommends that the restrictions now imposed by RBI on banks, viz., maximum period of sanction of ad-hoc limits, charging of penal interest of one per cent over the normal lending rate, etc., be dispensed with and terms and conditions for sanction of ad-hoc limits be left to the discretion of banks.

V.14 Quarterly Information System : As returns under QIS are an essential part of credit management, banks will continue to comply with the guidelines issued by RBI in this regard. However, consistent with its recommendation enhancing limits/cut-off points for applicability of some other aspects of lending discipline, the Group recommends application of QIS discipline in future to borrowing units having aggregate fund-based working capital limits of Rupees One crore and above from the banking system as against Rupees 50 lakh and above at present. Further, with the objective of improving compliance with QIS discipline, it is also recommended that banks might consider charging higher rate of interest on the entire credit limits of a borrower for failure to submit these returns in time for two consecutive quarters.

V.15 Commitment charge on unutilised portion of credit : The Group recommends continuation of the current guidelines for levy of commitment charge as well as exemptions thereof at present. It is further recommended that banks may adopt/introduce 'Cash Flow' approach as part of both CMA Data Base and QIS returns so as to be able to fix effective operative limits on a more realistic basis, separate limits for 'peak' period and 'non-peak' period of operation, which in turn will improve the percentage of utilisation of credit limits sanctioned by banks.

V.16 <u>Bill Culture</u> The objectives of bill culture are to ensure timely payment of credit purchases as also to reduce dependence on bank finance against book debts. It is, therefore, recommended that the existing guidelines inclusive of charging of additional interest of two percentage points above the relevant cash credit interest rate on that portion of the book debt finance in excess of the prescribed norm of 75 per cent of the limits sanctioned for financing inland credit sales should continue.

V.17 <u>Credit Monitoring Arrangement</u> : It is recommended that the present practice of banks reporting sanction of working capital limits of Rupees 10 crore and above and term loans of Rupees 5 crore and above to RBI for post-sanction scrutiny should continue. The Group has further recommended that the matter be reviewed as at the end of September, 1995, by which time a clear picture will emerge about (a) the impact of the on-going process of liberalisation in the financial sector, (b) the ability of the banking system ~~of~~ to function smoothly in a market-oriented situation and (c) the implementation of a standardised regular reporting system to RBI.

V.18 Standardised Regular Reporting System The Group felt that the present set of returns received in the Industrial and Export Credit Department of RBI would require thorough revision in the context of switch-over to market-oriented banking. Standardisation of the communication system will be crucial for (a) formulating industrial sector credit policy, (b) appraising/assessing credit needs of the industrial sector, (c) monitoring flow of credit to this sector and (d) evaluating the performance of the banks as well as industry. It has, therefore, recommended that the Committee of Direction ( a Standing Committee) be requested to review the position and suggest a revised reporting system.

V.19 Committee of Direction With the objective of ensuring a smooth switch-over of the banking system to market-oriented banking, it is recommended that the Committee of Direction should continue to function and meet at least once every quarter to address itself to problems, if any, on the implementation of the guidelines to be issued by RBI based on the recommendations made and/or to be made by (a) the Working Group to suggest revised method of lending in place of the present cash credit system, (b) the Committee to review the system of lending under consortium arrangement and (c) the Group itself.

V.20 <u>Conclusion</u> The broad approach of the Group has been to remove undue restrictions, which have been hampering the flow of credit to trade and industry from the banking system and to facilitate a smooth switch-over to market-oriented banking. The underlying objective of the recommendations is to bestow the required degree of latitude on the banks in the conduct of their day-to-day business subject to observance of the prescribed prudential norms and guidelines and macro-level credit policies.

| | |
|---|---|
| (I.T.Vaz) | (R.K.Jalan) |
| (S.J.Thaker) | (J.R.Prabhu) |
| (M.V.Raghavachari) | (Dr.A.Vasudevan) |
| (S.N.Dalal) | (P.K.Biswas) |

Bombay
September 29, 1993

ANNEXURE I

RESERVE BANK OF INDIA

INDUSTRIAL AND EXPORT CREDIT DEPARTMENT

CENTRAL OFFICE, BOMBAY

POLICY AND MONITORING DIVISION

Memorandum

Trade and industry have been voicing their concern for some time that it has been difficult for them to comply with the existing norms and procedures regarding the financing of the working capital through bank credit. They feel that the lending norms followed by the banks based on the recommendations of the Tandon and Chore Committees are somewhat rigid and require change. They have also represented that banks take even six months or more for taking a decision on their proposals requesting for renewal and/or enhancement of existing working capital limits.

