**Chapter Five:**

**Credit Analysis**

Learning Objectives: After studying this lesson, students will be able to:

* Explain the meaning and objectives of credit analysis;
* Describe the factors considered in credit analysis;
* Describe the sources of credit analysis;
* Mention the models of creating charges on securities; and
* Explain the secured loans and advances.

**5.1. The meaning and objectives of credit analysis**

In recent years, with the trend of the economic globalization and volatility of financial market, credit risk management will be the focus in finance. The field of credit risk and corporate bankruptcy prediction gained considerable momentum due to the increased competition in the field and the challenges of the present financial crisis. Credit risk is one of the main risks of commercial banks that will affect the banks’ ability of sustainable operation. Credit risk assessment is performed through the development of models usually based on a classification approach, in order to distinguish potential defaulters from non-defaulters.

Any amount borrowed or lent is called loan. If money is borrowed it is debt of business and if loan is given, it is receivable for the business. Loan is a method of lending under which bank gives credit to a borrower for a fixed period and for a specific purpose. Loan are promises for future payment, they have to be repaid in periods beyond a year and are, therefore long term liabilities. In other words, "when a banker makes an advance in a lump sum which cannot be paid wholly or partly and which the customer has permission to withdraw subsequently, it is called a loan."

Profit is the pivot on which the entire business activity routes. Banking is essentially a business dealing with money and credit. Like every other business activity. Banks are profit oriented. A bank invests its funds in many ways to earn income. The bulk of its income is derived from loans and advances. Banks make loans and advances to traders, businessman and industrialist against the security of some assets or on the basis of the personal security of the borrower. In either case, the banks run the risk of default in repayment. Therefore, banks have to follow a cautions policy and sound lending principles in the matter of lending. Banks in India have to consider the national interest along with their own interest while determining the lending policy.

Many times a borrower needs funds for fixed assets or non-respective type of activities and thus seeks money from the bank that is withdrawn in one lump sum. The loan amount is normally repaid in installments. Loan may be short-term, medium-term or long-term.

* 1. **Factors considered in credit analysis**

A number of factors can influence the choice of credit terms, which may well be specific to the trade or product. Most businesses have an environment of traditional custom and practice. However, some factors are common to all businesses, and for most sellers, the following points will almost certainly apply:

* The seller’s strength in the market
* The credit terms which the seller gets from its own suppliers
* The availability of the capital needed to finance sales and if this is to be borrowed, at what cost?
* The volumes of sales and the range of customers
* The profit margin
* Any special payment arrangements, including longer terms and/or installments
* Competitive pressures; (restricted facilities may be called for, but where competitors offer more advantageous terms, it may be necessary to match them)
* The character of the market; for example, the shorter the shelf life of the goods, the shorter the credit terms should be. Compare broccoli with greenhouses
* The period the buyer will have the goods; for example, if the buyer will resell them at once, payment should be prompt. If the buyer needs time to resell the goods, the credit facilities may also need to be extended
* The condition of the customer’s finances and the risk for allowing time to pay

– The amount at risk is not just the monthly total of sales to the customer but the maximum total unpaid at any one time

**Seasonal and incentive factors**: Sales may be greater at certain times in the year. Incentives to boost sales may include extra time to pay. The effect of this on the total exposure, its risk and cost must still be acceptable.

**The existence of any form of protection for the exposure:** such as, a legal charge, third-party guarantee and retention of title clause or credit insurance. Many businesses, large and small, will add to the above list, according to their own special circumstances. These might involve the time involved in the production of the goods and/or whether the product is customer-specific – making bespoke products for one customer carries its own special risks in respect of non-payment, with or without retention of title, for example. If the business has a monopoly, it may want to try to enforce its own terms and conditions, which customers may take or leave, though there could be legal consequences! Other specific factors may embrace the company’s marketing policy, possibly involving quality considerations, the repetitive character of sales and whether the products are for luxury or utility purposes.

The common thread through all these factors is the decision whether to trade on restrictive or more liberal credit terms. A bone of contention frequently aired between sales and credit management is the interpretation of the credit terms. Thirty days net should mean the same thing to both sales and credit, and equally should be clear to both seller and buyer. The credit terms decided upon, therefore, should be more than just the right ones – they must also be simple to understand and be capable of enforcement. Weekly credit terms, for example, would be meaningless unless the seller and the buyer both agree on what actual day payment is to be made. An example of poor terms is: ‘payment 15 days after receipt of invoice’. The date of receipt of the invoice can only be guessed at by the seller and would certainly be difficult to prove. The agreed terms should always have a clear due date, or be capable of arriving at one without disagreement.

Having agreed the credit terms, with a due date which is clear to all concerned, the seller has a responsibility in his own best interests to ensure that the customer keeps to those terms. If a seller consistently fails to enforce the originally negotiated and agreed credit terms, he is condoning late payment. The customer knows that his pattern of late payment has been accepted as satisfactory by the seller, and that a precedent has been established. The outcome is that the seller cannot now enforce the original credit terms because he has endorsed ‘new’ terms – the only option would be to sit down and start the negotiation process all over again. This scenario is all too common, and the professional credit manager should never allow it to develop.

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| ***Activity 5.1***  *Why the bankers need to consider different factors in credit analysis?* |

* 1. **Sources of credit information**

Credit Reports are collections of all the information regarding a person's history of credit placed into a single document. These reports are mainly used by lenders when evaluating new applicants for credit, although some other companies use them to assist in related financial application processes. Credit Bureaus (the companies that provide credit reports) are not the companies that are responsible for the information in your credit report. There are three main sources for information in credit reports, and the credit bureaus simply collect and report on that information. The three sources for information are companies you've done business with, the government, and local source.

1. **Information from Companies**

The majority of information on your credit report comes directly from companies that you've done business with. Any of your account specific information like payment history, account balances, open dates, and inquiries is reported to the credit bureaus on a regular basis by these companies. Many people don't know that this is also where the credit bureaus get information like your name, your address, and your date of birth. When you fill out an application for a new account, or update your information with an existing account (like when you move), the company updates their internal records and then sends that update to the credit bureaus as well.

1. **Information from the Government**

Sometimes, people have debts to the government or debts that the government has intervened with. Most people don't ever experience this, but it does happen. These accounts are referred to as Public Records There is three types of these accounts: Bankruptcies, Tax Liens, and Civil Judgments. In these cases, the government will update your credit report.

1. **Local Sources**

Information obtained from local sources is open to various faults, partiality or hostility to the one reported on or indifference to the correctness of the report, being among the number. Banks often take the attitude that they are not called upon to make a report, particularly upon a customer not a depositor and of whom they have no accurate knowledge other than of a general nature. Attorneys' reports are of all kinds, frequently carelessly irresponsible, the ordinary attorney not being an accurate judge of the financial condition of a business man.

