UNIT-2

Modes of Credit Delivery : Cash Credit – Loans – Overdrafts – Bills Finance – Pricing of loans – Types of Securities – Pledge, Hypothecation, Assignment, Lien and Mortgage.

# MODES OF CREIT DELIVERY:

The main methods of granting advances may be classified as:

1. Cash Credits
2. Overdrafts
3. Bill discounting
4. Issue of letters of credit
5. Loans

## Cash Credit:

Banks in India generally favour the granting of advances in the form of ‘Cash Credit’. It is estimated that out of the total bank credit, this method accounts for more than 50%. Under this method, the banker allows the customer to borrow up to a certain amount known as the ‘cash credit limit’. Usually the borrower is required to provide security in the form of pledge or hypothecation of tangible securities. In some cases, the limit is granted on the guarantees furnished by sureties acceptable to the banker. It may be noted that it is not necessary for the borrower to avail of the full cash credit limit in one installment. He can avail of the facility according to his requirements subject to the condition that the total amount availed of should not exceed the limit granted. The borrower is also allowed to credit any surplus cash in his possession. Interest is charged only on the amount actually utilized by the customer.

From the banker’s point of view, he stands to lose interest on the unutilized funds since the entire cash credit limit is placed at the disposal of the customer irrespective of whether he utilizes it or not. In order to compensate this, it is usual for the banker to incorporate a ‘minimum interest clause’ in the agreement with the customer in terms of which a certain rate of interest is payable on the unutilized portion of the cash credit limit.

## Overdrafts:

This method of granting advances resembles the cash credit system. However, to avail of an overdraft facility, the borrower has to open a current account. This account is allowed to be overdrawn up to a certain limit. As in the case of cash credit, here also the borrower need to pay interest only on the amount actually overdrawn and only for the period during which it’s utilized. Similarly, the minimum interest clause referred to above is not unusual in the case of an overdraft. At the close of the financial year, the borrower is required it wipe off the debit balance in the current account, i.e, the account has to be brought back to credit balance. Thus, theoretically an overdraft is a short-term credit facility. But the facility is usually renewed at the beginning of the next financial year. Thus ‘rolling over’ practice of the bank has the effect of an overdraft providing at least medium term credit facility to the customer.

## Bill Discounting and purchasing:

This method of granting advances is also a short-term facility intended to provide current working capital. Under this method, the banker advances money on the security of bills of exchange after deducting a certain percentage, technically known as ‘Discount’ from the face value of the bill concerned. This method of providing financial accommodation is heavily favored by conservative bankers according to whom the earning assets of a commercial bank should consist mainly of short term self-liquidating productive loans. A genuine commercial bill of exchange is considered to be a self-liquidating paper since it liquidates automatically out of the sale of the goods covered by such a bill.

## Issue of Letters of Credit:

Any arrangement however named or described whereby a bank (the issuing bank) acting at the request and in accordance with the instructions of a customer (the applicant of the credit) is to make payment to or to the order of a third party (the beneficiary) or is to pay, accept or negotiate bills of exchange (drafts) drawn by the beneficiary or authorize such payments to be made or such drafts to be paid, accepted or negotiated, by another bank, against stipulated documents and compliance with stipulated terms and conditions.

Thus when a stipulation is incorporated in the sale contract that the goods shall be paid by a banker’s letter of credit, the seller need not worry whether the goods will be cleared by the buyer on arrival at the destination and the buyer need not lock up his funds by making payment in advance. As a matter of fact, a commercial letter of credit substitutes the creditworthiness of the importer by the creditworthiness of the banker issuing the letter of credit since it is a promise by the bank to pay or accept the bill provided the exporter (the beneficiary) fulfils the terms and conditions set out in the credit.

## Loans:

The Term Loan is popularly used to denote the granting of an advance in lump sum, generally on the basis of securities acceptable to the banker. The distinguishing feature of a loan is that interest on it is payable on the entire amount, whether it is fully utilized or not. It is granted for a definite period and the borrower is given the facility to repay it in one lump sum or in installments. As far a banker is concerned, the operating cost of a loan is lower as compared to a cash credit or an overdraft. This method of granting an advance has the advantage of strengthening the financial discipline in the use of bank credit. Follow up, supervision and control of end-use of bank credit could be made more effective in the case of loans as compared to cash credits and overdrafts.

