UNIT – IV Commercial banks and creation of credit – Principle of sound lending- forms of advances; Cash credit, over drafts and loans and advances against work in progress - Purchasing and discounting of bills.

Commercial banks and creation of credit:

A central bank is the primary source of money supply in an economy through circulation of currency. It ensures the availability of currency for meeting the transaction needs of an economy and facilitating various economic activities, such as production, distribution, and consumption.

However, for this purpose, the central bank needs to depend upon the reserves of commercial banks. These reserves of commercial banks are the secondary source of money supply in an economy. The most important function of a commercial bank is the creation of credit.

Therefore, money supplied by commercial banks is called credit money. Commercial banks create credit by advancing loans and purchasing securities. They lend money to individuals and businesses out of deposits accepted from the public. However, commercial banks cannot use the entire amount of public deposits for lending purposes. They are required to keep a certain amount as reserve with the central bank for serving the cash requirements of depositors. After keeping the required amount of reserves, commercial banks can lend the remaining portion of public deposits.

According to Benham's, "a bank may receive interest simply by permitting customers to overdraw their accounts or by purchasing securities and paying for them with its own cheques, thus increasing the total bank deposits."

The process of credit creation can also be learned with the help of following formulae:

Total Credit Creation = Original Deposit * Credit Multiplier Coefficient

Credit multiplier coefficient= 1 / r where r = cash reserve requirement also called as Cash Reserve Ratio (CRR)

Thus, it can be inferred that lower the CRR, the higher will be the credit creation, whereas higher the CRR, lesser will be the credit creation. With the help of credit creation process, money multiplies in an economy. However, the credit creation process of commercial banks is not free from limitations.

Some of the limitations of credit creation by commercial banks are shown in Figure-3:

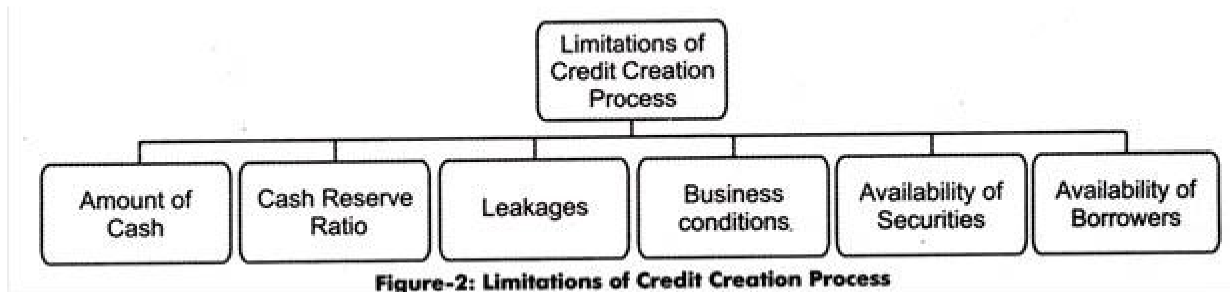

Figure-2: Limitations of Credit Creation Process

Principle of sound lending:

The principles of sound lending by commercial banks are:

Banks should follow some basic principles at the time of lending. This ensures efficient and long term working of the banks. Some of the basic principles of lending are as follows:

1. Safety of principal:

The first and foremost principle of lending is to ensure the safety of the funds lent. It means that the borrower is in a position to repay the loans, along with interest, according to the terms of the loan contract. The repayment of the loan depends upon the borrower's

i. capacity to pay and

ii. willingness to pay.

The banker should, therefore, take utmost care in ensuring that the enterprise or business to which a loan in to be granted is a sound one and the borrower is capable to repay it successfully.

2. Profitability:

Commercial banks are profit earning institutions. They must employ their funds profitably so as to earn sufficient income out of which to pay interest to the depositors, salaries to the staff and to meet various other establishment expenses and distribute dividends

to the shareholder. The sound principle of lending does not sacrifice safety or liquidity for the sake of higher profitability.

3. Marketability or Liquidity:

Liquidity of loans is another principle of sound lending. The term liquidity of loan indicates quick realisation of loans from the borrowers. Banks are essentially dealers in short term funds and therefore, they lend money mainly for short term period. The banker should see that the borrower is able to repay the loan on demand or within a short notice.

4. Purpose of the loan:

Before granting loans, the banker should examine the purpose for which the loan is demanded. If the loan is granted for productive purpose, thereby the borrower will make much profit and he will be able to pay back the loan. In no case, loan is granted for unproductive purpose.

5. Diversification:

The element of risk in relation to loans cannot be totally eliminated, it can only be reduced. Risks of lending can be reduced by diversifying the loans. While granting loans, the banker should not grant a major part of the loan to one single particular person or particular firm or an industry. If the banker grants loans and advances to a number of firms, persons or industries, the banker will not suffer a heavy loss even if a particular firm or industry does not repay the loan.