* 1. **Analysis of financial statement**

**Introduction to Financial Statement Analysis**

[**Financial statement**](http://www.readyratios.com/reference/accounting/financial_statement.html) analysis can be referred as a process of understanding the risk and profitability of a company by analyzing reported financial info, especially annual and quarterly reports. Putting another way, financial statement analysis is a study about accounting ratios among various items included in the balance sheet. These ratios include asset utilization ratios, profitability ratios, leverage ratios, liquidity ratios, and valuation ratios. Moreover, financial statement analysis is a quantifying method for determining the past, current, and prospective performance of a company.

The income statement shows the results of operations for the past year and usually includes both the current and prior year. It lists all sources of revenue and expenses. The statement measures the profitability of the cooperative for a given period of time. Although it does not show timing of cash-flows, the statement best describes the status of the business. In the analysis of income statements, net sales were set at 100 percent to find out the proportion that a single item represented in a total group or subgroup. Because the income statement variables were expressed as a percent of net sales, comparisons were possible between different sizes and types of operations. Thus, the statement used in this report became known as a “common size” income statement.

**Financial ratio analysis**

Looking beyond levels of assets, liabilities, member equities, sales, and expenses, cooperative managers and boards of directors need comparative measures to evaluate their cooperative’s financial performance. Standard ratios were used, including financial ratio analysis that allows performance comparisons between years and different cooperatives. No single financial indicator will provide enough information to determine a cooperative’s financial health.

Therefore, ratios must be carefully interpreted. It is important to look at a group of financial ratios over a period of time, evaluate other cooperatives with similar sales and functions, and/or compare performance with other cooperatives in the same geographical area. Performance ratios measure various levels of cooperative operations and generally have both a financial and operational impact. Four categories were used-liquidity, leverage, activity, and profitability. Many factors underlie each ratio and examining one ratio may not help pinpoint problems.

**Advantages of financial statement analysis**

The different advantages of financial statement analysis are listed below:

* The most important benefit if financial statement analysis is that it provides an idea to the investors about deciding on investing their funds in a particular company.
* Another advantage of financial statement analysis is that regulatory authorities like IASB can ensure the company following the required accounting standards.
* Financial statement analysis is helpful to the government agencies in analyzing the taxation owed to the firm.
* Above all, the company is able to analyze its own performance over a specific time period.

**Limitations of financial statement analysis**

In spite of financial statement analysis being a highly useful tool, it also features some limitations, including comparability of financial data and the need to look beyond ratios. Although comparisons between two companies can provide valuable clues about a company’s financial health, alas, the differences between companies’ accounting methods make it, sometimes, difficult to compare the data of the two. Besides, many a times, sufficient data are on hand in the form of foot notes to the financial statements so as to restate data to a comparable basis. Or else, the analyst should remember the lack of data comparability before reaching any clear-cut conclusion. However, even with this limitation, comparisons between the key ratios of two companies along with industry averages often propose avenues for further investigation.

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| ***Activity 5.2***  *How are you going to make the financial statement analysis?* |

* 1. **Secured Loans and Advances**

One of the primary functions of the commercial banks is lending. Lending of funds constitutes the main business of bank. The major portion of bank funds is employed by way of advances. The bulk of its income is derived from loans and advances. Bank makes loans and advances to traders, businessmen, industrialists and agriculturists to meet their financial requirements.

**5.5.1. Modes of creating charges on securities**

**Types of charges**

Security is obtained by the bank as an additional cover against default by the borrower in repayment of bank's dues. Charging of security means making such security available to the bank and involves certain formalities. Charging should be legal and perfect so that it is possible to realise the security if such a need arises. While extending credit, banker must secure his position. A wide range of securities e.g. Land, Building, Goods, Share Certificates, Life Policies, Fixed Deposit Receipts, Title Deeds etc. are accepted by banks as cover for a loan. Not only that the banker should insist on good securities proper charge should also be created on the securities in order to make them available as and when needed. Creation of charges on securities means making it available as a cover for an advance. Hence, the method of charging securities should be legal, perfect and complete. The important methods of charging securities are as follows:

**Pledge:** Pledge may be defined as the bailment of goods as security for payment of a debt or performance of a promise. Bailment means the delivery of goods by one person to another for some purpose, under a contract that the goods shall, when the purpose is accomplished, be returned or otherwise disposed of according to the directions of the person delivering them. The person, who delivers the goods, as security is called the ‘pledgor’ and the person to whom the goods are so delivered, is called the ‘pledgee’. The ownership remains with the pledgor. It is only a qualified property that passes to the pledgee. He acquires a special priority and lien which is not of ordinary nature and so long as his loan is not re aid no other creditor or ‘authority ‘can take away the goods or its price.

* There should be bailment of goods which implies that goods should be delivered the debtor (pledger) to the creditor (pledgee). The delivery may nevertheless be actual physical delivery or constructive delivery as in case of documents of title to goods.
* The bailment must be by the debtor or on behalf of the debtor.
* The delivery of goods must be with an intention of the parties to create security for die debt or performance of a promise.

In pledge the ownership of the goods remain with the borrower whereas physical control over these goods will be exercised by the bank. The borrower has a right to get the goods returned to him after payment of debt created here against.

In case of default by die borrower the bank can sell the goods after giving a reasonable notice of sale based on the agreements made between the two parties. Notice must clearly indicate the intention of the pledgee to sell the security and is compulsory before the sale can be affected. If the bank realises more than its dues by such sale, the excess realised will have to be returned to the borrower. However, if there is any shortfall, die bank can proceed against the borrower in a court of law for recovery of the balance.

This mode of charge may be considered as an ideal one for the bank as it has full control over the security and can even realise it without any legal process merely by serving a notice on the borrower. The borrower however, is put to great disadvantage as he losses coned over the goods and the account involves operational difficulties. Generally the raw material or finished goods or stock in‑trade etc. not immediately required by the borrower may be offered to the bank for pledge.

The goods pledged to the bank may sometimes be required by the borrower for undertaking a small process. The documents of title to goods deposited with the bank in the pledge account may be required to take delivery from the port/ railway etc. In such situations the bank may temporarily part with the goods on the borrower signing a 'Trust Receipt'. The possession of goods legally remains with the bank and the borrower keeps those goods 'in trust' for the bank during that temporary period. This facility is sometimes given by the bank as a sub‑limit of pledge account for operational convenience.

**Hypothecation:** Pledge takes away control over the goods from the borrower which may not be practicable as the borrower would require certain goods under his control to continue its manufacturing and/or trading activities.

