CHAPTER 3

CREDIT

Objectives

At the end of this chapter, students should be able to:
(i) explain what credit is;
(ii) list types and sources of credit;
(iii) explain the functions of credit;
(iv) identify credit instruments;

3.1 Introduction

Buying and selling and indeed consumption are sustained by credit systems and facilities. Some people, because of this describe the situation as credit economy. As people are encouraged to buy or consume more while producers respond by producing more and thus keep the economy going. Through credit systems, immediate payment is no longer needed before the citizens of a nation can satisfy their wants. Businesses also extend credit facilities to their customers in order to remain afloat and continue in business.

3.1.2 Meaning of Credit

Credit simply means buying now and paying later. In other words, credit is the transfer of possession or ownership or both of goods by the seller to the buyer who promised to pay for them at a later day as may have been agreed to by the parties.

3.2 Types and Sources of Credit

There are many types of credit. As credit varies, so are their sources, for example, credit can be extended to the buyer by the seller in two forms: Hire purchase and deffered payment. Credit run also arise between a lender and borrower. Two forms exist here; and they are: secured and insecured credits.

Mortgages

A mortgage is a loan from a bank, a building society or oneâ€™s employer for buying land or building houses. It is a means of saving for ownership of land or buildings through a loan repayable over a long period of years (10-30 years). It is land or building ownership on credit.

The borrower is referred to as *mortgager (mortgagor)* while the lender is known as *mortgagee.* The former must provide a substantial security like land, and or other buildings before getting the loan. The mortgagee usually asks for a *surveyorâ€™s valuation* of the property serving as security before granting the loan. Alternatively, the building in question might be used to secure the loan, in which case the mortgagee might grant up to 90% of cost of building. In other words, the mortgagor might be expected to have commenced work on the building to some elementary stage before the mortgagee could come to his assistance.

Some employers weave into the conditions of service the provision of mortgages to their senior staff who would have worked for a stated minimum number of years.

(a) The Advantages of a Mortgage

(i) One could become a house owner without waiting for many years of savings.

(ii) House ownership is a valuable asset and with good care, houses do appreciate with years. Landed property becomes handy at middle and old age.

(iii) Buildings and lands could be used to secure loans for other investments.

(iv) When used for commercial purposes (rentals), they can be self financing, i.e. pay for themselves through the rents collected on them.

(b) The Disadvantages of Mortgage

(i) Repayment terms might spell financial hardship for the mortgager and his family.

(ii) Repayment might last throughout oneâ€™s working life and with it, the associated financial hardships.

(iii) The mortgager stands the chance of forfeiting the landed property in the event of any default.

(iv) In spite of taking a lifetime to pay for, the type of buildingâ€™ its location and environment might not appeal to the ownerâ€™s children after his death, and the children might not live in it.

(v) Buildings meant for commercial purposes are fraught with problems from tenants for reasons of misuse, non-payment of rents an allegations of exorbitant rents which might lead to court actions.

3.2.2 Loans and Overdrafts

(a) **Loans:-** A loan is money which an organization such as a bank lends to people especially bank customers. However, there are exceptional cases where loans can be granted to non-customers who are well known and have good reputation. When a loan is granted, the customer or borrower pays interest on the whole loan at the ruling interest rate, while the principal, that is the loan, is repaid as agreed or arranged by the lender and the borrower. Loans can be of short-term, medium-term or long-term.

(b) **Overdraft:-** An overdraft is a loan of short-term nature given to bank customers who have current accounts. Overdrafts are mostly granted with less stringent conditions by commercial banks. Overdraft is the easiest and the most convenient method of borrowing by both businessmen and wage earners. Once the overdraft is approved or granted by the bank, the amount of the overdraft is usually indicated in red in the customerâ€™s ledger card.

3.2.3 Hire Purchase and Deferred Payments

Hire purchase and deferred payments are called instalmental payments.

(a) **Common Features**

Since each of these could be confused with the other, the best approach is to compare and contrast both. The common features (the similarities) to both are:

(i) In each of the systems, the goods pass from the seller to the buyer, and the latter has immediate use of the goods.

(ii) In both, there is no immediate full payment of the prices of the goods that are transferred from the seller to the buyer, only an initial deposit is required.

(iii) Both accommodate payments by instalments, until full payment is made.

(iv) Both apply to the same categories of goods durable, capital goods (machineries etc.) and durable consumer goods (motor cars etc.) but not consumable goods (food items) which are accommodated by the â€˜Book-me-downâ€™ credit system.

