Quadrant II - Notes

Paper Code: COG101

Module Name: forms of lending

FORMS OF LENDING

Cash credit,

- Overdraft,
- Loans,
- Demand loan vs. term loan,
- Secured vs. unsecured loan,
- Participation loan or consortium loan,
- Purchasing and discounting bills.

These types of advances are explained below.

Cash Credit

Cash Credit is an arrangement by which the customer can borrow money up to a certain limit known as the 'cash credit limit.' Usually, the borrower is required to provide security in a pledge or hypothecation of tangible securities. Sometimes, this facility is also provided against personal security.

This is a permanent arrangement, and the customer need not draw the sanctioned amount at once but draw the amount as and when required.

He can put back any surplus amount which he may find with him. Thus cash credit is an active and running account to which deposits and withdrawals may be affected frequently.

Interest is charged only for the amount withdrawn and not for the whole amount approved. If the customer does not use the cash limit to the foil extent, a commitment charge is made by the bank. This charge is imposed on the un-utilized portion of cash credit only.

Cash credit provides an elastic form of borrowing since the limit fluctuates according to the needs of the business. Cash credits are the most favorable mode of financing by large commercial and industrial concerns.

Overdraft

Oxford Dictionary of Finance and Banking defines overdraft as “a loan made to a customer with a cheque account at a bank or building society, in which the account is allowed to go into debt, usually up to a specified limit.”

According to the Cambridge Advanced Learner’s Dictionary, overdraft means “an amount of money that a customer with a bank account is temporarily allowed to owe to the bank or the agreement which allows this.”

The Economist defines an overdraft as “a credit facility that allows borrowers to draw upon it (up to a specified limit) as and when they need to. Borrowers pay only for what they use”.

Overdraft is an arrangement between a banker and his customer by which the latter is allowed to withdraw over and above his credit balance in the current account up to an agreed limit. This is only a temporary accommodation usually granted against security.

The borrower can draw and repay any number of times, provided the total amount overdrawn does not exceed the agreed limit. The interest is charged only for the amount drawn and not for the whole amount sanctioned.

A cash credit differs from an overdraft in one respect. Cash credit is used for the long-term by businesses in regular business, whereas overdraft is made occasionally and for a short duration.

Banks sometimes grant unsecured overdrafts for small amounts to customers having a current account with them. Such customers may be government employees with fixed incomes or traders.

Temporary overdrafts are permitted only where a reliable source of funds is available to a borrower for repayment.

Loans

As defined in Oxford Dictionary of Finance and Banking, the loan is the "money lent on condition by a bank that it is repaid, either in installments or all at once, on agreed dates and usually that the borrower pays the lender an agreed rate of interest (unless it is an ail interest-live loan)."

Oxford Dictionary of Finance and Banking defines a bank loan as "a specified sum of money lent by a bank to a customer, usually for a specified time, at a specified rate of interest."

According to Cambridge Advanced Learner's Dictionary, a loan means "a sum of money which is borrowed, often from a bank, and has to be paid back, usually together with an extra amount of money that you have to pay as a charge for borrowing."

W. Kocli defines loans as "a formal agreement between a bank and borrower to provide a fixed amount of credit for a specified period."

Ease of loan, the banker advances a lump sum for a certain period at an agreed rate of interest- The entire amount is paid on occasion either in cash or by credit in his current account, which he can draw at any time. The interest is charged for the full amount sanctioned whether he withdraws the money from his account or not.

The loans may be repaid in installments or at the expiry of a certain period. The loan may be made with or without security.

Once repaid in full or in part, a loan cannot be withdrawn again by the customer. In case a borrower wants a further loan, he has to arrange for a fresh loan.

Demand Loan Vs. Term Loan

The loan may be a demand loan or a term loan.

A demand loan is payable on demand. It is for a short period and is usually granted to meet the working capital needs of the borrower.

Term loans may be medium-term or long-term. Medium-term loans are granted for a period ranging from one year to five years for vehicles, tools, and equipment.

Long-term loans are granted for capital expenditures such as the purchase of land, construction of factory building, purchase of new machinery, and modernization of plant.

Secured Vs. Unsecured Loan

According to section 5(e) of the Bank Companies Act, 1991, “Secured loan or advance means such a loan or advance as made against the security assets, the market value of which is not at any means less than the amount of such loan or advance and unsecured loan or advance is that loan or advance or part of it does not require sanctioning against the security.”

Participation Loan or Consortium Loan

One loan is granted by more than one financing agency, termed a participation or consortium loan.

Such participation becomes necessary where either the risk involved is too large for one or more of the participating institutions to take individually or there are administrative or other difficulties in servicing and follow up the loan.

Purchasing and Discounting Bills

Bills of exchange, as defined in the Negotiable Instruments Act, 1 SSI, is “an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay (on-demand or at a fixed or determinable future time) a certain sum of money only to, or to the order of, a certain person or the bearer of the instrument.”

Banks grant advances to their customers by discounting bills of exchange. The net amount, after deducting the amount of interest/discount from the amount of the installment, is credited to the account of the customer.

In this form of lending, the interest is received by the banker in advance. Banks sometimes purchase the bills instead of discounting them.

Bills accompanied by **the document of title** to goods such as bills of lading or railway receipt are purchased by the bankers.

In such cases, the banker grants a loan in the form of overdraft or cash credit against the security of the bills.

The term ‘bill purchased’ seems to imply that the bank becomes the purchaser or owner of such bills. But in almost all cases, the bank holds the bill only as a security for the advance.