An equitable charge in favour of the bank over the goods is created in such cases without parting with the possession of the goods. A charge on a property for a debt where neither ownership nor possession is passed on to the creditor is known as ‘hypothecation charge’ Hypothecation agreements obtained by banks gener­ally have a clause under which hypothecation can be converted into a pledge at, a later date.

This form of charge is ideal from the point of view of the borrower as he is always in control of goods offered as security to die bank. In case of default by the borrower, the bank may take possession of goods and convert it to pledge only with the consent of the borrower notwithstanding any clause w this effect being included in the hypothecation agreement. The bank will have to move a court of law for taking physical possession of goods or their attachment before judgement.

Hypothecation charge extends to all the goods and moveable properties with the borrower as per the agreement of hypothecation and operations in these accounts are permitted on the basis of stock statement, submitted by the borrower periodically usually every month. Hypothecation may, however, be created as a fixed charge over a particular machinery/vehicle etc.

**Assignment:** Assignment means transfer of a right, property or debt by one person to another person. The person transferring the right is known as assignor and the person to whom the right is transferred is known as assignee. The assignment may be legal in which case the assignor must give a written notice of the assignment stating the name and address of the assignee to the debtor or may he equitable where no such notice is sent. This form of charge is generally adopted for charging of book debts, monies due from Government (supply bills) and life insurance policies etc. Banks generally go in for legal assignment and insist for obtaining an acknowledgement of assignment from the debtor.

**Mortgage:** Mortgage is a mode of charge associated with immovable property. Immovable property shall include land, benefits to arise out of land and things attached to the earth or permanently fastened to anything attached to the earth". Immovable property does not include standing timber, growing crops or grass. It also provides explanation to the term "attached to the earth" which means:

1. rooted in the earth, as in case of trees and shrubs,
2. imbedded in the earth, as in case of walls or buildings, or
3. Attached to what is so imbedded for the permanent enjoyment of that to which it is attached.

A similar definition of immovable property has also been given: Immovable property' includes land, buildings, hereditary allowances, rights to ways, lights, ferries, fisheries or any other benefit to arise out of land and things attached to the earth or permanently fastened to anything which is attached to the earth but not standing timber, growing crops nor grass".

A point in case may arise in respect of machinery. Machinery which is not permanently attached to the earth and can be shifted to other place will not be considered as immovable property. But if machinery is permanently attached to the earth in, a manner that it cannot be removed from there, it shall be considered as immovable property. A person transferring the interest is known as **'mortgagor'** and the person to whom the interest is transferred is known as **'mortgagee'**. Indian law recognises six different types of mortgages out of which the two most acceptable forms of mortgages are discussed hereunder:

**Mortgage by deposit of title deeds or equitable mortgage:** the Transfer of Property defines equitable mortgage as mortgage created by depositing title deeds of an immovable property to secure a debt, existing or future. Three basic conditions to constitute a valid equitable mortgage are

* Delivery of title deeds (original) by the mortgagor to the bank.
* Existence of a debt, existing or future.
* Intention of the mortgagor to create a mortgage on that property to secure the debt.

No equitable mortgage can be created if any of the above three conditions' is not complied with. This form of mortgage is very popular because it does not require finalisation of any mortgage deed and its subsequent registration which requires payment of heavy stamp duty. Mortgage is created simply by depositing the title deeds with the bank with an intention to create a security and no other agreement etc. is strictly required. Equitable mortgage can, however, be created only at places as notified by government in this regard.

**Simple Mortgage:** Transfer of Property relates to simple mortgage in which the mortgagor personally binds himself to pay the debt and agrees that in the event of non-payment by him, the mortgager may cause the mortgaged property to be sold and the proceeds of sale is applied in repayment of debt. The possession of mortgaged property, however, still remains with the mortgagor. The mortgagee does not have an absolute right to sell the property in case of default but has to seek intervention of the court.

A formal mortgage deed will have to be executed for creation of a simple mortgage which will also be required to be registered after payment of necessary stamp duty which is quite substantial and in all the cases will have to be borne by the borrower. All efforts should, therefore, be made to convince the bank to accept equitable mortgage. Simple mortgage may be resorted to only when equitable mortgage cannot be created as in cases where title deeds are not available,

In all forms of mortgages the mortgagor has a right of redemption on payment of the debt after it has become due. The mortgagor also has a right to inspect the documents of title to goods and make copies of or extracts from the title deeds which are in the custody of the bank.

**Lien:** Lien means the right of the creditor to retain the goods or securities of the debtor, which are in his possession until the debt due from the debtor is paid. It does not require any specific agreement to support this right. The lien may be general which confers the right to retain any goods for a general balance of account or it may be particular lien where goods can be retained by the creditor for a particular debt only. The person exercising general lien has only a right to retain the goods till the dues are paid and may not be able to sell those goods.

The right of the banks to general lien is however, considered on a different footing and banks have a general lien on all securities deposited with them as bankers by a customer, unless there be an express contract or circumstances that show an implied contract, inconsistent with lien. A banker’s lien is thus more than a general lien, it is an implied pledge. The bank, therefore, has a right to sell the goods in his possession after giving a reasonable notice. The lien can be exercised on bills and cheque deposited for collection, dividend warrants received by the banker as a mandate from the customer, securities left with the banker after a particular loan has been paid. The banker’s lien however, does not extend to:

* Securities or valuables lying in the locker rented to the customer.
* Securities deposited upon a particular trust.
* Securities deposited to secure a specific loan.
* Securities left with the banks after an advance against them has been adjusted.
* Securities left inadvertently with the bank.

No specific letter of lien agreement is necessary as the banks enjoy the right of lien under the Contract Act. However, in some cases the bank may obtain a specific letter of lien so that the borrower is not able to contend later that the securities were deposited by him for a specific purpose inconsistent with the lien.

### Negative Lien

The borrower may sometime be having no encumbered assets which are not charged to the bank as security. The borrower is thus free to deal with these assets and may even sell them if he so desires. To restrict this right of the borrower, bank may sometimes request him to give an undertaking to the effect that he will neither create any encumbrance on these assets nor sell them without the previous permission of the bank so long as the advance continues. This type of an undertaking obtained by the bank is known as 'Negative Lien'. Negative lien is in the form of a personal assurance or undertaking which has binding effect but confers no right on the bank to proceed against the property itself and thus creates no encumbrance or charge on the property.

**Set Off.** Set off is the right of combining of accounts between a debtor and a creditor so as to arrive at a net balance payable to one or the other. Set off in relation to bank means his right to apply the credit balance in customer's account towards liquidation of debit balance in another account of the customer provided both the accounts are maintained by him in the same capacity. The right may not be considered as absolute and the bank may be required to give a notice for exercising his right of set off. The right of set off can be applied by the bank only if the following conditions are met:

* The liability of the borrower is for a sum which is certain,
* The repayment of debt is due, and
* Both the accounts are held by the customer in the same capacity.