The prerequisite of this credit system is that goods must be of durable nature, since it takes a long period to make the final payment and at the end of this long period, the goods must still possess value since they could be repossessed under certain conditions, in the even of default of payments.

From the point of utility, it would give much displeasure psychologically, if goods like toothpaste; cassava food or pounded yam took three months to pay for and have no utility (services) after two or three weeks, or even after three or four hours.

(b) **The Differences Between Hire Purchase and Deferred Payment**

Hire Purchase	Deferred Payment
(i) Agreement terms and implication: As the term suggests, a hire purchase is an agreement to hire but with an option to buy finally.	This is an actual sale and not a hire.
(ii) Hire or ownership The party to the agreement is a hirer.	The party to the agreement is a buyer.
(iii) Possession or ownership The hirer secures an immediate possession of the goods in question, but does not gain	The buyer becomes the legal owner of the goods as soon as the agreement is complete.

ownership until he has made the final instalmental payment, thereby effecting his option in (i) above.	
(iv) Implication of defaulting If the hirer defaults, i.e. he is unable to meet the instalmental payments as and when due, the goods can be repossessed, especially if less than one-third of the payment is made already.	The goods cannot be repossessed by the buyer, without making a recourse to the court of law i.e. without the consent of the court of law.
(v) Order of preference Following from the points made above, the seller would prefer hire purchase agreement to deferred payments.-	The buyer naturally prefers the deferred payment agreements.

(c) **Finance by the traders (sellers):-** Sometimes the traders themselves pay for the goods which they sell to the consumers who make the first initial deposit and continue the instalmental periodical payments to the traders. In this case, the hire purchase agreements are strictly between the traders and the consumers. Since such are self-financed by the traders, their cash flow positions could be adversely affected if the hire purchases are granted on a large scale.

(d) **Finance by hire purchase companies:-** Hire purchase finance companies live on providing capital for hire purchases. The hire purchase agreements are between the finance companies and the hirers using the trader as the middleman, or an agent between the two parties. In this way, the tradersâ€™cash-flow positions are kept healthy, but the risks and profits in the transactions are passed on to the hire purchase finance companies who live on same. However, it must be added that the traders would have made their margin of profits through their selling prices.

(e) **Block discounting:-** The traders finance the hire purchases only to some amount. Beyond this limit, any additional hire purchases accepted by them are only on paper. They are in fact passed en-bloc to hire purchase finance companies for actual payments. The passing on of such bulk of hire purchase agreements to the hire purchase companies is termed *block discounting* i.e., the traders have discounted (turned to immediate cash) some bulk of the hire purchase agreements they have made with their customers. In this way, the traders are able to replenish their cash flow positions at the expense of passing some margin of their hire purchase profits to the hire purchase companies.

3.2.4 Finance Houses

Finance houses are one major avenue through which people or businesses borrow money to meet their short, medium and long term needs of goods and services - with a promise or agreement to repay at a future date. The major ones include Mortgage Banks, Building Societies, Commercial Banks and Merchant Banks.

(a) **The Mortgage Bank:-** This is a finance house which lends money at interest to people on mortgage. A mortgage may be granted to people who want to develop their landed property or who want to buy or own houses. The loan is given out on the security of the land to be developed or the house to be purchased.

A company can also borrow money on mortgage. In that case its fixed assets can be used as security. In a mortgage, if there is any default, the mortgaged property or fixed assets are auctioned to repay the mortgage loan.

(b) **The Building Societies:-** In Building Societies, people with surplus funds pool them together to provide loanable funds for others who wish to buy their own houses. This is done by way of mortgage in the sense that the persons borrowing to buy houses will give them (the houses) as security for the loan which the Societies can sell in the event of default to receive their money.

(c) **The Commercial Banks:-** A commercial bank as a finance institution or house provides loans to enable people meet their urgent needs. Loans are long term borrowing normally granted to customers who are able to provide securities for the loan called collateral. A loan attracts a certain percentage rate of interest which the borrower will pay in addition to repaying the loan according to the terms in the agreement signed with the bank.

Another form of loan granted by Commercial banks to its customers is the overdraft. The overdraft is a short-term loan which is given to their current account customers who are considered capable of handling the loan. Interest is paid on the amount drawn from the overdraft.

(d) **The Merchant Bank:-** A Merchant Bank is a finance house which lends money to big businesses such as importers of merchandize, petroleum products and manufacturers to import raw materials. The loans granted by merchant banks are on short-term basis and are secured on the borrowerâ€™s collateral which the merchant bank considers acceptable.