6. National policies:

Banks have certain social responsibilities towards society also. The banks have to take into account the economic and social priorities of the country beside safety, liquidity and profitability. While formulating the lending policy, the banks are guided by the government policies in relation to disbursal of credit. Thus, national interest and policies are influence the lending decisions of banks.

Forms of Advances in Banking

Forms of advances in commercial banking are;

- Cash credit,
- Overdraft,
- Loans,
- Demand loan vs term loan,
- Secured vs unsecured loan,
- Participation loan or consortium loan,
- Purchasing and discounting bills.

These types of advances are explained below.

Cash Credit

Cash Credit is an arrangement by which the customer is allowed to borrow money up to a certain limit known as the ‘cash credit limit’.

Usually, the borrower is required to provide security in the form of a pledge or hypothecation of tangible securities. Sometimes, this facility is also provided against personal security. This is a permanent arrangement and the customer need not draw the sanctioned amount at once but draw the amount as and when required.

He can put back any surplus amount which he may find with him. Thus cash credit is an active and running account to which deposits and withdrawals may be affected frequently.

Interest is charged only for the amount withdrawn and not for the whole amount approved. If the customer does not use the cash limit to the foil extent, a commitment charge is made by the bank. This charge is imposed on the un-utilized portion of cash credit only.

Cash credit provides an elastic form of borrowing since the limit fluctuates according to the needs of the business. Cash credits are the most favourable mode of financing by large commercial and industrial concerns.

Overdraft

Oxford Dictionary of Finance and Banking defines overdraft as “a loan made to a customer with a cheque account at a bank or building society, in which the account is allowed to go into debt, usually up to a specified limit”.

According to the Cambridge Advanced Learner’s Dictionary, overdraft means “an amount of money that a customer with a bank account is temporarily allowed to owe to the bank or the agreement which allows this”.

The Economist defines an overdraft as “a credit facility that allows borrowers to draw upon it (up to a specified limit) as and when they need to. Borrowers pay only for what they use”.

Overdraft is an arrangement between a banker and his customer by which the latter is allowed to withdraw over and above his credit balance in the current account up to an agreed limit. This is only a temporary accommodation usually granted against security.

The borrower is permitted to draw and repay any number of times, provided the total amount overdrawn does not exceed the agreed limit. The interest is charged only for the amount drawn and not for the whole amount sanctioned.

A cash credit differs from an overdraft in one respect. Cash credit is used for long-term by businesses in doing regular business whereas overdraft is made occasionally and for short duration.

Banks sometimes grant unsecured overdrafts for small amounts to customers having a current account with them. Such customers may be government employees with fixed income or traders.

Temporary overdrafts are permitted only where a reliable source of funds is available to a borrower for repayment.

Demand Loan Vs Term Loan

The loan may be a demand loan or a term loan.

A demand loan is payable on demand. It is for a short period and usually granted to meet the working capital needs of the borrower.

Term loans may be medium-term or long-term. Medium-term loans are granted for a period ranging from one year to five years for vehicles, tools, and equipment.

Long-term loans are granted for capital expenditures such as the purchase of land, construction of factory building, purchase of new machinery and modernization of plant.

Secured Vs Unsecured Loan

According to section 5(e) of the Bank Companies Act, 1991, “Secured loan or advance means such a loan or advance as made against the security assets, market value of which is not at any means less than the amount of such loan or advance and unsecured loan or advance is that loan or advance or part of it does not require sanctioning against the security”.

Participation Loan or Consortium Loan

Where one single loan is granted by more than one financing agency, it is termed as a participation or consortium loan. Such participation becomes necessary where either the risk involved is too large for one or more of the participating institutions to take individually or there are administrative or other difficulties in servicing and follow up of the loan.

Purchasing and Discounting Bills

Bills of exchange, as defined in the Negotiable Instruments Act, 1 SSI, is “an instrument in writing containing an unconditional order, signed by the maker, directing a certain person to pay (on-demand or at a fixed or determinable future time) a certain sum of money only to, or to the order of, a certain person or to the bearer of the instrument”.

Banks grant advances to their customers by discounting bills of exchange.

The net amount, after deducting the amount of interest/discount from the amount of the instalment, is credited in the account of the customer.

In this form of lending, the interest is received by the banker in advance.

Banks sometimes purchase the bills instead of discounting them.

Bills which are accompanied by documents of title to goods such as bills of lading or railway receipt are purchased by the bankers.

In such cases, the banker grants a loan in the form of overdraft or cash credit against the security of the bills.

The term ‘bill purchased’ seems to imply that the bank becomes the purchaser or owner of such bills. But in almost all cases the bank holds the bill only as a security for the advance.