The right of set off should, however, not be exercised arbitrarily and a notice for combining the accounts must invariably be served by the bank on the customer.

**5.5.2. Principles of sound lending**

As observed, the employment of funds is not an easy task. L While, lending his funds a banker is required to follow a cautious policy and conduct his business on the basis of the well known principles of sound lending in order to minimize the risk. The main principles of sound lending are;

**1) Safety:** Safety is the first important of principle of sound lending. The very existence of a bank depends upon the safety of its funds. Safety depends upon the security offered by the borrowers and the repaying capacity and willingness of the borrower. Banker should see that the funds lent out by him would come back in normal course without being forced to resort to legal action.

**2) Liquidity:** Liquidity refers to the ability of an asset to convert into cash without any drastic reduction in its face value with in short time. To meet the demand of the depositors’ time, the bank should keep its funds in liquid state. The banker should see that his advances are given mainly for short term. Again he should see that the securities, which he accepts are easily realizable without much loss in the event of default of borrowers.

**3) Profitability:** Like all other commercial institutions banks are run for profit. Banks earn profit to pay interest to depositor, to declare dividend to share holder meet establishment charges and other expenses .A banker should employ its funds in such a way that they will bring him adequate and steady returns.

**4) Purpose of loan:** Purpose of the loan has assumed a special significance in the present day concept of banking. Before loans a banker should enquiry about the purpose for which it is needed .Loans granted for productive purpose increases the earning capacity of the borrower and ensure prompt repayment. Loans for undesirable activities should be discouraged.

**5) Security:** Customers may offer different kinds of securities viz., land and building, machinery, stocks, shares, debentures, goods, documents of title to goods etc to get advances. The security of the customers is insurance and banker can fall back upon them in times of necessity. Therefore, he should ensure that the security is adequate, marketable and free from encumbrances. Securities, which could be marketed easily, quickly without loss, should prefer.

**5.5.3 Advances against Goods**

Advances sanctioned by scheduled banks in India are secured by goods and commodities broadly divided into four main heads as follows:

(i)                Food articles.

(ii)              Industrial raw materials.

(iii)            Plantation products, and

(iv)            Manufactures and materials.

These advances meet the needs of working capital of a large number of business and industrial concerns. In fact, such advances are essential for all trading and commercial activities in the country, i.e. for storing the agricultural output, the industrial raw materials and the finished products from the time of their harvest or production till their final consumption. An evaluation of goods and commodities as security to the banker reveals the following merits and demerits:

**1. *Safety.***Goods and commodities are tangible assets and provide better security to the banker as compared to the unsecured advances, including guaranteed advances and discounting of bills. If the debtor fails to repay the loan, the banker realizes his dues by selling the pledged goods and may recover the balance, if any, from other property of the debtor. Even as a secured creditor the banker is not fully safe from the risk of fraud or dishonesty on the part of the borrower. With utmost precautions on his part, he cannot verify the quantity and quality of the goods pledged to him. It is practically impossible for the bank manager or the god own-keeper to check and vouch the correctness of the contents of each and every bag, container or package stored in a god own. A dishonest borrower can deceive the banker by pledging goods which do not tally with the description given by him in the documents.

There is the additional risk of deterioration in the quality of the goods or of damage caused to the goods due to unsatisfactory storage arrangements. All goods are not equally durable. Food grains and agricultural crops are likely to be damaged, reduced in weight or may become worthless if stored for a very long period of time. Goods and commodities are, therefore, suitable securities for advances for a shorter period only.

**2. *Price Stability.***As regards the price of the goods and commodities, mixed behavior is experienced. The prices of the goods which are necessaries of life are relatively stable over a short period though not necessarily over a long period. But wide variations in the prices of luxury goods take place due to changes in demand, fashions and tastes of the people. Bankers are generally reluctant to accept the commodities the prices of which are uncertain and fluctuate too widely and frequently. The problem of valuation of stocks pledged is not a difficult one, as daily market quotations are published in the papers and more quotations can be had from reliable traders and brokers.

**3. *Easy Marketability.***Goods and commodities can be liquidated more easily than fixed assets like land, buildings or plants and equipments. Some commodities like wheat, sugar and cotton enjoy ready market while the demand for manufactured articles of seasonal utility or of durable consumer goods is not constant throughout the year. The banker is naturally inclined to accept the commodities having regular and steady demand and wide market.

**4. *Shorter Duration of Advances.***As the goods and commodities decay or deteriorate in quality over a period of time, bankers lend against them for shorter period only. In practice, however, the advances continue even after the normal period is over and are renewed for another period. Such loans are called ''rolled over loans''. Advances against documents of title to goods like the bill of lading or railway receipt are self-liquidating in nature because as soon as the documents are handed over to the consignee against payment or acceptance of the bill of exchange the banker gets back the funds lent by him.

**Precautions to be taken by a Banker**

Goods and commodities are safe, sound and dependable securities for a banker but they are not always free from certain risks. A banker should, therefore, be very careful in accepting them as security and take the following precautions:

1. Though the goods and commodities are the best securities to a banker for granting loans, the customer is also equally important. The customer must be honest and trustworthy otherwise the risks of fraud or dishonest practices always remain. The banker should depend upon his past experience about the customer and also on the goodwill enjoyed by him in the market. The customer must possess business talent and experience, otherwise even an honest and reliable customer without competence and practical experience is not free from risk. The customer must know his trade well and should possess adequate practical experience therein.

2. Before accepting any commodity as security the banker must be well acquainted with the nature of its demand. He must enquire whether the commodity is an item of necessity, comfort or luxury and whether its demand is elastic or otherwise, is constant throughout the year or is seasonal in nature. He should readily accept the commodities which are necessaries of life and are regularly consumed by a large number of people because of their easy marketability in case of need.

The banker should also confirm whether the commodity can be stored for a reasonable period of time without deterioration in its quality or value. Some commodities like rice appreciate in value if stored for some time but other agricultural products are damaged if stored for a long period.

3. The banker must be well acquainted with the commodity market. He should know well the commodities offered as security, the conditions and customs of their trades and also the trend of their prices in the market. Such knowledge is essential for him to regulate the margins to be maintained.

