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Loans and Advances

35.1 Introduction

In the previous lesson you have learnt the meaning and types of deposit-accounts including the procedure of opening and operating bank accounts. We have seen that the commercial banks accept deposits and also lend money to the people who require it for various purposes. Lending of funds to traders, businessmen and industrial enterprises is one of the important activities of commercial banks. The major part of the deposits received by banks is lent out, and a large part of their income is earned from interest on such lending. There is a considerable difference between the rate of interest which the commercial bank grants on deposits, and the rate they charge on loans and advances. It is this difference which constitutes the main source of bank earnings.

Operation and expansion of business and commercial activities depend a great deal on the availability of loans/advances from commercial banks. In this lesson, you will learn about the procedure of getting loans and advance, cash credits, overdrafts, etc from the commercial banks.

35.2 Objectives

After studying this lesson, you will be able to:-

- enlist the utility of granting loans and advances by commercial banks;

- differentiate borrowing rates from lending rates;
- enumerate the ways of lending money;
- distinguish between long-term and short-term loans;
- point out the nature of security provided for loans; and
- outline the procedure for grant of cash credit, overdraft and discounting of bills of exchange.

35.3 Meaning of Loans and Advances

The term 'loan' refers to the amount borrowed by one person from another. The amount is in the nature of loan and refers to the sum paid to the borrower. Thus. from the view point of borrower, it is 'borrowing' and from the view point of bank, it is 'lending'. Loan may be regarded as 'credit' granted where the money is disbursed and its recovery is made on a later date. It is a debt for the borrower. While granting loans, credit is given for a definite purpose and for a predetermined period. Interest is charged on the loan at agreed rate and intervals of payment. 'Advance' on the other hand, is a 'credit facility' granted by the bank. Banks grant advances largely for short-term purposes, such as purchase of goods traded in and meeting other short-term trading liabilities. There is a sense of debt in loan, whereas an advance is a facility being availed of by the borrower. However, like loans, advances are also to be repaid. Thus a credit facility- repayable in instalments over a period is termed as loan while a credit facility repayable within one year may be known as advances. However, in the present lesson these two terms are used interchangeably.

Utility of Loans and Advances

Loans and advances granted by commercial banks are highly beneficial to individuals, firms, companies and industrial concerns. The growth and diversification of business activities are effected to a large extent through bank financing. Loans and advances granted by banks help in meeting short-term and long term financial needs of business enterprises. We can discuss the role played by banks in the business world by way of loans and advances as follows :-

(a) Loans and advances can be arranged from banks in keeping with the flexibility in business operations. Traders, may borrow money for day to day financial needs availing of the facility of cash credit, bank overdraft and discounting of bills. The amount raised as loan may be repaid within a short period to suit the convenience of the borrower. Thus business may be run efficiently with borrowed funds from banks for financing its working capital requirements.

(b) Loans and advances are utilized for making payment of current liabilities, wage and salaries of employees, and also the tax liability of business.

(c) Loans and advances from banks are found to be 'economical' for traders and businessmen, because banks charge a reasonable rate of interest on such loans/advances. For loans from money lenders, the rate of interest charged is very high. The interest charged by commercial banks is regulated by the Reserve Bank of India.

(d) Banks generally do not interfere with the use, management and control of the borrowed money. But it takes care to ensure that the money lent is used only for business purposes.

(e) Bank loans and advances are found to be convenient as far as its repayment is concerned. This facilitates planning for future and timely repayment of loans. Otherwise business activities would have come to a halt.

(f) Loans and advances by banks generally carry element of secrecy with it. Banks are duty-bound to maintain secrecy of their transactions with the customers. This enhances people's faith in the banking system.

Intext Questions 35.1

1 Write 'true' or 'false' as may be appropriate against the following statements :

(a) Banks provide credit facility to businessmen only.

(b) 'Loan' is an amount borrowed from bank.

(c) Loan is always repaid in lump-sum.

(d) The period for which loan or advance is granted cannot be extended on customer's request.

(e) 'Advance' carries the sense of debt.

2 Fill in the blanks with suitable words.

(a) A bank charges interest on loan/advance and allows interest on deposits. The difference constitutes ____________ of the bank.

(b) A 'credit' whereby money is lent in lumpsum and recovery is made in instalment is called ________ .

(c) Banks generally grant 'advance' for _________ period.

(d) Bank loan may be used for paying ____________ .

(e) The rate of interest charged by banks on loans and advances is regulated by _____________ .

(f) An advantage of bank loan/advance is that the bank is duty bound to maintain _________ of the customer's transactions.

