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## Credit Monitoring Arrangement (CMA Data) And MPBF Method Of Working Capital Finance – An Insight

Rahul Sharma

B.Com, FCA, MBA (Fin.), LL.B., CAIIB

Senior Manager – UCO Bank,

152/41, Shipra Path, Opp. Patel Marg,

Mansarovar, Jaipur - 302 020

**Brief History and Background :-** Prior to CMA implementation i.e. between 1965 and 1988 another mechanism called Credit Authorization Scheme (CAS) was the key instrument for credit control in India. CAS was being used by the RBI to regulate Bank Credits exceeding prescribed limits. Under CAS mechanism provision of prior approval of RBI was required for sanctioning and dispensation of big credit proposals. RBI authorization was causing long delays which were disliked by Banks and customers. A better system of Monitoring and disbursement was the main concern of the country's central bank.

Concept of CMA came into being in 1975 as a result of recommendation of the guidelines given by the Chore committee and Tandon group in 1974. However the CMA was introduced in the banking system in 1988. The aim of CMA was to prevent delays in loan approval and disbursement. Later on in 1997 MPBF concept was withdrawn by the RBI (The Central Bank) and consequently the CMA was also scarped at their end. Procedure of Working Capital Limit Assessment has been left at the discretion of the banks, Boards of Banks were given power to device their own policies. Even if MPBF is not mandatory and CMA is not compulsory banks are continuing with the same system which was introduced in 1988.

**Credit Monitoring Arrangement (CMA) Format – An analysis :-** CMA format is a report on Past and Projected Performance of the applicant. It has an aim to understand Financial Health, It also provide information as to how applicant has procured funds and used them in past 2 years and how same will be done in next 3 years. Basically CMA ensure sanctioning of funds to sound businesses only. Not only arithmetical accuracy but also scientific (Logical) approach is needed in CMA preparation. **Form I (Concept)** : This is the first part of the CMA data which present details about Fund Based and Non Fund Based Limits, this part provide details about usage limit and credit history of the applicant. This part also inform that applicant has clean credit history and proposed limits are in conformity fund limits. **(Procedure Intricacies)** : *(Sub Head A)* Information should be provided in respect of each working capital Facility Viz. Cash Credit/OD/EPC/WCTL/Bills Purchased and Discounted. Details about Quasi Credit (Non Fund Based) Viz. LC/BG/co acceptance to be included. *(Sub Head B)* Details of DPG (Loan backed by Deferred Payment Gurantee (DPG) /Term Loan/Foreign Currency Loans (Excluding WCTL) is to be provided in this sub head. Foreign Currency Loans which are not covered by DPG are to be shown separately. Exchange rates used for