# PRICING OF LOANS

With progressive deregulation of interest rates, banks are required to price their deposits and loans scientifically. The banks’ profitability will depend on the price charged on their loans vis-à-vis the cost of funds so as to have a positive spread and protect its NII/NIM (Net Interest Income/Net Interest Margin).

A bank has the option between investing in credit risk-free Government security or risky commercial loan. If a bank decides to give a commercial loan, it has to be compensated for the credit risk over and above the risk free return. Further, all commercial loans are not of the same degree of risk. Loan pricing will, therefore, be based on the credit risk rating of the borrower and higher the risk; the more should be the compensation. A commercial loan is 100% risk weighted for regulatory capital adequacy purpose and the bank has to have a minimum 8% (or as prescribed by the regulatory) capital on the risk-weighted loan. Capital needs servicing and has therefore a cost attached to it. Loan pricing should also compensate this cost.

The loan pricing should, therefore be enough to recover:

* Cost of funds
* Credit risk premium
* Capital adequacy cost and
* Overheads

This is the intrinsic value pricing of a loan. However, the bank is operating in a market place and its pricing should be comparable to the market price; otherwise it will be out-priced. The bank has to reconcile between intrinsic pricing and comparison or market pricing in order to attract business.

# LIABILITY PRICING (COST OF FUNDS)

As loan pricing depends on cost of funds it is, therefore important to:

* Accurately measure the cost of funds; and
* Evaluate alternative funding sources/costs.

The cost of funds is not constant and changing due to change in interest rate scenario. The loan return should also change to maintain positive NII/NIM. It is, therefore, necessary that the banks price their products carefully.

The general level of interest rate is same for all the banks in their liability pricing. However, certain banks may enjoy a cost advantage in the market place because of their high credit rating, location advantage and franchise or clientele loyalty.

A high rated bank should be able to raise liability at a lower cost compared to a low rated bank. Similarly, banks having location advantage such as money centre banks, or low cost branch network in rural or semi urban or residential areas, can garner liabilities at a low cost. A bank enjoying a franchise or clientele or loyalty can raise liabilities from the loyal clientele at a lower interest rate and enjoy a spread over its competitors.

**Evaluation of alternative funding sources** and cost should be done so as to keep the cost of funds to the minimum. Treasury and Asset-Liability Management Committee (ALCO) play an important role here. A bank can give pricing signal to outsiders to encourage or discourage a particular source of funds, e.g. CDs vs FSs. Interest bank vs. Retail, short maturity vs. long maturity etc., keeping in mind its “views” on interest rate movements. Internally, through transfer price mechanism, a bank may encourage or discourage some liabilities of assets (loans) keeping in view the considerations for interest rate risk and asset-liability management. Needless to state, a bank can have competitive advantage in pricing its loan if the cost of funds is kept to the minimum.

## Computation of Cost of Funds

There are several methods to estimate the cost of funds. The more important ones are:

* Average historical cost of funds
* Marginal cost of funds
* Weighted marginal cost of funds
* Grossed-up cost of funds

### Average Historical Cost of Funds:

It is the simple method to calculate the cost of funds. This is estimated by dividing the expenditure (interest and non-interest) incurred in accepting the total liabilities.

Average historical cost of funds overstates cost of funds in a falling interest rate scenario and understates cost of funds in a rising interest rate scenario. A bank pricing its loans based on average historical cost of funds will overcharge its borrowers in a falling interest rate scenario and undercharge in a rising interest rate scenario. Many Indian banks follow this method. This is not desirable in a competitive market. It is, therefore, preferable to look into the marginal cost of funds.

### Marginal Cost of Funds:

Marginal cost of funds is the cost to acquire one additional unit of funds. Marginal cost (MC) is calculated as shown below:

Interest Cost + Service Cost + Insurance cost, etc \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

1-Percentag of funds deployed in non-earning assets

For example if:

Interest cost = 10%

Service cost = 0.30%

Insurance cost = 0.05%

Percentage of funds deployed in non-earning assets like CRR = 5%

0.10+0.0030+0.0005

MC = \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_

1-0.05

MC assumes that specific sources of funds are tied to specific uses of funds. If a bank gets a fixed rate loan of a definite tenor and price, it tries to get a liability of equal tenor with a fixed price so as to get a desired positive spread. This spread is maintained throughout the tenor of that loan and liability.

### Weighted marginal cost of funds:

Weighted Marginal Cost (WMC) of funds gives proportionate weight to each source of funds and computes the WMC.

A bank makes a forecast of each source of funds and marginal cost attached to it and thereafter computes WMC.