2. Consequent to the issue of circular No.DBOD.Fol.BC 8/16.13.100/92-93 dated July 27, 1992, reiterating the extant guidelines on discounting/rediscounting of bills as also on lending under consortium arrangement (viz., that banks should not extend any facility to a borrower (fund-based or non-fund based) without the consent of the existing bank/consortia), the number of such representations made by the Chambers/Confederations/Associations of trade and industry has increased voicing their concern on the hardship faced by the industry on account of lack of adequate and/or timely supply of credit for financing their operations. The main issues

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raised in different fora are as under

(a) Implementation of RBI guidelines would affect discounting of genuine trade bills

(b) Restrictions imposed on banks for not extending credit to borrowers, where banks are neither regular bankers nor members of consortia, would result in non-availability of adequate bank credit in time ;

(c) Lending discipline evolved on the basis of the recommendations of the Tandon/Chore Committee, as modified from time to time, have become outdated ; and

(d) The guidelines related to lending under consortium arrangement should have more flexibility.

3. In respect of the Tandon/Chore Committee norms it may be mentioned that the Tandon Committee appointed to frame guidelines on the follow-up of bank credit emphasised a shift from the security-oriented system of lending to the production-oriented system of lending based on a total study of the borrower's operations. It, therefore, stressed that norms be evolved for holding of inventory/receivables to ensure need-based credit and at the same time prevent pre-emption of scarce resources of banks by favoured customers/ groups. The Committee also opined that bank finance should only supplement a borrower's resources in carrying a reasonable level of current assets in relation to production needs. For this purpose the main recommendations of the Committee, which have been accepted and still form the basis for lending, are

(a) The extent of bank finance should relate to the norms specified for the industry. It should relate to past trends where borrowers have managed with lower levels in the past and in cases where no norms have been specified. (Norms for 15 industries were evolved by the Committee in consultation with industry. These are periodically reviewed and norms have been evolved for 49 industries as on date) ;

(b) A progressive increase in the contribution from long-term funds for supporting current assets to reduce dependence on bank borrowings and ensure a minimum current ratio (under the I method of lending banks can finance upto 75 per cent of the working capital gap while under the II method banks can finance working capital gap less borrowers' contribution which should be atleast 25 per cent of the current assets) ;

(c) An annual review of the accounts to appraise performance and assess the working capital needs for the next year ; and

(d) Submission of statements under the Quarterly Information System to ensure planned and proper end-use of funds.

4. Even though the extant guidelines do permit flexibility in interpreting the same, considering the number of representations received, it was felt necessary to discuss the matter with the representatives of banks, trade and industry. A series of discussions culminated with the high-level meeting chaired by Governor, Reserve Bank of India, on November 4, 1992, wherein it was decided inter alia to constitute an internal group (In-House Group) to review the necessity of continuation of the role of the Reserve Bank of India in laying down norms, etc., for bank lending for working capital purposes. The Reserve Bank of India accordingly appoints the following persons under the

chairpersonship of Ms. I.T.Vaz, Executive Director, to constitute the In-House Group

1. Shri R.K.Jalan — Member
Chief Officer
Reserve Bank of India
Rural Planning and Credit Department
Central Office
Bombay

2. Shri S.J.Thaker — Member
Chief Officer
Reserve Bank of India
Industrial and Export Credit Department
Central Office
Bombay

3. Shri D.N.Samarth — Member
Chief Officer
Reserve Bank of India
Financial Institutions Cell
Central Office
Bombay

4. Shri J.R.Prabhu — Member
Additional Chief Officer
Reserve Bank of India
Department of Banking Operations and Development
Central Office
Bombay

