Quadrant II – Transcript and Related Materials

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Unit 1: Bank Credit

Module Name: Types of Credit

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Notes

Types of Credit

Following are the types of credit facilities extended to business firms by the lending intuitions:

- Demand Loan
- Cash Credit
- Overdraft
- Term loan

Demand Loan:

Demand loan also termed as Working Capital Demand Loan (WCDL) is basically the ready to repay loan on demand of the lenders. In demand loan, the financiers or lenders can ask for the lent money to be repaid by the borrower in relatively shorter duration. The borrowers also have the liberty to repay the amount anytime without facing any pre-payment charges. Demand loan is a form of short-term finance with no fixed tenure.

The common purposes for opting for a demand loan are as follows:

- Short-term funding for start-up businesses
- To meet daily and temporary working capital requirements
- Used for raw material purchase
- Paying office space rent and salaries
- Purchasing small assets like cars, farm animals or equipment

Features of demand loan are as follows:

- Demand loans are basically secured loans granted by the lenders against collateral.
- Borrowers needs to pay the interest only on the used amount.
- Borrowers doesn't have to worry about long-term EMIs.
- Borrowers has the flexibility to make a small payment until they are eligible to pay the whole amount.
- The loan amount or tenure is fixed by the lenders in consultation with the borrower.
- The loan tenor shall not be less than seven days.
- Loan component can be split by the banks, with different maturity periods as per the needs and requirements of the borrowers.

Cash Credit:

Cash credit (CC) is a facility to withdraw money from a current bank account without having credit balance but limited to the extent of borrowing limit, which is fixed by the commercial bank. The interest in this facility is not charged on the borrowing limit, which is given by the bank but on the daily closing balance. CC is a very common facility by banks. It is one of the essential short-term sources of finance for a business. The availability is also not very difficult.

Features of cash credit are as follows:

1. In the cash credit facility, there is a limit on the maximum. Till this limit is not exhausted, the borrower can withdraw and deposit funds any number of times.
2. Unlike other types of loans, the interest here is charged on the daily closing balance of the cash credit current account and not on the sanctioned amount.
3. A bank would levy minimum commitment charges in the situation when the borrower is not using the cash credit account.
4. A cash credit facility is extended against security. Securities may be in the form of stock, debtors, etc. as primary security and fixed assets and other immovable properties, etc. as collateral security.
5. The limit allowed is valid for one year, and then the drawing power will be re-evaluated.
6. Upon studying a company's books of accounts and income-tax filings of the promoters, a bank will decide on the amount to sanction. It may range anywhere between 50%-75% of the collateral offered as security.
7. Cash credit is shown in current liabilities under the sub-head "Short Term Loans" in the balance sheet for accounting purposes.

Overdraft:

An overdraft is a financial instrument to provide an extension of credit when the savings or current account balance reaches zero. Most of the banks offer an overdraft limit depending on the customer's existing relationship with the bank. Bank also charges the interest and fees on exceeding the overdraft limit of the accounts. There are two types of overdrafts - Secured overdrafts and unsecured overdrafts.

- Secured overdrafts are the ones that are taken against one’s saving or current account.
- Unsecured Overdrafts are the ones that are not taken against any collateral are known as unsecured overdrafts.

An overdraft facility works like an approved loan where the interest is charged only on the utilized amount. An overdraft facility helps individuals and self-employed businessmen to resolve short term cash flow issues as customers can avail of this facility through various platforms like a mobile app, internet banking, or visiting the bank branch.

The features of availing overdraft facility are:

- The credit limit of every borrower varies from bank to bank. The limit is predetermined on the customer relationship with the bank.
- The interest rate of overdraft loan is calculated on the amount of overdraft used. The amount is calculated daily and billed at the month-end.
- There are no prepayment charges on using the overdraft facility.
- The credit taken through an overdraft facility is not paid in EMI’s. The customers can repay the overdraft loan cumulatively.

Term loan

A term loan is a funding from a bank for an amount that is to be repaid as per EMI (Equated Monthly Instalment) schedule. The interest rate can be either fixed or floating rate as per the choice of the borrower. Term loan can be extended for variety of purposes including setting up of business, working capital expense, purchase of equipment, overhaul of plant and machinery etc. The loan tenure can range between 1 year to 3 years to 10 years. The tenure may be extended on a case-to-case basis up to 30 years. Shorter-term credits can be extended for companies which need funds but do not qualify for longer term credit. Term loans are extended for both green field and brown field projects.