### Grossed-up cost of funds:

The concept of grossed-up cost takes into account the cost of funds and the statutory pre-emption of a part of it at a regulated rate and then deciding the break-even rate to be charged on the residual funds to be deployed as loan.

# TYPES OF SECURITIES

1. **Primary Security:** This refers to securities which are created with the help of finance made available by the bank. For example, purchase of a ready built house or a flat through the bank loan. Here the primary security is the ready built house or the flat as the case may be, i.e the one financed by the bank.
2. **Collateral Security:** The word collateral means additional. It is a supporting security. Finance is not made available against additional security, but the Banker insists upon additional security when they feel the necessity for the same.
3. **Personal Security:** This type of security provides legal remedy to the bank against the borrower by providing right of action against the borrower personally. Security such as promissory note, bill of exchange and security bond etc. Loan given against this type of security may be an unsecured one since it is not backed by any tangible asset or liquid asset.
4. **Tangible Security:** Securities in the form of land, building, and machinery are examples of tangible security for the reason that they are in a tangible form and such securities can be relied upon in times of crisis.
5. **Liquid Security:** The most reliable form or part of security, easily convertible into cash, e.r., Fixed Deposit, Receipt held as security, Blue chip companies shares, company deposits etc.
6. **Government Securities or Gilt-edged Securities:** Government Securities otherwise called as Gilt-edged are in the form of Bonds, Promissory Notes, Treasury Bills issued by the Government.
7. **Stock Exchange Securities:** They are in the form of shares and debentures.
8. **Blue Chip Security:** It refers to the share of highly rated, consistently dividend paying, growth on an upward spiral companies.

# SECURING ADVANCES

A banker secures advances by means of:

1. Lien
2. Pledge
3. Mortgage
4. Hypothecation

## BANKER’S LIEN:

Lien is a right to retain properties belonging to the debtor until he has discharged the debt due to the retainer of the properties. A banker’s lien is a general lien, which confers a right to retain properties in respect of any general balance due by the debtor to the banker. Bankers have a general lien on all securities deposited with the bankers in their capacity as bankers by a customer unless there is an express contract or circumstances that show an implied contact inconsistent with the lien as has been held in Brandao vs. Barnett. In the case of lien, banker’s right of sale extends to only fully negotiable securities. As far as such securities as concerned, the banker may exercise his right of sale after serving reasonable notice to the customer. In the case of securities other than fully negotiable securities, the banker is well advised to realize them only after getting sanction from a Court of Law

## PLEDGE:

A pledge is a contract where by an article is deposited with a lender or a promise as security for the repayment of a loan or performance of a promise. To complete a contract of pledge, delivery of the goods to the banker is necessary. Delivery of the documents of title relating to the goods, or the key of the godown where the goods are stored, may be sufficient to create a valid pledge. Legal aspects relating to pledges in this section cover documents of little also.

There are three essential features of a pledge, namely:

1. There must be a bailment of goods, i.e., delivery of goods;
2. The bailment must be by way of security and
3. The security must be for payment of a debt or performance of goods;

A pledge gives the pledge no right to ownership. But under section 173 of the Indian Contract Act, he get a special interest to retain possession even against the true owner until the payment of the debt, and any other expenses incurred in respect of the possession or preservation of the goods. In case of a pledge of special interest and not the special property is transferred to the pledgee who is impliedly authorized to sell the goods pledged in case of default in accordance with the provisions of the Contract Act as had been held by Kunhunni Elaya Nayar Vs. Krishna Pattar.

The pledgee’s right of disposition is governed by the terms of the pledge and is limited to the recovery of the amount due under the pledge as had been held in the above referred case of Shatzadi Brgum saheba and others Vs Girdharilal Sanghi and others.

The law permits a pledge by a non-owner under certain circumstances. They are:

1. A mercantile agent can create a valid pledge provided he is in possession of the goods with the consent of the owner. Further, a valid pledge may be created even when the mercantile agents are acting without the authority of the owner provided the pledge acts in good faith.
2. A seller who is in possession of the goods after the sale may create a valid pledge provided the pledge acts in good faith and without notice of the sale.
3. A buyer who is in possession of the goods or of the documents of title to the goods, before payment of the price, may create a valid pledge, provided the pledge acts in good faith and without notice of the defective title of the pledge.
4. A pledgee who has only a limited interest in the goods which he pawns can create a valid pledge to the extent of such interest.
5. One of the joint owners in sole possession of the goods with the consent of the others may create a valid pledge.
6. A person who is in possession of the goods under an avoidable contract (on the grounds of, say, fraud, misrepresentation, coercion, etc.,) may create a valid pledge provided the contract is not rescinded at the time of the pledge. However, a thief cannot create a valid pledge of the stolen goods.