5. Shri M.V.Raghavachari — Member
Adviser-in-Charge
Reserve Bank of India
Credit Planning Cell
Central Office
Bombay

6. Shri A.Seshan — Member
Adviser-in-Charge
Reserve Bank of India
Department of Economic Analysis and Policy
Central Office
Bombay

7. Shri S.N.Dalal — Member
Economic Adviser
Reserve Bank of India
Industrial and Export Credit Department
Central Office
Bombay

8. Shri P.K.Biswas — Member-Secretary
Joint Chief Officer
Reserve Bank of India
Industrial & Export Credit Department
Central Office
Bombay

The In-House Group may co-opt, if considered necessary, any official to serve on the Committee or for any other reason.

5. The terms of reference of the Group, inter alia, will be as under

(a) To examine and recommend (in the context of revised economic policies, growth of more diversified financial systems and public preference for disintermediation) the necessity or otherwise of continuing with the process of allocation of credit by fixing the extent of bank credit (Maximum Permissible Bank Finance - MPBF) ;

(b) To examine and recommend the necessity or otherwise of fixing of norms and lending discipline by the RBI (Central Banking Authority) as against fixation of prudential exposure norms.

6. The Group is expected to submit its report within three months.[1]

7. The secretarial services will be provided by the Industrial and Export Credit Department, Reserve Bank of India, Central Office, Bombay

Sd/-
(D.R.Mehta)
Deputy Governor
January 5, 1993

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[1] Extended up to end of September, 1993

ANNEXURE II

## Consolidated statement of comments/suggestions/views of banks in reply to the questionnaire forwarded to them

Comments/suggestions/views of banks

| State Bank of India (1) | Nationalised Banks (2) | OTHER Banks (3) | Foreign Banks (4) |
|---|---|---|---|
| (No. of respondents 6) | (No. of respondents 22) | (No. of respondents 9) | (No. of respondents 13) |

Question : The Tandon Committee had suggested quantitative norms for holding of inventory and receivables for the purpose of determining the quantum of bank credit for working capital purposes in order to prevent use of bank credit for speculative and/or non-productive purposes. It had also suggested a phased reduction in the dependence on bank borrowings for working capital by gradually increasing the support for build-up of current assets from long-term sources. These recommendations were implemented in order to ensure that the competing demands of various sectors of the economy on bank credit were not pre-empted by large borrowers. In the changing economic scenario, should flow of credit continue to be regulated in the above manner ? If not, alternatives may be suggested.

| State Bank of India (1) | Nationalised Banks (2) | OTHER Banks (3) | Foreign Banks (4) |
|---|---|---|---|
| Most of the respondents are of the view that the flow of credit should continue to be regulated through various norms stipulated by RBI, as even in the changing economic scenario, the rationale behind these norms, namely that the competing demands of various sectors of the economy on bank credit are not pre-empted by large borrowers, still remains valid. While they have not suggested | Four respondents have not offered their views.<br><br>Thirteen respondents are of the view that the existing norms are realistic and arrived at scientifically and hence these should continue. They have suggested that banks be empowered to permit deviations from norms on merits of each case so as to meet the changing needs for working capital of the industry. | Three respondents have not offered their views.<br><br>Remaining six respondents have firmly opined for continuation of the present methodology as it ensures uniformity among banks, prevents pre-emption of credit and inculcates financial discipline among borrowers, among others. Hence they have not suggested any alternative, but | Four respondents have not offered their views.<br><br>Eight respondents have suggested to discontinue totally the present quantitative norms and replace it by banks arriving at their own credit decisions (e.g., as suggested by one based on total debt to be availed of by the borrower, total liabilities/tangible |