Types of Term Loans:

1. Short-term loan: The loans are for less than a year or up to 18 months. These companies may also be ones that do not qualify for longer tenure of credit.
2. Intermediate term loan: The period for such loans could vary from 2 year – 5 years. These loans could be critical for company’s cash flow. Typically, companies which are new and have established afresh may need such intermediate term loans.

3. Long-term loan: These loans can run anywhere between 5 years – 10 years. The company’s assets are offered as collateral. The repayment could be either monthly or quarterly as per the company’s profit or cash flow recognition.

Features of term loans are:

- Term loans are secured loans, the asset purchased will be collateral to the lender.
- At times term loans can also be unsecured, in which case the interest rate would be higher.
- Regardless of the financial situation of the company (borrower), the loan must be repaid over the fixed term.
- The proposal is evaluated for credit risk, loan amount and tenure for which the loan is taken and the interest rate on the loan will be adjudged.
- Rate of interest will be negotiated between the lender and borrower at the time of loan distribution.
- Term loans will have a tenure of 5 – 10 years, repayment is made in instalments.
- Tenure can be re-scheduled in the case the borrower is in financial distress.
- Based on conditions, the term loan can be converted into equity holding.
- Defaults are subject to penalty levied by lender.
- Commitment fee is charged on the unutilized loan amount.
- Principal loan amount is repaid after the initial grace period of 1-2 years.
- Towards the end of the tenure, the instalment is likely to have higher principal amount and lower interest amount.

Basic differences between the loan types:

Differences between demand loan and term loan can be studied under following categories.

1. **Purpose**: Demand loans are basically sanctioned to meet the working capital financial need such as purchase of small equipment, raw materials or repaying short-term liabilities whereas, term loans are basically granted for starting a new business or expansion of existing business, purchase of land/plant, machinery for setting up factory etc.
2. **Tenure:** Demand loan is generally granted for a short-term ranging from minimum 7 days to few months whereas, term loan is granted for mostly 1 year to 20 years.
3. **Repayment**: Demand loan has open-ended repayment schedule. Borrowers can repay the borrowed amount anytime when they have surplus amount. But they are subjected to repay the entire loan amount anytime on demand of the lender. Term loans have a specified repayment terms with fixed instalment facilities. Interest is charged on the principal amount in this case.

4. **Interest**: In demand loan, interest is charged on the amount used by the borrowers instead of the total loan amount but in the term loan, interest is charged on the whole amount sanctioned as a loan.
5. **Security**: Demand loans are sanctioned by banks or financial institutes against some kind of security as goods or stocks, shares, land building or any other assets. However, in case of term loan, mortgage of land, plant and machinery, building may be shown as the security to avail the loan.
6. **Penalty**: In demand loan there is no such penalty for pre-payment which is normal to other loans with fixed lock-in period but in term loan, the borrower has to pay a penalty amount in case of repayment of their borrowed money before maturity term.

Difference between cash credit and overdraft:

1. Interest rate is lower in Cash credit but comparatively higher in overdraft.
2. Cash credit loan can be availed on hypothecation of stocks and inventory whereas, Overdraft amount can be availed based on credit history, relationship with bank and investments like FDs, insurance policies, etc.
3. Cash Credit should be availed for business purposes, only. However, Overdraft can be used for any purpose.
4. Loan amount is based on financial statements and security deposited on the volume of stocks and inventory including business related requirements in cash credit.
5. Cash Credit does not reduce over time but there is a monthly reduction in case of Overdraft.
6. To avail Cash Credit, new account needs to be opened. Overdraft facility is availed on existing account of the applicant (account holder).
7. Cash credit loan can be availed for minimum 1 year. Overdraft facility can be availed for shorter tenure like a month or quarter, maximum for 1 year.
8. Cash credit loans can be availed by individuals, retailers, traders, manufacturers, distributors, companies, partnerships, sole proprietorship, LLPs, etc. Overdraft facility can only be availed by account holders of the respective bank.
9. Cash credit is sanctioned based on the business performance and market situation.