3.2.5 Charge Accounts

This is usually a simple monthly or even shorter period credit buying. It is commonly adopted by large retailers, e.g. the departmental stores. An account is opened for each approved customer. All the customersâ€™ purchases during that month are debited into his account and a statement of the accounts is sent to the customer at the end of the month, or at shorter intervals, by which time he is expected to settle his bills.

The peculiar aspect of charge accounts is to encourage the customer to settle his bills promptly, and he is offered a small discount if payment is made within a given period. Consequently, under this form of credit facility, the customer buys in cash. The traderâ€™s satisfaction lies in the very small profit margin he makes, and also in the goodwill he enjoys among a large number of customers that are attracted to the scheme.

3.2.6 Budget Accounts

This is otherwise known as *subscription accounts facility.* As in charge accounts, they are operated by the large shops - chain stores, multiple stores and departmental stores.

The approved customer opens an account with an initial deposit with the stores, an amount equal to this initial deposit is paid to this account every month. In return for this monthly deposit, the account holder is granted a revolving credit, equal to about eight and twelve times the deposit. He can then purchase goods of any value within the limit of this credit facility as long as he sends his monthly deposit payment to the stores. Some customers, in order to avoid defaulting, make their monthly payments by bankersâ€™ order.
Normally, the store adds a service charge of about 5% or more to the value of the monthly bills; and for this reason, it is unlike the charge account where credit purchases are usually cheaper than cash payment purchases.

3.2.7 Club Trading

Club trading is similar to the monthly or periodical contributions- *esusu* commonly practised among office or factory workers in many establishments in West Africa. Some people come together, from the club and agree on a fixed amount of contribution per head per period of time. It is usually a monthly contribution for salary earners, or weekly for weekly wage earners. They further agree on the type of goods they would wish to own within the value of the total contributions.

One member of the club is assigned the task of organizing the collections and making the periodical purchase of the chosen goods. They then agree on, or they ballot for the order by which each member receives his own goods. This, in effect, is a credit facility to the receiver of the goods at the end of each period, since the value of the goods he receives is equalled only by the totality of contributions made by all other members each month. Only the member that takes his own share last receives no credit facility.
If the order in the first round was by voluntary agreement rather then by balloting, when members start the second round, the order in the first round could be reversed - so that the last in the first round becomes the first in the second round, and so on.

3.3 Functions of Credit

Credit enables idle funds or resources to be fully utilized for productive, distributive and service purposes as funds are moved from those who have them to those who need them.

It enables the nation to sustain its production and consumption level as it helps to bridge the financial gap between production and consumption stages. It can be used by the government as an instrument of fiscal planning through the manipulation of the volume of credit at any point in time. At international level, loans (borrowing and lending) can be used as diplomatic levers in dealing with other nations or countries. In the areas of distribution credit plays an important function as it assists the retailer and the wholesaler in replenishing their stock.

3.3.1 Functions of Credit to a Retailer

The retailer is the link between the wholesaler or producer and to the ultimate consumer. Since the consumer may ask for credit to enable him to purchase certain goods, the retailer may be compelled to allow the consumer to buy certain goods on credit. And so credit plays the following functions to the retailer:-

(i) **Increase in the Sales Volume:** As the retailer allows credit, those who cannot afford to pay for the goods immediately, can now buy the goods and pay later. By so doing the total sales will increase.

(ii) **Increase in customersâ€™ loyalty or franchise:** Credit facilities make customers to continue to patronise the retailer as he has created strong goodwill for his business or store.

(iii) **Reduction in overstocking:** As many customers come to buy from the retailer who allows them credit, goods are almost sold as soon as they are bought thereby reducing overstocking the store with unsold goods and so capital is not tied down unnecessarily.

(iv) **Increase in Profit:** The total effect of all these is increase in the profit of the retailer.

3.3.2 Functions of Credit to a Wholesaler

The wholesaler is the link between the producer or importer and the retailer who sells to the final consumer. The functions of credit to the wholesaler are similar to that of the retailer.

(i) **Increase in sales:** Credit facilities extended to the retailer encourages him to buy more goods as he is not bound to pay for them immediately. This increases the wholesalerâ€™s sales volume.