| (1) | (2) | (3) | (4) |
|---|---|---|---|
| any alternative, one of them has suggested that banks be vested with power to approve deviations from norms without referring to RBI. Two others have indicated that norms could be used as indicative guidelines and SBI has suggested that RBI might continue to review as well as to update these norms. | Five respondents are of the view that the present system of fixing quantitative norms for holding of inventory and receivables for the purpose of determining the quantum of bank credit need not be continued. Even these banks have suggested that individual banks may use norms as indicators.<br><br>An alternative has been suggested that credit be assessed equivalent to number of months sales arrived at on the basis of average net sales (excluding excise duty). | have advocated for flexible approach on the part of the banks in the manner as indicated by the Tandon Committee. | net worth, quarterly financial information, disclosure/caps on capital expenditure and investments, cash flow, any other material information).<br><br>More or less all have suggested for strict application of prudential exposure norms, capital adequacy and income recognition norms, credit ratings, etc., at macro-level.<br><br>However, one respondent is of the view that transformation from the present norms to banks' own discretion needs to be carried out gradually together with adoption of higher current ratio. |



**Question** : Trade and industry have been expressing difficulties in having access to adequate bank credit for their operations. Is the present lending discipline (viz., norms for inventory and receivables, method of lending, regulating credit through the information system and annual review of accounts) restrictive? If so, what modifications could be made in the discipline under each of the above four heads? (Reasons and advantages in support of the suggested modifications may be clearly mentioned).

| | | | |
|---|---|---|---|
| All the respondents are of the view that in the interest of ensuring | Three respondents have not offered views. | Three respondents have not offered their views. | Four respondents have not offered their views. |

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| (1) | (2) | (3) | (4) |
|---|---|---|---|
| financial discipline among the borrowers, all the four existing disciplines (viz., norms for inventory and receivables, method of lending, regulating credit through the information system and annual review of accounts) are necessary.<br><br>One of them has suggested adoption of Second Method of Lending for all borrowers enjoying fund-based working capital limits of Rs.10 lakh & above (as against Rs.50 lakh at present) but application of inventory norms for limits of Rs.50 lakh and above (as against Rs.10 lakh at present).<br><br>SBI has suggested that the minimum current ratio be increased to 1.5:1 as against 1.33:1. | Twelve respondents have firmly indicated that the four disciplines should be followed with the objectives of achieving supply of need-based credit together with observance of financial discipline. However, banks should have discretion in permitting deviations from norms for inventory & receivables.<br><br>Six others have suggested for continuation of these disciplines with major modifications as under<br><br>(a) Norms for inventory & receivables should vary from borrower to borrower and need not be pre-determined.<br><br>(b) The existing cut-off point (Rs.50 lakh and above) for applicability of the Second Method of Lending be enhanced to Rs.1 crore and above.<br><br>(c) For fixing MPBF total outside liability/tangible net worth be fixed for each type of industry.<br><br>(d) Sanction could be separate for core working capital need and fluctuating working capital need as recommended by the Chore Committee. | Remaining five respondents have suggested for continuation of the four disciplines.<br><br>One has suggested for raising the limit for applicability of the Second Method of Lending from Rs.50 lakh and above to Rs.1 crore and above.<br><br>Two have suggested for flexibility while using norms for inventory and receivables.<br><br>One has suggested that applicability of QIS discipline be raised from existing Rs.50 lakh and above to Rs.3 crore and above. | Remaining nine respondents have suggested for continuation of annual review of accounts and submission of quarterly information system statements though a few among these nine has suggested for use of banks' own information statement proformae rather than using those prescribed by the RBI.<br><br>Regarding Method of Lending, five have suggested (the other four out of nine have not offered comments) abolition of the present set of guidelines and each bank may decide its own methodology based on various financial and/or accounting ratios.<br><br>All the nine respondents have suggested total abolition of norms for inventory and receivables and it be replaced with -<br><br>(a) Each bank to decide exposure limit on each individual borrower(one respondent);<br><br>(b) Each bank to fix borrowing norms as defined by gearing ratios, liquidity |

| (1) | (2) | (3) | (4) |
|---|---|---|---|
| | (e) Banks be delegated with power to decide the Method of Lending depending on the overall financial strength of the borrower and that there is no slip back in debt-equity ratio.<br>(f) Minimum current-ratio be reduced to 1.25:1 from 1.33:1. | | ratios and debt/interest servicing ratios (one respondent); and<br>(c) Inventory and receivable norms provided by RBI are to serve as references (one respondent). |