35.4 Borrowing Rate and Lending Rate

People make their funds available to the banks by depositing their 'savings' in various types of accounts. In other words, bank funds mainly consist of deposits from the public, though banks may also borrow money from other institutions and the Reserve Bank of India. Banks, thus mobilises funds through its deposits. On public deposits the banks pay interest at and the rate of interest vary according to the type of deposit. The borrowing rate refers to the rate of interest paid by a bank on its deposits. The rates which the banks allow depend upon the nature of deposit account and the period for which the deposit is made with the bank. No interest is generally paid on current account deposits. The rate is relatively lower on savings account deposits. Higher rates ranging from 6% to 12% per annum are paid on Fixed deposit accounts according to the period of deposit.

Banks also borrow from other institutions as well as from the Reserve Bank of India. When the Reserve Bank of India lends money to commercial banks, the rate of interest it charges for lending is known as **'Bank Rate'**.

The rate at which commercial banks make funds available to people is known as **'Lending-rate'**. The lending rates also vary depending upon the nature of loans and advances. The rates also vary according to the purpose in view. For example if the loan is sanctioned for the purpose of activities for the development of backward areas, the rate of interest is relatively lower as against loans and advances for commercial/business purposes. Similarly for smaller amounts of loan the rate of interest is higher as compared to larger amounts. Again lending rates for consumer durables, e.g. loans for purchase of two-wheelers, cars, refrigerators, etc. are relatively higher than for commercial borrowings.

However, the Reserve Bank of India from time to time announces changes in the interest-rate structure to regulate the lending of funds by banks. Different rates of interest are prescribed for various categories of advances, such as advances to agriculture, small scale industries, road transport, etc. Graded rates of interest are prescribed for backward areas. Lower rate is normally charged from agencies selling food-grains at fixed price through Govt. approved outlets.

Lastly, lower rate of interest is charged for loans granted to persons belonging to 'weaker sections of the society'.

Intext Questions 35.2

Match column (A) with column (B) as given below :–

Column A	Column B
(A) Bank-borrowing	(1) is the rate at which Reserve Bank of India lends money to commercial banks.
(B) Bank- Rate	(2) usually get loans/advances at a relatively lower rate of interest
(C) Reserve Bank of India	(3) Mobilize funds by accepting the deposits.

(D) Commercial Banks	(4) an apex institution from which banks can borrow.
(E) Lending-rate	(5) the funds deposited by the public in banks.
(F) Weaker sections of the society	(6) is the rate at which commercial banks make funds available to public.

35.5 Lending of Money

You have noted in the earlier lessons that commercial banks lend money in four different ways: (a) direct loans, (b) cash credit, (c) overdraft, and (d) discounting of bills. These are briefly discussed below:

(I) Loans

Loan is the amount borrowed from bank. The nature of borrowing is that the money is disbursed and recovery is made in instalments. While lending money by way of loan, credit is given for a definite purpose and for a pre-determined period. Depending upon the purpose and period of loan, each bank has its own procedure for granting loan. However the bank is at liberty to grant the loan requested or refuse it depending upon its own cash position and lending policy. There are two types of loan available from banks :

(a) Demand loan, and

(b) Term loan

(a) A **Demand Loan** is a loan which is repayable on demand by the bank. In other words, it is repayable at short-notice. The entire amount of demand loan is disbursed at one time and the borrower has to pay interest on it. The borrower can repay the loan either in lumpsum (one time) or as agreed with the bank. For example, if it is so agreed the amount of loan may be repaid in suitable instalments. Such loans are normally granted by banks against security. The security may include materials or goods in stock, shares of companies or any other asset. Demand loans are raised normally for working capital purposes, like purchase of raw materials, making payment of short-term liabilities.

(b) **Term Loans** : Medium and long term loans are called term loans. Term loans are granted for more than a year and repayment of such loans is spread over a longer period.

The repayment is generally made in suitable instalments of a fixed amount.

Term loan is required for the purpose of starting a new business activity, renovation, modernization, expansion/ extension of existing units, purchase of plant and machinery, purchase of land for setting up of a factory, construction of factory building or purchase of other immovable assets. These loans are generally secured against the mortgage of land, plant and machinery, building and the like.

(II) Cash credit

Cash credit is a flexible system of lending under which the borrower has the option to withdraw the funds as and when required and to the extent of his needs. Under this arrangement the banker specifies a limit of loan for the customer (known as cash credit limit) up to which the customer is allowed to draw. The cash credit limit is based on the borrower's need and as agreed with the bank.

Against the limit of cash credit, the borrower is permitted to withdraw as and when he needs money subject to the limit sanctioned.