(ii) **Increase in production:** As retailers increase their purchases, the wholesalersâ€™ sales increase thereby making the wholesalerâ€™s warehouse ready for more goods. The wholesaler in turn will clear the producersâ€™ warehouse, thus helping him to produce more by advancing some money to enable him as there is room in the warehouse for storage.

(iii) **Maintenance of retailerâ€™s loyalty:** As the wholesaler supplies goods to the retailer and allows him to pay gradually, the retailer will remain loyal to the wholesaler.

(iv) **Increase in the wholesalers profit:** The overall effect of credit on the activities of the wholesaler is increase in his profit taking.

3.4 Credit Instruments

The credit instruments discussed here are those normally used in the business transaction of credit buying and selling. They are Bill of Exchange, Promissory Note, IOU. (I Owe You) and Credit Card.

3.4.1 Bill of Exchange (B/E)

A Bill of Exchange is an order in writing from the seller (creditor) to the buyer (debtor) asking him (the buyer) to make payment to him (the seller) of a definite sum of money at a particular time in future. The Bill of Exchange is usually prepared by the seller and sent to the buyer for acceptance. If the buyer accepts the bill he will write the word â€œAcceptedâ€and his signature is across the face of the bill. After the bill has been accepted, it will be sent back to the seller in exchange for the goods he sold. It then becomes a debt he has to pay. You can see that a Bill of Exchange as our instrument of debt does not originate from the buyer (debtor) but from the seller (creditor). The seller can keep the bill until it is due for payment. It is then said to have become mature and it is paid by the debtor (buyer).

If the creditor (seller) is in dire need of money before the bill matures he can sell it to another party usually a bank or an individual at a price less than the surface value of the bill. If this happens, the bill is said to be discounted. Use of the Bill of Exchange to pay for local purchases is no longer in practice. It is mostly used in foreign or international trade, here it is called a foreign Bill while the one used for local payments is called an Inland Bill. See the specimen below.

₦120,000

Akohia Quarters
Umudin Imenyi
Orsu North LGA

1st Nov. 2003

Five months after date pay me or my order the sum of one hundred and twenty thousand Naira for value received.

To J.A. Ayodele
P.O. Box 12448
Ilesha

Fig. 3.1: *Specimen of a Bill of Exchange*

3.4.2 Promissory Note

In credit sales transaction another credit instrument which the seller accepts in exchange for his goods is the promissory note. As the name indicates, it is a promise to pay and it originates from the buyer (debtor), and so its acceptance does not require any formality. A promissory note is negotiable, that is, it can be transferred to a third party by mere endorsement.

₦80,000

41 Road C' Close
Block 2, Flat 6
FESTAC Town, Lagos

1st November, 2003

Four months after date I promise to pay Pius Igwe or order the sum of eighty thousand Naira for value received.

J. Mebaane

Fig. 3.2: *Specimen of Promissory Note*

3.4.3 IOU (I Owe You)

â€˜IOUâ€™ is a shortened form of â€˜I owe youâ€™, which is a mere acknowledgement of a debt. It is neither a promise to pay (and to this effect it gives no date) nor a negotiable instrument. It is usually an evidence of, or a note for a temporary loan of a small amount of money. It cannot be substitute for payment by means of currency, bills of exchange or promissory notes. It does not bear a stamp either, since it is not a receipt. However, if a debtor indicates a date for payment on an â€˜IOUâ€™ note, then it becomes promissory note.

It must be added that a bill of exchange, a promissory note and an â€˜IOUâ€™are only temporary means of accepting liability for payment; the actual liability must be liquidate in one way or the other in the final analysis.

3.4.4 Credit Cards

The credit card scheme is a form of credit granted by a bank or an association of banks who have made special arrangements with some shopping centres and service establishments to accept credit cards from such banks, for credit purchases up to a given limit.

It has just come into practice in Nigeria and some West African countries. The popularity of its adoption in Western Europe and the United States of America, coupled with the rapidity by which commercial practices transcend national and international borders, makes its wide acceptance in Nigeria and West Africa a possibility in the near future. In Britain, the popular credit card is *the* **Barclay card* which is organized by Barclays Bank (known as Union Bank in Nigeria) and Unicard organised by Union Bank of Nigeria PLC is the most popular in Nigeria.

These cards are issued to some approved individuals, who might not necessarily be customers of the banks, on payment of an initial deposit. The card owners are granted facilities to buy goods to some limits based on the assessed income level of the applicant. Agreements would have been made with the establishments which would accept such cards for credit purchases by the holders. These are hotels, large retailers and some transport authorities. The card holder gets a statement of his accounts monthly, plus a charge % payable only on unsettled balances within a given period of time.