<u>Question</u> : Keeping in view the nature of answers to the preceding questions, (2) & (3), banks may suggest/indicate <u>whether</u> any <u>changes are called for</u> in the extant directives/guidelines/instructions on analysis/appraisal/monitoring/sanction of working capital and term loan proposals.

| (1) | (2) | (3) | (4) |
|---|---|---|---|
| Respondents are of the view that RBI guidelines are necessary for adoption of uniform practice among banks. One of them has also suggested for continuation of post-sanction scrutiny by the RBI. Two have, however, also suggested that gradually banks should develop their own guidelines. | Three respondents have not offered views.<br>Certain changes suggested by the remaining respondents are as under :<br>(a) Borrowers may be permitted to divert funds to the extent their current ratio does not slip back below 1.33:1 (two respondents);<br>(b) Time limit for submission of Form No.I and Form No.II under QIS be fixed at 2 to 3 weeks from the close of the last quarter (one respondent);<br>(c) Submission of QIS Form I may be discontinued (three respondents); | Six respondents have not offered views.<br>Certain changes suggested by the remaining three respondents are as under :<br>(a) SCC norms may be abolished (one respondent) ;<br>(b) Some flexibility from the single/group borrower exposure limits is required (one respondent); and<br>(c) Inspection of stocks should be carried out every month (one respondent) | Four respondents have not offered views.<br>Specific suggestions offered are as under :<br>(a) There should not be any credit control for borrowal accounts upto Rs.10 crore and/or any directive/guideline for banks by the RBI. For accounts involving Rs.10 crore to Rs.100 crore, simple credit control system (as specified in details in the response) is to be evolved and only for accounts of more than Rs.100 crore direct RBI control through periodic returns is necessary (one respondent);<br>(b) Role of RBI should be restricted to monitoring the overall credit aggregates and financial soundness of individual banks (five respondents), and |

| (1) | (2) | (3) | (4) |
|---|---|---|---|
| | (d) Export receivables are to be completely excluded for calculation of MPBF (one respondent);<br>(e) SCC directives should be withdrawn [one respondent];<br>(f) Post-sanction scrutiny of sanctions by RBI should be discontinued and replaced by RBI obtaining monthly information about sanctioned limits and their utilisation by large borrowers (one respondent); and<br>(g) Directive on compliance with bill culture be withdrawn (one respondent) | | (c) Individual credit decisions should be left to the banks' perception of risk in lending to the corporates and the availability of credit should be determined by supply and demand forces. Borrowers should be given freedom to choose the banks based on pricing and their perception of services being offered (one respondent). |
| | <u>Question</u> : In case the quantitative norms for holding of inventory and receivables continue to be the yardstick for determining quantum of bank finance, should there be <u>sub-norms</u> for each item of inventory and for receivables or <u>should it be based on the overall production cycle of the industry</u>? Should RBI (Central Banking Authority) prescribe these norms as hitherto or should it be left to the banks? | | |
| Respondents are of the view that while RBI may continue to prescribe inventory norms, these should more be used as guidelines rather than mandatory and banks should have the discretion of | Four respondents have not offered views.<br>Majority (eleven) of the remaining respondents are of the view that the quantitative norms, particularly, sub-norms, should be dispensed with as sub-norms bring about rigidity in the system. | Four respondents have not offered views.<br>Three respondents are of the view that fixation of sub-norms, if any, should be left to the discretion of individual banks, which may fix the same | Five respondents have not offered views.<br>Seven respondents have suggested that quantitative norms should be dispensed with and banks be advised to fix individually such norms on the basis of overall production cycle for each industry. |