It is normally sanctioned for a period of one year and secured by the security of some tangible assets or personal guarantee. If the account is running satisfactorily, the limit of cash credit may be renewed by the bank at the end of year. The interest is calculated and charged to the customer's account.

Cash credit, is one of the types of bank lending against security by way of pledge or /hypothetication of goods. **'Pledge'** means bailment of goods as security for payment of debt. Its primary purpose is to put the goods pledged in the possession of the lender. It ensures recovery of loan in case of failure of the borrower to repay the borrowed amount. In **'Hypothetication',** goods remain in the possession of the borrower, who binds himself under the agreement to give possession of goods to the banker whenever the banker requires him to do so. So **hypothetication** is a device to create a charge over the asset under circumstances in which transfer of possession is either inconvenient or impracticable.

(III) Overdraft

Overdraft facility is more or less similar to 'cash credit' facility. Overdraft facility is the result of an agreement with the bank by which a current account holder is allowed to draw over and above the credit balance in his/her account. It is a short-period facility. This facility is made available to current account holders who operate their account through cheques. The customer is permitted to withdraw the amount of overdraft allowed as and when he/she needs it and to repay it through deposits in the account as and when it is convenient to him/her.

Overdraft facility is generally granted by a bank on the basis of a written request by the customer. Sometimes the bank also insists on either a promissory note from the borrower or personal security of the borrower to ensure safety of amount withdrawn by the customer. The interest rate on overdraft is higher than is charged on loan. The following are some of the benefits of cash credits and overdraft :-

(i) Cash credit and overdraft allow flexibility of borrowing, which depends upon the need of the borrower.

(ii) There is no necessity of providing security and documentation again and again for borrowing funds.

(iii) This mode of borrowing is simple and elastic and meets the short term financial needs of the business.

(IV) Discounting of Bills

Apart from sanctioning loans and advances, discounting of bills of exchange by bank is another way of making funds available to the customers. Bills of exchange are negotiable instruments which enable debtors to discharge their obligations to the creditors. Such Bills of exchange arise out of commercial transactions both in inland trade and foreign trade. When the seller of goods has to realise his dues from the buyer at a distant place immediately or after the lapse of the agreed period of time, the bill of exchange facilitates this task with the help of the banking institution.

Banks invest a good percentage of their funds in discounting bills of exchange. These bills may be payable on demand or after a stated period.

In discounting a bill, the bank pays the amount to the customer in advance, i.e. before the due date. For this purpose, the bank charges discount on the bill at a specified rate. The bill so discounted , is retained by the bank till its due date and is presented to the drawee on the date of maturity. In case the bill is dishonoured on due date the amount due on bill together with interest and other charges is debited by the bank to the customers account.

Intext Questions 35.3

Fill in the blanks with suitable word/s.

(a) There are four different ways of bank lending; these are:

1. __________
2. __________
3. ___________
4. ___________

(b) Bank Loan can be divided into two categories, viz. ___________ and ____________ .

(c) When the loan is repayable on demand or at a very short notice, the loan is known as _________ .

(d) When the loan granted by bank is for a long or medium period, the loan is called ______________ .

(e) ___________ is a flexible system of lending under which the borrower has the option to withdraw the amount as and when required.

(f) _________ is an arrangement with the bank by which a current account holder is allowed to draw an amount in excess of the balance in his account.

(g) Due date of bill is also known as date of__________ .

35.6 Long-term and Short-term Loans

Commercial banks grant loans for different periods-long, short and medium term for different purposes.

(1) Short-term loans

Short term loans are granted by banks to meet the working capital needs of business. The working capital needs refer to financial needs for such purposes as, purchase of raw materials, payment of wages, electricity bill, taxes etc. Such loans are granted by banks to its borrowers to be repaid within a short period of time not exceeding 15 months.

Short term loans are normally granted against the security of tangible assets like goods in stock, shares, debentures, etc. The rate of interest charged on short term loans ranges from 12% to 18% p.a.

(2) Term Loans

Medium and long term loans are generally known as **'term loans'.** These loans are granted for more than 15 months. In case of medium term loan, the period ranges from 15 months to less than 5 years. Medium term loans are generally granted for heavy repairs, expansion of existing units, modernisation/renovation etc. Such loans are sanctioned against the security of immovable assets. The normal rate of interest ranges between 12% to 18% depending upon the period, purpose, nature and amount of the loan. Though banks may grant long term loans, they avoid granting loan for more than 5 years.

Intext Question 35.4

Write true (t) or false (f) as may be appropriate against the following statements:

(i) Short term loans are sanctioned only for one month.

(ii) Medium or long term loans are known as 'term loans'.