conversion of Foreign Currency Loans are to be indicated. In case of multi division companies, if separate limits are availed for different divisions then Form I has to be filled division wise. Credit Facilities which are outside consortium to be indicated separately. Maximum/Minimum utilization of facilities during past 12 months and their recent outstanding balances are to be shown. Information on Associate Companies should be given separately in Form I Annexure. Nature of Association to be indicated. Date upto which accounts are made is also to be indicated. **Form II (Concept):** Form II deals with Operating Statement. This Form is there to Analyze in a scientific (Logical) manner current and projected growth capacity of the applicant/borrower. It is conversion of Growth Opportunities available in figures and also a roadmap of the organization to materialize those opportunities in real terms. **(Procedure Intricacies)** : For Last Two Years if Audited Figures are not available we may go for Un Audited figures. Assumptions on which projections are based Viz. Sales (Turnover), Profitability, Stock, Receivables, Other Current Assets (OCA), Current Liabilities (CL), Other Current Liabilities (OCL) to be clearly defined and scientifically (Logically) evolved. In case applicant has multiple divisions then division wise data is must for Form II and Form IV & is Optional for Form III (Where ever Possible). Sales/Costs etc. are to be projected at current ruling prices and in no case should comprise provisions for Price Escalation. If Projections shows wide variation as compared to trends details like Quantity and Units price to be shared with the form (Truth lies in details – Is the fundamental rule). Income/Expenditure related with subsidiaries/holding companies are to be provided by way of foot note. **Form III (Concept)** : This is the form for Balance Sheet Analysis. It indicates *Financial Soundness* of the Applicant/Borrower. Under this form Current/Non Current Assets and Current/Non Current Liabilities are analyzed. This form concludes Networth Position of the borrower. Here also 2 years Audited and 3 Years Projections are used. **(Procedure Intricacies)** : Projected carrying cost of Inventory and Receivable should be in conformity with norms/past trends/usual levels – If they are higher than there has to be reason thereof (Scientific and Logical). *Exclude* – Carrying of Inventory for speculative purposes and commodities under selective credit control provisions. Imported Spares more than 12 month and Domestic Spares more than 9 month consumption is to be categorized as Non Current Assets. Projected Level of Current Assets other than Inventory & Receivables and Current Liabilities are also to be compared with past trends. If variations are there then they have to be explained by way of logic and details. While preparation of CMA – valuation principles accepted for Financial Statement Preparation are to be followed. Current Liabilities and Current Assets are to understood in the way Banks understands them and not as per their accounting definitions. Specific provisions for Known Liabilities e.g. Dividend, Tax etc are to be made. Details of Term Liabilities raised during the Year are to furnished separately i.e. Term Loan, DPG, Long Term Deposits. Though Bills Purchased and Discounted are Contingent Liabilities yet they are to be shown in Form III item 28 (i) & (ii) and Form IV item 5 and 6. Outstanding Liability for credit purchases under usance LC/Co Acceptance facility from banks should be shown under point no. 3 of Form III. In case of Seasonal Activity based borrower where Peak Level is not achieved on Balance Sheet date, data in respect of peak levels is to be provided separately. Details of Holding / Subsidiary i.e. Name, Extant & nature of holding interest is to be provided as foot note under Form III. **Form IV (Concept)** : This form deals with Changes in Working Capital position of the Applicant/Borrower. This is comparative analysis of the movement of Current Assets and Liabilities. This is a form which shows ability of the Applicant/Borrower to meet daily working capital on it's own and also shows How much assistance is needed to meet working capital requirement of Applicant/Borrower. **Form V (Concept)** : This form calculates the capacity of the borrower/applicant to borrow money. It is actually the borrowing capacity (at sustainable level) in numerical terms which is calculated on the basis of the recommendation of Chore and Tandon Committee. Where Two method of Lending were prescribed and 2<sup>nd</sup> Method was termed superior than the 1<sup>st</sup> one. MPBF is applicable only for the cash credit component of borrower limit – MPBF calculates Drawing Power. **(Procedure Intricacies)** : This is applicable in all cases other than Sick/weak units MPBF has to be calculated on the basis of 2<sup>nd</sup> method of lending. In case Applicant/Borrower wants to opt for 1<sup>st</sup> method then proper reason has to be assigned for the same. **Form VI**

**(Concept)** : Form VI is of Fund Flow Statement. This form ensure the Borrower/Applicant has sufficient fund available to carry on operations further This statement also ensure that Borrower/Applicant is using funds properly or not. **(Procedure Intricacies)** : If there is unreasonable flow of fund towards Inventories and Receivables and there is substantial increase in their figures then that should be explained. If there is substantial decrease in Current Liabilities then changes there in has to be explained. Similarly if there is Increase in Working Capital which is not commensurate with the changes in sales figure then that has increase has to be explained. (Truth lies in details – Is the fundamental rule). **Form VII (Concept)**: Form VII is for ratio analysis. This is the concluding part of CMA which summarizes the applicant's/Borrower's growth and Loan Repayment Capacity.