4.  *The banker should take delivery of the goods* before he grants a loan against it to a customer. Delivery may be either actual delivery or constructive delivery. In case of the latter, the customer hands over the keys of the god own store the goods to the banker or transfers the services of the watchman. In some cases the banker provides facilities usually called ''factory type'', meaning thereby that the stocks pledged with the banker are permitted to be processed or utilized by the debtor. The banker retains his charge over the same and a name-plate of the banker is displayed at an important place in the business premises of the debtor to indicate that the goods are pledged to the banker. Wherever desirable, a contract of hypothecation may also be entered into to provide such facilities to the borrower.

5. The banker should estimate the value of the goods very carefully. He should ascertain the exact quantity of the goods pledged and find out their prices in the market through a broker, if necessary. The invoice price, given by the borrower, should be checked because it might be an inflated one.

6. The banker should also take necessary care regarding the storage of the goods pledged. The god owns should be safe from water, fire, etc., and should be situated in a good locality. Proper record should be kept in the god own register. Serial number of the god own and its capacity and size should also be recorded.

7. The goods should be duly and adequately insured against fire, theft, etc. As the fire insurance policies contain an "Average Clause'', the banker must get the goods insured for their full value irrespective of the amount of the loan advanced because if the full value is not insured, the insurance company will pay the damages in the same proportion in which the total value stands to the amount insured. The insurance premium and the rent of the god own, if paid by the banker, should be treated as a part of the loan granted to the customer and interest thereon should be charged.

8. As the borrower is allowed by the banker to repay the loan in parts also and to get the commodities released, it is very important for the banker to ensure that goods released should be in proportion to the amount of the loan repaid by the customer. Hence, the banker should strictly regulate the delivery of the goods. All deliveries must be sanctioned by the Manager through the Delivery Orders specifying the quantum of goods and their distinctive numbers. It is also essential that responsible officials should inspect the god owns frequently and without notice to ensure effective check.

**5.5.4** **Advances against Documents of title to goods**

A document of title to goods is a document used in the ordinary course of business as a proof of the possession or control of goods, it authorizes, either by endorsement or by delivery, the possessor of the document to transfer or receive the goods represented by it of the Sale of Goods. Thus, a document of title to goods represents actual goods in the possession of somebody else. It confers on the purchaser the right to receive the goods and to transfer such right to any other person by mere delivery or by endorsement and delivery. There are two tests by which we may judge the validity of such a document:

(a) The person who possesses such document is recognized by law or by business practice as possessing the actual goods; and

(b) The person who possesses such document can transfer the goods to any person by endorsement or delivery of by both. The transferee is thus, entitled to take delivery of the goods in his own right.

Bill of Lading, Dock Warrants, Warehouse-keeper’s or wharfinger''s certificate, railway receipts and delivery orders are the instances of the documents of title to goods. Documents of title to goods must be distinguished from those documents which are mere acknowledgement of receipt of the goods. In case of documents of title to goods, the person possessing such documents is entitled to have the legal title to goods, and the said goods are taken "out of the order and disposition of the insolvent". It means that if the person in whose possession the goods lie becomes insolvent, the official receiver will not include such goods amongst the total assets of the insolvent.

**Risks in Case of Advances against Documents**

The documents of title to goods represent actual goods and hence, they are presumed to be as good a security as the goods. However, the advances against documents of title to goods are subject to the following risks in addition to the risks involved in advances against goods:

**1. *Greater Risks of Frauds and Dishonesty.***The transporter or warehouseman grants a receipt for the goods entrusted to him but he does not certify or guarantee the correctness of the contents of the bags or the packages. A dishonest trader may deceive the banker by giving false description of the goods in the documents of title which are pledged with the banker. For example, if a trader dispatches by rail hundred bags containing sand but gives the description of sugar on the forwarding note, he receives a railway receipt for sugar bags which may be handed over to the banker for securing an advance. The banker will have no remedy against the transporter in such circumstances. Moreover, the documents may be forged also or the figures therein may be raised fraudulently.

**2. *Not Negotiable Documents.***The documents of title to goods are not negotiable instruments like checks, bills of exchange or promissory notes. A negotiable instrument confers on its bonfire holder in due course an unimpeachable title to goods irrespective of the defect in the title of the endorser or the transferor. The documents of title to goods are however, transferable ones and can be endorsed to any person but the transferee does not get a better title than of the transferor.

**3. In case of railway receipt**, there is the *risk of the borrower’s taking delivery* of the goods on the basis of an Indemnity Bond, while the railway receipt is given to the banker as security. An interesting case of such fraud was reported in which five wagons containing 415 bales of fully pressed cotton were delivered in a private siding belonging to a firm of Saharanpur and unloaded by them without producing the railway receipt, which was duly endorsed in favor of United Commercial Bank. The bales were pledged to the Central Bank of India and the firm took an advance from the latter.

The Railway Protection Force alleged lapse on the part of the railway men for surrendering the railway receipt by the party and negligence on the part of the bank authorities for not ascertaining the ownership of the bales before advancing huge sums. The RPF took into possession the bales from the god own of the firm and the same were handed over to the Central Bank of India on *superdari* (entrustment) by the Court.

**Precautions to be taken by the Banker**

* In order to avoid risks of fraud and dishonesty, the banker should accept such documents as security from honest, reliable and trusted parties only.
* Special care should be taken to see that documents are genuine and not forged ones.
* It should be carefully noted that the documents of title do not contain any onerous or prejudicial remark about packing of the goods. If the document contains a remark to this effect, such as "Packing defective" or "goods not properly packed" or "the container is leaking”, the banker should not grant any advance against such receipt.
* The goods must be insured for its full value against the risks of fire, theft etc.
* To ensure that the goods packed in bags, etc. actually conform to the description contained in the documents; it is desirable that a certificate from a reliable firm of packers is obtained, especially in case of valuable goods.
* The banker should also take a memorandum of charge from the borrower authorizing the banker to sell the goods if the borrower defaults in making payment.
* It is also essential that the issuer of the document of title to goods, i.e. transporter, warehouseman, etc. is a reliable person of firm.

**Important Documents of Title of Goods**

1. **Bill of Lading.** A Bill of Lading is a document issued by a shipping company acknowledging the receipt of goods for carrying to a specified port. It also contains the conditions for such transportation of goods and full description of the goods, i.e. their markings contents as declared by the consignor. The shipping company gives an undertaking to deliver the goods to the consignee or to his order in the same condition in which it has received, on payment of the freight and other charges due thereon. It is to be noted that a Bill of Lading is prima facie evidence of the fact that the packages, as specified therein, were put on board the ship but the shipping company is not responsible for the contents of the bags or the bales entrusted to it for transportation. It is, therefore, essential for the banker to accept such documents from reliable and trustworthy parties only.