**Right of Realization of the Securities Pledged**

Under Section 176 of the Indian Contract Act, a pledge has the following rights in case of default in payment of the debt by the pledgee:

1. He may file a suit for recovery of the amount due to him, while retaining the goods pledged.
2. He may file a suit for the sale of the goods pledged and the realization of the money due to him.
3. He may himself sell the goods pledged after giving reasonable notice to the pledger notwithstanding any contract to the contrary.

***Whether the Banker as a Pledgee is entitled to any Accretion to the Goods Pledged?***

Section 163 of the Contract Act lays down specially that, in the absence of any contract to the contrary, the bailee is bound to deliver to the bailer, or according to his directions, any increase or profit which may have accrued from the goods bailed. The meaning of this provision has been made sufficiently clear in M.R.Dhawan vs Madan Mohan, where it has been held that any accretions to the goods pledged will be, in the absence of a contract to the contrary, the property of the pledger and a pledge is not entitled to such accretions.

## MORTGAGE

Section 58 of the Transfer of Property Act defines a ‘mortgages’ thus:

A mortgage is the transfer of an interest in a specific immovable property for the purpose of securing the payment of money advanced or to be advanced by way of loan, an existing or future debt, or the performance of an engagement which may give rise to pecuniary liability.

In terms of the above definitions, the essentials of a mortgage are:

1. There must be a transfer of interest in an immovable property.
2. The immovable property must be a specific one.
3. The consideration of a mortgage may be either money advanced or to be advanced by way of a loan, or the performance of a contract.

**Mortgagor and Mortgagee**

The person who transfers an interest in a specific immovable property is known as the ‘mortgagor’, and the person to whom the interest is transferred is called the ‘mortgagee’.

**Creation of a Mortgage:**

A mortgage may be created either by deposit of title deeds, or by delivery of possession, or by a registered document. According to section 59 of the Transfer of Property Act:

## HYPOTHECATION – MORTGAGE OF MOVABLES:

A ‘mortgage of movables’ may be defined as a transfer, by way of security of the general ownership of the chattel, subject to the equity of redemption of the mortgagor. Mortgage of movables can be made by mere parole and without transfer of possession. However, a subsequent mortgagee with possession, in the absence of notice of the previous mortgage, will get priority over a prior mortgage without possession. In the strict sense, the term ‘mortgage’ is used only in connection with immovables. In the case of movables is created by delivery of possession of goods, it is known as a ‘pledge’, and where no possession is given it is known as ‘hypothecation’.

**Letter of Hypothecation:**

In the case of hypothecation, a document knows as ‘Letter of Hypothecation’ is executed. This document details the terms under which the relevant goods are hypothecated. Briefly, the following are the main contents of the letter of hypothecation:

1. Affirmation by the borrower that the goods are free from encumbrances, that further encumbrances will not be created on them and that he is the absolute owner of the goods;
2. Undertaking by the borrower that proceeds arising from the sale of the hypothecated goods will be utilized for the repayment of the advance;
3. Undertaking by the borrower to meet all expenses relating to the safe custody of the hypothecated goods and that sufficient margin acceptable to the banker will be maintained at all times; and
4. Provision to the effect that the banker has the right to take possession of the hypothecated goods and to realize them in the event of the borrower making default in the repayment of the advance.

**DFIFFRENCE BETWEEN PLEDGE, HYPOTHECATION & MORTAGAGE**

These terms are used for creating a charge on the assets which is given by the borrower to the lender as a security for any loan.  Thus, one of these terms will be normally used whenever an individual or a business firm avails any loan and the bank keeps some assets as a security, so that it will be able to sell the same in case that individual or the firm defaults in repayments.

**(1) Pledge** is used when the lender (pledgee) takes actual possession of assets (i.e. certificates, goods).  Such securities or goods are movable securities.  In this case the pledgee retains the possession of the goods until the pledgor (i.e. borrower) repays the entire debt amount.   In case there is default by the borrower, the pledgee has a right to sell the goods in his possession and adjust its proceeds towards the amount due (i.e. principal and interest amount).  Some examples of pledge are Gold /Jewellery Loans, Advance against goods,/stock,  Advances against National Saving Certificates etc.

