Tutorial Notes

Class: M.Com, Semester IV (MC 4.3 / EC3)

Subject: Financial Institution &Market

Topic: Depository Institutions

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Bank Credit

Bank credit is usually referred to as a loan given for business requirements or personal needs to its customers, with or without a guarantee or collateral, with an expectation of earning periodic interest on the loan amount. The principal amount is refunded at the end of loan tenure, which is duly agreed and mentioned in the loan covenant.

In today's world, demands are continuously increasing, but means to fulfill those demands are limited; hence borrowing money will enable as the source to finance varied needs of a business, profession, and personal.

Bank credit is given to borrowers on the fulfillment of the necessary documentation required by the bank. Interest rates, terms of repayment are duly mentioned in the loan covenant. Documentation to bank includes financial statements, income tax returns, projected financial statements for three to five years, and changes based on the type of loan and from person to person.

Characteristics of Bank Credit

The following are characteristics of bank credit.

1. **Borrower:** Person who borrows money.
2. **Lender:** The person who lends money is usually the bank.
3. **Rate of Interest:** Rate of interest can be fixed or floating rate of interest. The floating rate of interest is based on benchmark rates like LIBOR or MIBOR.
4. **Terms of Repayment:** These are mentioned in the loan covenant and strictly adhered to avoid the prepayment penalty.

5. **Mode of Loan:** Normally given in cash but sometimes will be given in the form of raw material, fixed assets.

#1 – Classification Based on Borrower

Let’s discuss classification based on the borrower.

1 – Loan for Personal Purpose

Personal loans are given to meet the particular needs of an individual or the group of an individual. Personal loans are taken for the purchase of consumer goods, electronics, houses, vehicles, etc.

2 – Loan for Business or Profession Purposes

These loans are offered for meeting the needs of the business. It can be a working capital loan, cash credit facility to meet short term liquidity crunch. Companies borrow money for major fixed asset expansion, diversification of business into different product portfolios, varied customer segments. The purpose of lending money will be different for different businesses based on circumstances, needs, environments in which the company operates.

#2 – Classification Based on Security

Let’s discuss classification based on security.

1 – Secured Loan

Secured loans are secured against collateral, guarantee given to the Bank by the third party. Loans can be secured against property, plant and machinery and equipment, debtors, stock, fixed deposits, and any other asset which can be sold or liquidated by Bank in case of nonpayment of installment on the part of the borrower.

Bank will also lend money against the guarantee given by the third party on behalf of the borrower. In case of a guarantee, the guarantor will be liable to pay a balanced amount if the borrower fails to do so.

2 – Unsecured Loan

Unsecured loans are neither secured against any asset, nor any guarantee is provided to the Bank. A borrower with a great history of the settlement of dues, good credit rating, sound financial records will generally get an unsecured loan. Unsecured loans are usually provided by small banks, 'Patpedhis' and relatives.

#3 – Classification Based on Duration

Let's discuss classification based on the duration.

1- Short Term Loans

These loans are given for a shorter duration, say one month to one year.

- **Credit Card Loans:** These usually are given for one month. Credit cards are issued by the bank to borrowers to facilitate day to day needs of business and individuals. Credit cards are issued to sales managers with a specific limit to spend expenditure on travel and sales-related expenses. Individuals use credit cards for day to day requirements.
- **Cash Credit Facility or Bank Overdraft Facility:** This is extended to current account holders to withdraw more than the debit balance of bank account. CC or bank OD facility is mainly used when business is having a cash crunch and must settle sudden liabilities.
- **Working Capital Loans:** These can be both short term or long term in nature. It depends on the working capital cycle of the Company. In an industry that sells seasonal goods, the working capital cycle may be more than twelve months. The working capital loan is required when companies are unable to manage working capital effectively. The credit period allowed by vendors is lower than the credit period allowed to debtors, and the stock turnover ratio is higher than the need for working capital loans arises. Stock turnover ratio means how quickly businesses can convert stock into sales.

2 – Long Term Loans

These loans are given for a longer duration, say three to five years or more than that. These loans are provided for the expansion of business, diversification of product portfolio or business, substantial investment in fixed assets, real estate where the cost to buy such assets or investments is so vast that repayment of the same within a year is not possible.

Purpose of Bank Credit

The following are the purpose of the loan.

- **Educational Loans:** These are given for pursuing higher education, repayment of which is due after completion of education. Interest gets accumulated for the loan.
- **Housing Loans:** These are given to buy home. The repayment of principal and interest is based on EMI principal. House is collateral for such loans, and excessive documentation is required.
- **Vehicle Loans:** These are given to purchase vehicles like car, tempo, two-wheeler, auto, truck. Normally assets are hypothecated to Bank unless and until final installment due is paid. You often see "we banked …. Bank" written on the backside of cars. This indicates a loan is taken from "… Bank".
- **Vendor Financing:** This is an arrangement provided by the Bank to pay to vendors as per agreed credit terms, and in turn, the borrower will pay to the Bank after say 60 days or 90 days. The bank charges a rate of interest to the borrower for paying in advance to suppliers. The advantage of this is minimal documentation required by the Bank.
- **Letter of Credit Facility:** Like vendor financing but predominantly used while importing goods or making payments to overseas vendors. Terms of repayment, rate of interest is mutually agreed between the parties.

Advantages

The different advantages related to bank credit are as follows.

- The loan is not repayable on demand. Terms of repayment, rate of interest are pre-decided; hence cashflows can be managed in a better way.
- It helps businesses and individuals when there is a need for funds.
- Interest payments can be negotiated and paid only for a certain period, and the balance period borrower will pay only the principal.
- The cost of debt is lower than the cost of equity; hence the appropriate proportion of debt in the portfolio enhances returns to equity shareholders by leveraging the cost of debt.

Disadvantages

The different disadvantages related to bank credit are as follows.

- A borrower may have to surrender ownership of an asset if installments are not paid in time.
- Bank charges one-time processing fees that need to be paid up front.
- There is a pre-payment penalty if the borrower pays the loan in advance.
- Companies should maintain the right debt-equity ratio. If there is a significant reliance on loans by the Companies, then in the event of crises, it will be difficult to pay interest.