Bills of lading are issued in sets of three, duly signed and bearing the mark ''original'', ''duplicate'' or ''triplicate'', respectively. The shipping company delivers the goods on presentation of any one of the three copies of the bills of lading, thus rendering the other two ineffective. It is, therefore, essential for the banker to demand all the three copies of the bill of lading duly endorsed, before an advance is made against it.

A bill of lading is not a negotiable instrument, though it is transferable by endorsement and delivery. Therefore, a bonafide holder for value of such a bill of lading does not get title to the goods better than that of the transferor of the documents. He can sue on his own name and can give valid discharge.

2. **Warehouse Receipts.** An important objective of promoting warehousing in the country has been to enable the owners of commodities—agriculturists and traders—to acquire a convenient security in the form of warehouse receipt, which can be accepted as security by the banks. To popularize the warehouse receipts as security for loans from banks, the Reserve Bank granted some concessions in respect of such advances in its selective credit control directives in the past. Most of the advances against warehouse receipts have been sanctioned to the traders.

**Precautions to be taken by the Banker**

* A Warehouse Receipt is not a negotiable instrument under the Negotiable Instrument Act and hence, the transferee (i.e. the banker) cannot acquire title better than that of transferor. In case the receipt is a stolen one or the endorsement thereon is a forged one, the banker will have no protection. The banker should, therefore, satisfy himself as to the title of the holder or the transferor. Some bankers usually confine such advances to the original depositors of the goods or to the first endorsee or transferee only. The banker should also take a declaration from the borrower certifying that the goods are his absolute property.
* The banker should ensure that the Warehouse Receipt is a genuine one. The signatures of the Warehouseman and the endorsee, if any, should also be confirmed.
* The receipt should be pledged with the banker with a memorandum of pledge.
* The banker should inform the warehouseman about his lien over the Receipt and the latter’s acknowledgement be secured by the banker.
* An additional undertaking should also be taken from the customer that he will not take delivery of the goods on the basis of Indemnity Bond. He should also inform the warehouseman not to release the goods without the consent of the banker.
* The banker should release the Receipt on payment of the debt. If in the meanwhile a part of the goods is to be released to the customer, the banker should issue a delivery order.

**3.** **Railway Receipt.** Railway receipt is a document acknowledging the receipt of goods specified therein for transportation to a place mentioned therein. It is transferable but not a negotiable instrument. It can be transferred by endorsement and delivery. As the Receipt is to be produced before the railway authorities to clear the goods at the destination, advances sought against such receipt are for very short periods. Generally, the consignor of the goods draws a bill of exchange or a hundi on the consignee for the amount of the goods consigned and discounts the bill/hundi with the banker.

The Railway Receipt is enclosed with the bill which is called a documentary bill. The banker releases the Railway Receipt to the consignee against payment/acceptance of the bill. The Bombay High Court held that an endorsee of a Railway Receipt could not file a suit for damages for short delivery in consignment of the goods unless he had been shown to be the owner of the goods. Though this right of action is ordinarily vested in the consignor but the consignee, who is in possession of a railway receipt duly endorsed by the consignor, may maintain an action, but he could do so not because he is the consignee but because he is the owner of the goods. A bare consignee who is not the owner of the goods could not maintain a suit for such compensation. The banker should take the following precautions in this connection:

(i) The consignor may give wrong description of the goods consigned. The banker should, therefore, discount only such documentary bills with Railway Receipt which are drawn by parties of repute.

(ii) Sometimes the goods are delivered by the railway authorities on the basis of Indemnity Bond furnished by a wrong party. In such circumstances, the banker shall have to file a suit in the court of law. To avoid such a situation, the banker should inform the railway authorities at the destination about his interest in the goods and ask them not to release the goods without the railway receipt duly discharged.

(iii) The railway receipt should be on railway risk and without any alterations. The banker should prefer "Freight Paid" railway receipt because he will not be required to pay the freight, if he is forced to take the delivery of the goods at the destination.

**4.** **Trust Receipts.** The goods or the documents of title to goods pledged with a banker as security for an advance are usually released by the banker on the repayment of the borrowed amount. Sometimes, the borrower wishes to get the security released before he actually repays the loan. In such cases, the banker may, at his discretion, allow the customer to get back the goods or documents and ask the latter to execute a Trust Receipt. By signing such Receipt, the customer undertakes to receive the goods or the documents of title to goods in trust for the lender. The borrower promises to hold the goods or their sale proceeds as trustee for the banker and to pay the same to the latter as and when received.

The legal position of the Trust Receipt from the banker’s point of view, however, remains unsatisfactory. As regards the ineffectiveness of a Trust Receipt as security for the banker, the Banking Commission, 1972, opined that, "The present position seems to be that advances against trust receipt do not create any trust, that goods released against trust receipt would be affected by the reputed ownership clause under the insolvency laws in India, that the borrower may validly create unauthorized pledge of the documents of title to goods released to him under a Trust Receipt and that any wrongful dealing with the goods it may not be possible to prosecute the borrower."

The Commission, therefore, concluded that "from the banker’s point of view, the trust receipt is considered practically valueless as a document creating a security interest in their favor." Banks treat advances against trust receipts as unsecured and grant this facility only too well established customers.

**5.5.5** **Advances against Stock Exchange Securities**

Stock exchange securities include securities in which dealings take place on the stock exchanges. They can be classified into three categories:

1. ***Government securities:*** They include securities issued by the Central and the State Governments.
2. ***Semi-government securities****.* They include securities issued by semi-government institutions like Port Trusts, Improvement Trusts etc.
3. ***Corporate securities****:* They include securities issued by public limited companies. They may further be classified as (i) ownership securities consisting of equity and preference shares, and (ii) creditor-ship securities represented by debentures.

Shares and debentures of private limited companies are not suitable form of security for grant of bank advances on account of their being not quoted on a stock exchange, restrictive transferability and non-marketability.

Government and Semi-government securities (also known as gilt-edged securities) are the safest form of security on which the banks can advance money. Out of corporate securities the banks would prefer debentures in comparison to shares and preference shares in comparison to equity shares since debentures have a priority in payment over shares and preference shares have a priority in payment over equity shares. However, while investing their funds in or granting of loans against shares, the banks have to keep in mind the statutory restrictions placed by section of the Banking Regulation. The section provides as follows: “No banking company shall hold shares in any company, whether as pledgee. mortgagee or absolute owner, of an amount exceeding 30% of the paid-up share capital of that company or 30% of its own paid-up share capital and reserves, whichever is less.