With the cards, holders can draw money out of any of the member banks up to the permitted limit. The cards are also useful for identification purposes in cashing cheques in any of the branches of the bank.

3.4.5 Value Card

This is a form of credit card. On application, a customer may be allowed to load any amount he likes on the card. With this card he can withdraw money from any branch of the bank to transact business up to the value of the amount loaded in the card.

3.4.6 Payment Via Electronic Media

ATM (Automatic Teller Machine). This equipment is now being installed by some banks to enable customers to withdraw money from their accounts at any time and from any of the machines wherever it is located.

To be able to enjoy this facility, the customer has to apply and be given a card which contains password with which the customer can access his account and make withdrawal.

3.4.7 Gigo, Monigram, Western Money Transfer etc. All these are facilities created by banks to enable customers and non-customers to transfer to or receive money from abroad or overseas.

3.4.8 â€˜Book-Me-Downâ€™

This is the commonest type of credit system among the working class, the manual workers and the labourers, e.g. on a construction site. The term â€˜Book-me-downâ€™ is colloquial. It works like this: most low-paid workers run short of cash before the next payday so that they might not be able to buy such neccessities of life like food and other habitually consumed goods like cigarettes, kola-nuts, etc. They therefore, ask the local traders to sell such goods to them on credit until their paydays, when they come back to pay the amount owed.

Summary

Some forms of credit facilities are referred to as hire-purchase, deferred payments, book-me-down, mortgage, charge accounts, budget accounts and club trading.

In hire purchase, there is no buyer but a hirer until the full payments are made; and until then there is no legal owner.

In deferred payment, legal ownership commences as contract is struck and a buyer emerges.

Revision Questions

A. Essay Questions

1. What are the features which distinguish the hire purchase system from the deferred payment system?

2. Write short notes on the following credit systems: -
   (a) Credit cards
   (b) Club trading
   (c) Budget accounts

3. Explain the points for and against the mortgage system as practised now in Nigeria.

4. State clearly four function of the credit system to:
   (a) The retailer
   (b) The wholesaler

5. Write short notes on the following finance houses:
   (a) Commercial Banks
   (b) Building Societies
   (c) Merchant Banks

B. Objective Questions

1. An agreement by which a buyer pays instalmentally but does not own the goods until final settlement is made is known as:
   A. Hire purchase
   B. Deferred payment
   C. Conditional sale
   D. Features trading

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2. A default after payment of one third price under the hire purchase agreement means that:
   A. Seller can immediately repossess the goods.
   b. The buyer has become the owner.
   C. Only the court can permit repossession.
   D. The buyer has become the owner *WASSCE 2000*

3. A loan from a bank, a building society or an employer for purchase of a land or a house is referred to as
   A. Book-me-down
   B. Mortgage
   C. Hire purchase
   D. Club trading
   E. Credit card

Using the term â€˜A-Eâ€™ below, you are expected to answer question 4-7 below.

A. Book-me-down
B. Mortgages
C. Credit cards
D. Club trading
E. Hire purchase

4. A periodical contribution among office/factory workers to be collected in turns by the individual contributors at the end of each period.
   A
   B
   C
   D

5. A coloquial term used to describe the system of credit facilities given to site workers/labourers on some food items, cigarrettes, kolanuts, etc.
   A
   B
   C
   D

6. A credit facility by which you can collect the goods on a payment of a deposit with the balance by instalment.

A
B
C
D

7. The practice of granting credit facilities by accepting the use of some cards as per pre-arrangement.
   A
   B
   C
   D

8. The practice whereby all purchases in a period are charged to an account which statement is sent to the customer for settlement at the end of a period is known as
   A. Charge account
   B. Club trading
   C. Credit cards
   D. Deferred payment
   E. Hire purchase

9. One of these is a disadvantage of hire purchase.
   A. An improvement on the standard of living of the hirer
   B. Possibility of paying more than the cost of the hired goods.
   C. Cash flow relief for the hirer.
   D. Likely increase in turnover for the seller.

10. Which of these goods is more suitable for â€œbook-me-downâ€ arrangement?
    A. T.V. set
    B. A holiday abroad
    C. Pounded yam on a building site
    D. A motor car
    E. A helicopter

Project

Take a look at your home including the house itself and write a comprehensive list of the household furniture that could have been bought under:-

(a) Hire purchase system

(b) Book-me-down arrangement