### **Rigidities in the MPBF method and the relaxations permitted by RBI :**

Certain rigidities have crept in the process, which became more prominent during 1990s during the initiation of process of financial liberalization in India. We may summaries these rigidities in the following manner:-

1. **Many of the items classified as Current Assets and Current Liabilities did not fit with the principle of Asset backed financing** :- As the concept of MPBF is Asset backed Finance (Asset-backed finance is when a loan is taken out by a business using its already existing assets as a way to secure payment. Likewise, the assets to secure payments include buildings, offices, vehicles, IT software, and equipment, but this time it can also include inventory and unpaid invoices, also known as accounts receivable.) which itself is substituted by concept of Asset Finance. There are Current Assets and Current Liabilities which are not fit for Asset Backed Finance. Example of such current assets are security deposits made with government departments and example of Current Liabilities are Short term loans. This left a substantial gap between MPBF assessed and credit amount delivered.
2. **The Standard Current Ratio(CR) of 1.33 was viewed a stiff target**: Industry and large section of practicing bankers observed that establishing current ratio as 1.33 a benchmark is a very stiff target for some industries. Example of such industries are BPOs/KPOs and other service units, Departmental stores (They have low receivables and high payables) etc. However on account of the mandatory nature of the compliance, the CR was always required to be projected at the level of 1.33 (minimum) on the basis of which the MPBF was calculated. In most of the cases is resulted in the actual CR falling short of the standard (accompanied with the excess borrowing). At the time of the renewal of the working capital credit limits, it was a difficult proposition for the bankers to explain the basis of such proposition.

As the bankers experienced difficulty in complying with MPBF prescriptions, more so, because they had to compete with other banks for quality lending business (which demands a dilution in the rigidities in case of creditworthy borrowers), RBI made optional the use of MPBF prescriptions by the lending banks, in its credit policy of 1997. Thus banks were now allowed to evolve their own logical and rational system of Working Capital computation method. Most of the banks, however modified the process of classification of Current Assets (CA) and Current Liabilities (CL) for computation of WC Gap and validation of holding norms, while retaining the basic structure of MPBF method. The manner of reclassification and recognition of CA and CL has not been uniform across the various banks, and this leads to an element of heterogeneity in the WC assessment system done by the individual banks.

**Box Diagram Current Assets Financing as per Tandon Committee**

Other Current Liabilities	Current Assets consisting of Inventory, Receivables And Other Current Assest
Bank Borrowing	
Net Working Capital (Part of Net Worth)	

Example :A term loan of Rs. 500 lacs is disbursed for 5 yrs to purchase plant and machinery. Installment of Rs. 100 lacs is due within next 1 year. This 100 lacs [termed as Other Current Liabilities (OCL) has financed Fixed Assets and not Current Assets.

Applying this logic to the box diagram above we come to the conclusion that the Tandon Committee assumes that the OCL (Other Current Liabilities) funds Othet Current Assets (OCA) like Cash, Advance Tax etc. on which lenders do not enjoy a security interest and OCA & OCL level match. As a corollary, the working capital gap becomes equal to the level of Chargeable Current Assets.

If Bills are discounted they find place on both side of balance sheet. As current assets they ought to have margin of 25% but credit is delivered to customer without margin which is reflected on the liability side.

**Suggested Approach:**

These inconsistencies result into a substantial gap between WC assessment and WC delivery, if one follows the MPBF computation method in it’s present form. Following modification may be suggested in the MPPBF computation that would ensure a convergence between the assessment and delivery of WC credit, while removing the anomalies observed in the above analysis :

1. The Installment of term loan payable during the ensuing year be treated as part of the long Term Loan. However, irregularities in Term Loan may be treated as Other Current Liabilities (OCL). Bills discounted may be eliminated from both Assets and Liabilities side of the Balance Sheet. This can be added later to find out the full bank borrowing limit by the bank.
2. The current liabilities may be classified into 3 categories : i. Trade Credit, ii. Bank Borrowing and iii. Other Current Liabilities(OCL). Term OCL may be redefined under suggested approach.
3. Similarly the current assets may also be classified into three major categories i.e. i. Inventories i. Receivables and iii. Other Current Assets (comprising Cash, Advance Tax etc.). Charge can be created for I and ii hence they can be called chargeable and financing against them is possible under Asset backed financing mechanism which is the core of MPBF.

**Box Diagram : Suggested Approach for Current Assets Financing**

Trade Credit	Inventory (Unpaid)
Fundable WCG funded by Net Working Capital and Bank Borrowing	Inventory (Paid Up)
	Receivables
Other Current Liabilities	Other Current Assets

(Source : Credit Appraisal, Risk Analysis and Decision Making by D.D. Mukherjee)