**Merits on stock-exchange securities**

In comparison to other form of securities, stock exchange securities have the following merits:

1. ***Reliability:*** The security being tangible is better in comparison to personal guarantees given for payment of debts. Moreover, it is easier for the banker to verify the title of the borrower to these securities.
2. ***Liquidity:*** Stock exchange securities, particularly gilt-edged securities are more easily realizable as compared to land, buildings, goods and similar other securities.
3. ***Price stability****:* Good stock exchange securities do not have much fluctuation in their prices. Hence, a banker can be more sure of recovering his If the need arises.
4. ***Easier valuation:*** Since the securities are quoted on the stock exchange, the banker can ascertain their value quite easily.
5. ***Transferability:*** The ownership of the stock exchange securities can be easily transferred as compared to other partially negotiable securities such as land, buildings etc. Moreover, in time of need the banker may also obtain funds on the basis of these securities.
6. ***Regular recovery:*** The dividend or interest which is received from time to time on these securities can be used for recovery of interest due on the loan or repayment of the principal itself.

**Advances against Goods/Stock in Trade**

Advances needed to the customers when they feel crisis of fund. And when the customers need advances they went to bank for help. Then bank help the customers by giving advances against Goods/Stocks in Trade. About 2/3 of the total secured advances are sanctioned by banks against the security of goods which include food articles, industrial raw material plantation products, manufactured articles and minerals. Goods have many distinct advantages over other forms of securities:

1. They are easily realizable on account of their having a ready market.
2. Their value can easily be ascertained from the market.
3. They are tangible assets and, therefore, can be realized in case the necessity arises.
4. Loans against commodities are of a seasonal character. They are repaid before the commencement of the next season. Therefore, there is no unnecessary locking up of funds.
5. In case of commodities which are used as necessaries of life, there is not much of price fluctuations.

**However, goods as ‘security’ have their own limitations.**

1. Effective supervision over goods may not be possible particularly when they are hypothecated. Dishonest persons may cheat the banks.
2. Quality of goods is difficult to verify. The goods actually pledged may be quite different than those which were promised to be pledged.
3. Goods deteriorate in quality with the passage of time. This results in erosion in bank’s security.
4. Heavy transportation costs may have to be incurred for realizing the best possible price for the goods.

**Precautions and Procedures**

The bank should keep in mind the following points while advancing money on the security of goods.

* Selection of the borrower. The banker should satisfy himself regarding the character, capacity and capital of the borrower. Since in case of goods, chances of fraud are more, this is all the more important.
* Selection of the commodities. Commodities should be such which have fairly stable prices. The Head Office should prepare a list of such commodities and in case a branch wants to lend money on the security of a commodity which is outside this list, the branch should take permission of the Head Office. .
* Charging the security. Goods can be deposited by way of security either in the form of a pledge or hypothecation. In case of hypothecation the borrower must be dependable since the banker has little control over the movement of goods. The banker must also obtain a declaration from the borrower stating that
* the borrower is the owner of the goods hypothecated and
* He shall not charge the same goods to any other person without the prior consent of the bank.
* Storage of goods, following points should be taken into account while storing the goods offered by way of security:

(i). the god own should safe from water, fire etc. and situated in a good locality.

(ii). In case of hypothecation of goods the borrower should give an undertaking that he will allow inspection of god own and stock books as and when desired by the bank’s officials.

(iii). In case of pledge the god own should have a bank lock with the bank’s name engraved on it. Some name plates declaring that the goods are pledged should be prominently displayed in the god own.

(v). In case of payment of loan in installments it should be seen that the goods released are in proportion to the amount paid by the borrower.

(vi). the goods should be insured for full value so that the bank may not have to suffer on account of “average clause m case of under insurance.

[**Conduct of the account**](http://bankbankerbanking-bd.com/category/bank-account/)

* No loan should be granted before the bank obtains either actual, constructive delivery of goods. In case of the bank permits the borrower process out the raw materials hypothecated into a finished product, appropriate name plate that the goods are hypothecated with the bank should be prominently displayed.
* The balance in the borrower’s account should not be allowed exceed the drawing limit.
* The drawing limit should be fixed by taking into account the value of the goods (calculated on the basis of cost or market price, whichever is less) and appropriate margin in respect of those goods. While valuing the goods both quantity and quality of goods should be seen.
* The borrower should clear the old debt before the commencement of the next season. In case he has not done so, necessary explanation should be called for.
* The advances should be made for genuine trade needs and, not for speculation activities.

**Legal requirements:**

Under its selective credit control scheme, Bangladesh Bank issues from time to time directives regarding granting of loans against selective commodities. The banker should abide by these directives.

**Documents required Advances against Goods/Stock in Trade:**

1. Application for credit
2. Accepted copy of sanction letter
3. D. P. note
4. Letter of arrangement
5. Letter of continuity
6. Letter of lien (containing set-off clause).
7. Letter of Hypothecation (if Hypothecated)
8. Letter of Pledge (if Pledged).
9. Stock report
10. Letter of delivery of stock (it pledged).
11. Insurance policy in the joint name of the Bank and the borrower.
12. Irrevocable power of attorney in favor of Bank.
13. Letter of authority to pay the salary & allowances to the god own staff (if pledged).
14. Letter of consent and Letter of disclaimer from the owner of the god own/warehouse (if rented).
15. Letter of Guarantee from 3rd party (if any).
    * 1. **Advances against Land and buildings**

**Advances against Real Estate**

Though real estates, i.e., immovable property like land and buildings, are tangible assets, commercial banks do not regard them suitable security for advancing loans. Banker's reluctance to accept real estate as security is largely due to the following practical difficulties and legal complications:

***(a) Ascertaining the Title of the Owner****.* Before accepting the real estate as security, the banker must ascertain the title of the owner to the property to be mortgaged. This is a difficult task because the laws are quite complicated. The banker, therefore, asks his solicitors to examine the documents of het title to property to ascertain whether the borrower possesses the right to mortgage the property. It is also to be confirmed that the property is unencumbered, i.e., no prior charge exists; otherwise the second charge over the property in favor of the banker will have second priority. This is done by inspecting the Register of Mortgages for which necessary expenses are to be incurred and much time is spent.

The problem of establishing the right of ownership is extremely difficult in case of agricultural land because land records are not properly maintained. Even if eth initial survey and settlement of land have taken place, subsequent changes, if any, in ownership as a result of sale or partition of land often fail to get promptly and correctly recorded in the basic village records. Land records relating to cultivating tenants are still less satisfactory, as the provisions of land reform legislation are widely circumvented and oral or informal tendency is widespread. In the absence of up-to-date and accurate record of rights in land, it is difficult for the banker to accept such land as security.

***(ii) Restrictive Laws.***The commercial banks are placed at par with other ordinary money-lenders under the debt relief laws and other Acts regulating money-lending with the effect that they are also restricted from proceedings against defaulters, who are agricultures. In some cases, the agriculturists are barred from transferring their land to the commercial banks. These restrictive laws limit the utility of land as a suitable security for the commercial banks. The Rural Credit Review Committee, therefore, recommended that those features of het legislation which inhibit the commercial banks from providing credit to agriculturists be deleted by the State Governments.