| (1) | (2) | (3) | (4) |
| --- | --- | --- | --- |
| inter-changability within the total production cycle. | Two respondents are in favour of continuation of sub-norms but banks should have more flexibility in their application/use. They are of the view that RBI should continue to fix such sub-norms keeping in view the overall monetary and credit policy. One of them has further stated that delegation of power to banks may lead to unhealthy/unethical competition amongst banks.<br><br>Four respondents are of the view that RBI should continue to prescribe norms through its Committee of Direction because -<br><br>(a) Individual banks do not possess adequate expertise, manpower, machinery, data, etc., in the given area;<br><br>(b) In case, individual banks are given the freedom to fix up the norms, there could be disparities; and<br><br>(c) It would lead to confusion in assessing the working capital requirements of an account falling within the purview of consortium discipline. | within the overall production cycle of the industry.<br><br>The remaining two respondents are of the view that RBI should continue to fix norms (not sub-norms) for uniformity. | One respondent is of the view that RBI should compute norms (as banks are not equipped to undertake such studies). But norms should be as few as possible and [redacted] no [redacted] sub-norms are required. |

| (1) | (2) | (3) | (4) |
|---|---|---|---|
| **PERCENTAGE LEVEL OF COMPLIANCE WITH LENDING DISCIPLINE AS AT THE END OF DECEMBER, 1992** | | | |
| **TIMELY REVIEW OF ACCOUNTS** | | | |
| 67.50% | 53.75% | 53.91% | 84.97% |
| **NORMS FOR INVENTORY AND RECEIVABLES** | | | |
| 87.96% | 87.01% | 96.77% | 66.16% |
| **FIRST METHOD OF LENDING** | | | |
| 71.66% | 44.52% | 66.94% | 46.35% |
| **SECOND METHOD OF LENDING** | | | |
| 74.46% | 79.48% | 68.61% | 60.40% |
| **QUARTERLY INFORMATION SYSTEM** | | | |
| 78.20% | 77.19% | 53.04% | 64.75% |

**Time taken for disposal of loan proposal**

| Type of loan proposal | Proposals received during the period January 1992 to December 1992 | Time taken for final disposal | | Average(Weighted) time taken for disposal | |
|---|---|---|---|---|---|
| | | Minimum | Maximum | Minimum | Maximum |
| (1) | (2) | (3) | (4) | (5) | (6) |
| | | State Bank of India and its Associates | | | |
| | | No. of respondents 6 | | | |
| Fresh loan proposal | 1392 | 4 to 30 days | 18 to 90 days | 7.69 | 37.63 |
| Renewal of loan proposal | | | | | |
| - without change | 2869 | 3 to 15 days | 11 to 90 days | 4.36 | 21.81 |
| - with enhancement | 1454 | 4 to 24 days | 12 to 75 days | 7.74 | 28.15 |

| (1) | (2) | (3) | (4) | (5) | (6) |
|---|---|---|---|---|---|
| Ad-hoc limits | 360 | 2 to 15 days | 4 to 15 days | 5.24 | 20.62 |
| Additional limits | 241 | 3 to 22 days | 4 to 60 days | 4.95 | 17.07 |
| Others | 57 | - | - | - | - |
| | Nationalised Banks | | | | |
| | No. of respondents 17 | | | | |
| Fresh loan proposal | 10,589 | 1 to 75 days | 30 to 240 days | 12.27 | 69.23 |
| Renewal of loan proposal | | | | | |
| - without change | 12,764 | 1 to 75 days | 10 to 240 days | 10.96 | 75.74 |
| - with enhancement | 6,923 | 1 to 75 days | 15 to 180 days | 13.21 | 61.39 |
| Ad-hoc limits | 5,590 | 1 to 75 days | 7 to 150 days | 4.19 | 20.72 |
| Additional limits | 3,795 | 1 to 75 days | 10 to 180 days | 5.60 | 29.43 |
| Others | 7,886 | 1 to 75 days | 3 to 150 days | 2.92 | 18.99 |
| | Other Banks | | | | |
| | No. of respondents 8 | | | | |
| Fresh loan proposal | 2,113 | 3 to 30 days | 45 to 150 days | 12.86 | 119.97 |
| Renewal of loan proposal | | | | | |
| - without change | 906 | 2 to 30 days | 14 to 120 days | 14.13 | 83.04 |
| - with enhancement | 480 | 2 to 30 days | 21 to 120 days | 11.42 | 57.04 |
| Ad-hoc limits | 270 | 1 to 30 days | 7 to 90 days | 2.96 | 25.37 |
| Additional limits | 81 | 2 to 30 days | 10 to 90 days | 15.01 | 41.21 |
| Others | 10 | 2 to 10 days | 7 to 31 days | 6.00 | 19.00 |