(iii) Long term loans are not required to meet the working capital needs of the business.

(iv) Shares and Debentures are 'immovable assets'.

(v) Commercial banks normally grant loans for more than a period of 15 months.

(vi) Before sanctioning loan, the bank examines the customer's/ borrower's financial position.

35.7 Nature and Security of Loans

To ensure the safety of funds lent, the first and most important factor considered by a bank is the capacity of borrowers to repay the amount of loan, The bank therefore, relies primarily on the character, capacity and financial soundness of the borrower. But the bank can hardly afford to take any risk in this regard and hence it also has the security of tangible assets owned by the borrower. In case the borrower fails to repay the loan, the bank can recover the amount by attaching the assets.

It can sell the assets offered as security and realize the amount. Thus from the view point of security of loans, we can devide the loans into two categories: (a) secured, and (b) unsecured. **Unsecured loans** are those loans which are not covered by the security of tangible assets. Such loans are granted to firms/institutions against the personal security of the owner, manager or director. On the other hand, **Secured loans** are those which are granted against the security of tangible assets, like stock in trade and immovable property. Thus, while granting loan against the security of some assets, a charge is created over the assets of the borrower in favour of the bank. This enables the bank to recover the dues from the customer out of the sale proceeds of the assets in case the borrower fails to repay the loan.

There are various types of securities which may be offered against loans granted, but all of those are not acceptable to the banks. The types of securities generally accepted by the bank are the following:

- Tangible assets such as plant and machinery, motor-van, etc.
- Documents of title to goods, like Railway Receipt (R/R), Bills of exchange, etc.
- Financial Securities (Shares and Debentures)
- Life-Insurance Policy
- Real estates (Land, building, etc).
- Fixed Deposit Receipt (FDR)
- Gold ornaments, Jewellery etc.

Intext Questions 35.5

Fill in the blanks with appropriate words given in the bracket.

(a) The most important factor to be considered to ensure the safety of loan sanctioned is .... of the customer/borrower. (Health/ Goodwill/Capacity to Pay)

(b) In case of default on the part of the borrower to repay, the bank can .... the goods/asset offered as security. (release, sell, return).

(c) The loans which are not covered by the security of tangible assets are .... loans. (long term, short term, unsecured)

(d) Financial securities include .... (shares & debentures, bill of exchange, bonds)

(e) Real estate as security refers to .... (stock in trade, motorcar, house or flat)

35.8 Procedure of granting Cash Credit, Overdraft and Discounting Bills

We have studied in this lesson that banks provide financial assistance to its customers in the form of loans, advances, cash credit, overdraft and through the discounting of bills. The procedure of applying for and sanction of loans and advances differs from bank to bank. However, the steps which are generally to be taken in all cases are as follow:–

(I) Filling up of loan application form

Each bank has separate loan application forms for different categories of borrowers. When you want to borrow money from a bank, you will have to fill up a loan application form available with the bank free of cost.

The loan application form contains different columns to be filled in by the applicant. It includes all information required about the borrower, purpose of loan, nature of facility (cash-credit, overdraft etc) required, period of repayment, nature of security offered, and the financial status of the borrower. A running business limit may be required to furnish additional information in respect of :

— assets and liabilities

— profit and loss for the last 2 to 3 years.

— The names and addresses of three persons

(which may include borrowers, suppliers, customers and bankers) for reference purposes.

(ii) Submission of form along with relevant documents

The loan application form duly filled in should be submitted to the bank along with the relevant documents.

(iii) Sanctioning of loan

The bank scrutinizes the documents submitted and determines the credit worthiness of the applicant. If it is found to be feasible, the loan is sanctioned. If the loan is for Rs 5000 or less, normally the Branch Manager himself can take the decision and sanction the loan. In case the amount of loan is more than Rs 5000, the application is considered at regional, zonal or head office level, depending on the amount of loan.

(iv) Executing the Agreement

When the loan is sanctioned by the bank and the borrower is informed about it, he will have to execute an agreement with the bank regarding terms and condition for the amount of loan raised.

(v) Arrangement of Security for Loan

The borrower will now arrange for security against the loan. These securities may be immovable properties, shares, debentures, fixed deposit receipts, and other documents, like, Kisan Vikas Patra, National Savings Certificate, as per agreement.

When the borrower completes all the formalities, he is allowed to get the amount of loan/advance/ over draft as sanctioned by the bank. In case of 'discounting of bills', the bank credits the amount of bill to the customer's account before the realization of the bill and thus, makes available the fund. In case, the bill is dishonored on due date, the amount due on the bill together with interest and other charges are payable by the party whose bill is discounted.