**(2) Hypothecation** is used for creating charge against the security of movable assets, but here the possession of the security remains with the borrower itself.   Thus, in case of default by the borrower, the lender (i.e. to whom the goods / security has been hypothecated) will have to first take possession of the security and then sell the same.   The best example of this type of arrangement are Car Loans.   In this case Car / Vehicle remains with the borrower but the same is hypothecated to the bank / financer.   In case the borrower defaults, banks take possession of the vehicle after giving notice and then sell the same and credit the proceeds to the loan account.  Other examples of these hypothecation are loans against stock and debtors.  [Sometimes, borrowers cheat the banker by partly selling goods hypothecated to bank and not keeping the desired amount of stock of goods.   In such cases, if bank feels that borrower is trying to cheat, then it can convert hypothecation to pledge i.e. it takes over possession of the goods and keeps the same under lock and key of the bank].

**(3) Mortgage** is used for creating charge against immovable property which includes land, buildings or anything that is attached to the earth or permanently fastened to anything attached to the earth (However, it does not include growing crops or grass as they can be easily detached from the earth).  The best example when mortage is created is when someone takes a Housing Loan / Home Loan.  In this case house is mortgaged in favour of the bank / financer but remains in possession of the borrower, which he uses for himself or even may give on rent.

**Difference Between Pledge, Hypothecation and Mortgage at a Glance:**

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Pledge** | **Hypothecation** | **Mortgage** |
| **Type of Security** | Movable | Movable | Immovable |
| **Possession of the security** | Remains with lender (pledgee) | Remains with Borrower | Usually Remains with Borrower |
| **Examples of Loan where used** | Gold Loan, Advance against NSCs, Adv against goods (also given under hypothecation) | Car / Vehicle Loans, Adv against stock and debtors | Housing Loans |

**PLEDGE, HYPOTHECATION AND MORTGAGE UNDER INDIAN LAW**

**Pledge :** Section 172 of the Indian Contract Act defines pledge as "The bailment of goods as a security for the payment of a debt or performance of a promise"   The bailor in this case is called a Pawnor and the bailee is called Pawnee

To create a valid pledge in the eyes of Law, the three important points needs to be noted : (a) Delivery of Possession :  As in bailment, in pledge too delivery of possession is required.  For example, in Revenue Authority vs Sundarsanam Pictures, AIR 1968, it was held NOT to be pledge because the film producer borrowed a sum of money from a financier and agreed to deliver the final prints of the film when ready.  Thus, there was no delivery of the goods at the time of agreement; (b) Delivery is in return of a loan or promise to perform something.    Therefore, if your friend gives you his Motor-cycle to go to college, it is not pledge but can be called simple bailment;  (c) It should be in pursuance of a contract :  The delivery must be done under a contract (oral or written).   However, it is not necessary that delivery and loan take place at the same time.  Delivery can be made even after the loan is received.

**Hypothecation**   was not defined under Indian Law for long time and was used more on the basis of practice.   However, now under the Secruitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, hypothecation is defined as "a charge in or upon any movable property, existing or future, created by a borrower in favour of a secured creditor without delivery of possession of the movable property to such creditor, as a security for financial assistance, and includes floating charge and crystallization into fixed charge on movable property".  .

**Mortgage**   is defined in Section 58 of the "Transfer of Property Act 1882".  It is the transfer of an interest in specific immovable property for the purpose of securing payment of money advanced by way of loan.

**WHAT IS AN ASSIGNMENT?**

There is another term (i.e. Assignment) which is sometimes confused with above terms.  An assignment constitutes an action taken with a contract.  Assignment occurs when the owner of a contract, known as the assignor, gives a contract to another party, known as the assignee.   The assignee assumes all responsibilities and benefits of the contract.  When it comes to loans, assignment can relate to life insurance policies and mortgage contract from one party to another.    Mortgages and other contracts sometimes contain provisions limiting or stipulating conditions for assignment.2

One example of assignment is 'transfer by the holder of a life insurance policy (the assignor) of the benefits or proceeds of the policy to a lender (the assignee), as a collateral for a loan'.    In such case in the event of the death of the assignor, the assignee is paid first and the balance (if any) is paid to the policy's beneficiary.      However, insurance policies other than life insurance may not be used for this purpose.

**Assignment means** transferring some or all property rights and obligations to another person through a written agreement. For example, a payee assigns rights for collecting note payments to a **bank**. A trademark owner transfers, gives, or sells another person interest in the trademark.