| (1) | (2) | (3) | (4) | (5) | (6) |
|---|---|---|---|---|---|
| | Foreign Banks | | | | |
| | No. of respondents 11 | | | | |
| Fresh loan proposal | 367 | 1 to 30 days | 15 to 60 days | 8.26 | 29.74 |
| Renewal of loan proposal | | | | | |
| - without change | 1,072 | 1 to 30 days | 15 to 60 days | 5.92 | 17.76 |
| - with enhancement | 1,075 | 1 to 30 days | 15 to 60 days | 11.57 | 28.09 |
| Ad-hoc limits | 234 | 1 to 7 days | 4 to 45 days | 1.58 | 7.21 |
| Additional limits | 107 | 1 to 15 days | 10 to 45 days | 9.55 | 25.30 |
| Others | 85 | - | - | - | - |

ANNEXURE III

Names of banks/institutions/organisations/ persons, who submitted oral/written comments/ suggestions/views to the Group

(A) TRADE & INDUSTRY

1. Bombay Chamber of Commerce and Industry
2. Confederation of Indian Industry
3. Federation of Associations of Maharashtra
4. Federation of Indian Chambers of Commerce and Industry
5. Federation of Indian Export Organisations
6. Indian Chamber of Commerce, Calcutta
7. The Associated Chambers of Commerce & Industry of India

(B) INDIVIDUALS

| | | |
|---|---|---|
| 1. | Mr. Sanjeev Bhasin | Manager, Corporate Banking, The Hongkong and Shanghai Banking Corporation Limited |
| 2. | Mr. Ravish Chopra | Deputy Chief Executive Officer, The Hongkong and Shanghai Banking Corporation Limited |
| 3. | Shri J.M. Gandhi | Mutual Industries Limited |
| 4. | Shri Ramesh Gelli | Chairman, Vysya Bank Limited |
| 5. | Shri V.A. Gore | Manager, I-Sec (ICICI) |
| 6. | Shri Supriya Gupta | Deputy Managing Director, State Bank of India |
| 7. | Shri N.R. Kulkarni | Executive Vice President (Finance), Hindustan Motors Limited |
| 8. | Prof. Sampat P. Singh | Visiting Faculty, IIM, Ahmedabad and NIBM, Pune |
| 9. | Dr. R. Srinivasan | Retired Chairman and Managing Director of Bank of India |
| 10. | Shri N. Vaghul | Chairman, ICICI |

(C) INSTITUTES

National Institute of Bank Management, Pune

(D) BANKS

1. ABN - AMRO Bank
2. American Express Bank
3. Andhra Bank
4. ANZ Grindlays Bank
5. Bank of America
6. Bank of Baroda
7. Bank of India
8. Bank of Maharashtra
9. Banque Nationale de Paris
10. Bareilly Corporation Bank Limited
11. Canara Bank
12. Central Bank of India
13. Corporation Bank
14. Credit Lyonnais
15. Dena Bank
16. Hongkong Bank
17. Indian Bank
18. Indian Overseas Bank
19. Karnataka Bank Limited
20. Nainital Bank Ltd
21. New Bank of India
22. Oman International Bank
23. Oriental Bank of Commerce
24. Punjab and Sind Bank
25. Punjab National Bank
26. Societe Generale
27. Sonali Bank
28. Standard Chartered Bank
29. State Bank of Bikaner and Jaipur
30. State Bank of India
31. State Bank of Indore
32. State Bank of Mysore
33. State Bank of Patiala
34. State Bank of Travancore

35. Syndicate Bank
36. The Benares State Bank Limited
37. The British Bank of the Middle East
38. The Catholic Syrian Bank Limited
39. The Federal Bank Limited
40. The Punjab Co-operative Bank Limited
41. The Ratnakar Bank Limited
42. UCO Bank
43. Union Bank of India
44. United Bank of India
45. Vijaya Bank