Intext-Questions 35.6

Fill in the blank With Suitable Words:-

(i) The procedure to apply for and sanction of loans and advances ____________ from bank to bank.

(ii) Loan Application forms are available with the bank ____________ of cost.

(iii) The Bank determines ________________ of the applicant before sanctioning loan.

(iv) A loan of Rs.80,000 would generally be considered at _________ level.

(v) Agreement with the bank includes _________ for the amount of loan raised.

(vi) In case of ___________ the bank credits the amount of bill to the customers account before the realization of the bill.

35.8 What You Have Learnt

The main activities of a commercial bank include acceptance of deposits, that is mobilisation of funds, and lending these funds to people who require it for various purpose. On the deposits received the bank pays interest to the depositors at a specified rate. This is known as the 'Borrowing Rate'. When the Reserve Bank of India lends money to commercial banks, the rate of interest it charges is known as 'Bank rate'. The other important activity of a bank is that of granting loans and advances to the public. The rate of interest at which commercial banks lend money to the people is known as 'Lending rate'. The borrowing rates and lending rates are subject to change from time to time.

There are four different ways of lending money by banks; viz. (a) Direct loans; (b) Cash credits; (c) Overdraft, and (d) discounting of bills. Bank loans may also be classified into 3 categories i.e. Short-term loan, medium term loan and Long-term loan. Short-term loans are granted by banks to meet the working capital needs of business. Medium-term loans and long-terms loans are generally known as 'Term loans'. These loans are granted for more than one year for heavy repairs, expansion of units, modernisation/renovation etc. Such loans are sanctioned against the security of permanent, immovable assets.

To ensure the safety of the funds lent, banks require the security of tangible assets owned by the owner, both in the case of short-term and term loans. Unsecured loans are those granted against the personal security of the borrowers. There are various types of securities which are acceptable by banks against loans and advances.

For getting a loan sanctioned by any bank, one has to apply for it with relevant documents. The bank verifies the application and determines the creditworthiness of the applicant. If it is feasible, the loan is sanctioned. After the sanction of loan the borrower has to enter into an agreement with the bank regarding terms and conditions of the loan. The last step is to arrange for the security for the loan granted by bank. After completing these formalities the borrower is allowed to draw money against the loan.

35.9 Terminal Exercise

(I) What is meant by 'Secured loans'? Enumerate the types of securities generally required by banks for such loans.

(II) Discuss in brief the different ways of lending money by commercial banks.

(III) Is there any difference between 'Demand loan' and 'Term loan'? If yes, write in brief.

(IV) Enumerate the advantages of loans and advances raised from banks by business firms.

(V) Outline in brief the difference between the terms: 'Lending-rate' and 'Borrowing-rate' of a modern bank.

(VI) What do you mean by 'cash-credit' and 'overdraft'? How do banks extend the facility of 'overdraft'?

(VII) How do banks make funds available to their customers through 'discounting of bills'?

(VIII) What is the difference between 'Loan' and 'Advance'?

(IX) State the meaning of:

(a) Term Loan (b) Cash Credit (c) Borrowing Rate

(d) Lending Rate (e) Bank Rate

Practical work:

(A) Chart out the procedure for getting loans and advances from bank with the important documents required and other formalities to be completed.

(B) Visit the nearest bank and enquire about the prevailing rates of interest on different accounts and loans and advances.

(C) Familiarise yourself with the important documents, like application form for loan, including procedure involved in getting Short-term and Term loan.

(D) Discuss with Bank Manager/P.R.O. regarding different types of securities to be pledged/mortgaged against any particular type of loan raised.

35.10 Answers to Intext Questions

35.1 1. True (a), (b)

False (c), (d), (e)

2. (a) Earning;

(b) Loan

(c) Short

(d) Current liabilities

(e) Reserve Bank of India

(f) Secrecy.

35.2 Matching

(A) ---- (5)

(B) ----- (1)

(C) ----- (4)

(D) ----- (3)

(E) ----- (6)

(F) ----- (2)

35.3 (a) (1) Direct loan

(2) Cash credit

(3) Overdraft

(4) Discounting of Bills

(b) Demand loan and Term loan

(c) Demand loan.

(d) Term loan

(e) Cash credit

(f) Overdraft

(g) Maturity.

35.4 True (ii), (iii), (vi)

False (i), (iv), (v).

35.5 (a) Capacity to pay

(b) Sell

(c) unsecured

(d) Shares and Debentures

(e) House or flat.

35.6 (i) Differs

(ii) Free

(iii) Credit worthiness/Paying capacity

(iv) Regional/Zonal

(v) Terms and Conditions

(vi) Discounting of bills.