***(iii) Land and Buildings are not readily releasable assets.***These are, not preferred by the commercial banks because of their obligation towards the depositors to repeat their deposits on demand. Arranging the sale of land and buildings takes time as their demand is influenced by many factors. Sometimes, it is difficult to dispose them of quickly. In the absence of a ready market, real estate’s are not considered easily marketable assets and eth funds of the banker remain unrealized for a considerable period of time, if the borrower defaults.

***(iv) The Valuation of Property is a difficult problem.***If the banker accepts a building as security for a loan, he is naturally interested in the *realizable value of the property* and not its book value or its cost of construction. The total amount invested in a building by the customer might not be realizable if the property is offered for sale because of its location, special type of construction or lack of demand at a particular time. Expert values or brokers are, therefore, deputed by the banker for valuing the property offered as security.

***(v) Legal formalities.***Preparation of Mortgagee Deed and its registration takes time and excess expenses are incurred in the form of Stamp Duty, Registration fee, etc. Thus much cost is involved in creating a charge on real estates in favor of the banker.

**Precautions to be taken by the Banker**

In spite of the above-mentioned drawbacks, banks are offered real estate’s as security/ collateral security to cover a partly secured or unsecured advance. The banker should take the following precautions while accepting real estate as security for an advance.

***(i) Financial Soundness of the Borrower.***A prudent banker always scrutinizes the financial soundness of the borrower and the viability of his business enterprise for which a loan is to be advanced. He should be satisfied about the capacity and competence of the borrower to return the borrowed money from his own resources. Though he is legally entitled to take recourse to the mortgaged property, a banker likes to avoid this and depends upon the financial soundness of the borrower.

***(ii) Examination of the Documents of Title.***The banker should refer the documents of title to property to his lawyer, to ascertain whether the mortgagor possesses absolute and undisputed title to the property and also the right to mortgage it. The banker and this lawyer should examine the Abstract of Title to find out the transfer of property in the past. Banker should entertain any such proposal, if the solicitor confirms borrower's absolute right in the property.

*(****iii) Investigation of Prior Charge /over the Property.***It is also essential for the banker to ascertain whether the property, offered as security, is unencumbered and without having any previous charge in favor of any other party. The banker should, therefore, conduct search by a lawyer into the Register of Mortgages and Charges either since the purchase by the mortgagor or for the last 20 years, whichever period is shorter.

***(iv) Valuation of the property.***Valuation of real estate must be undertaken by the banker very carefully. The banker usually entrusts this work to the expert values or engineers who take into account all the relevant factors before computing the value of the property. The following factors should be taken into consideration in this regard:

**(a) For the purpose of the lending banker the *realizable value of the property is relevant***rather than its b book value or its cost of construction. Banker's interest as lender will be safe if the property can fetch a value equal to the amount of the liability of the borrower in case necessity arises to sell the property. The realizable value may fall short of the book value due to lack of demand for such property at a particular time and in the particular locality where it is situated.

**(b) The value of real estate also depends upon the *ownership right, i.e.,*** whether it is freehold or leasehold. In case of leasehold right, the value of the property declines as the unexpired period of the lease narrows down. The banker should take into account the expired period of lease, the lease rent paid by the borrower and the chance of renewal of het lease for another period.

(c) The prices at which similar properties have been transacted in the same locality in recent past is also a dependable guide as to the realize value of the property in question because real estate *prices are influenced by the location of the property* to a large extent. Vast differences may be found in prices of similar properties located in a posh colony and at a neglected and far-off-place.

**(d) *The value of the building also depends upon their size, structure, lay-out and construction.***If the asset is too large a size like a palace, few buyers would be interested in the bargain and its price may be affected if there is a competition amongst the buyers. Similarly, if the layout and structure of property is such that it may be put to only one particular of property type of use, the realizable value is likely to be substantially lower if that particular use is not deemed profitable. For example, a building meant for a cinema or a hotel will not fetch a reasonable price if these businesses are not profitable at the place it is located. The quality, of the construction material used and the life of the building obviously are other significant considerations.

***(e)******The market value is ascertained by capitalizing the rental value***of the property at a reasonable rate of interest. For example, if a building has a rental value Br 8,000 per annum the normal rate of interest or the expected return on investment is 10% per annum, the market value is derived by capitalizing the rental value as follows:

100 \* 8,000 = Br 80,000

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***(v) Sufficient margin to be maintained.***As an immovable property is not an easily realizable security and its estimated value is just a guesswork, bankers should safeguard their by keeping sufficient margin. Banks generally keep margin ranging between 33% and 50% of the value of the property.

***(vi) The property must be insured.***The banker should insist that the building to be mortgaged must be insured against fire to the extent of is full value irrespective of the amount of the loan advanced. It is essential to safeguard the banker's interest because the ''''Average Clause'''', inserted in the free insurance policies, makes the insurance company responsible on a *pro rata basis,* if the property is under-insured.

**For example,** if the property worth Br 1000 is insured for Br 75,000 only and the loss occurs to the extent of Br 50,000 the insurance company will be liable to pay three-fourths of the actual loss, i.e., Br 37,500 only instead of Br 50,000 because only three-fourths of eth value of the property was insured. The fire insurance policy should be assigned in favor of the banker. The borrower policy should be assigned in favor of the banker. The borrower or the banker must renew the policy regularly till the loan is repaid.

***(viii) Registration of Legal Mortgage.***If the amount secured by a legal mortgage is Rs. 100 or more, the mortgage must be created by a registered Mortgage Deed. The banker should, therefore, insist on the registration of het mortgage deed. In case the mortgagor is a joint stock company, both legal and equitable mortgages must also be registered with the Registrar of joint Stock Companies within 30 days from the date of their creation.

**House Building Advance to Central Government Employees**

**1**. The Scheme of House Building Advance to Central Government Employees is aimed at providing assistance to the Government employees to construct/acquire house/flats of their own. The scheme was introduced in 1956, as a welfare measure. Ministry of Urban Development & Poverty Alleviation act as the nodal Ministry for the same.

**2.** House Building Advance is admissible to all those temporary employees also who have rendered 10 years of continuous service. The Ministries/Departments are delegated powers to sanction House Building Advance to their employees in accordance with the House Building Advance Rules.

**3.** With effect from 27-11-2008, the following provisions of grant of House Building Advance shall be in operation, until further orders:-

(i). The maximum limit for grant of HBA shall be 34 months' of pay in the pay band subject to a maximum of Rs. 7500lakh or cost of the house or the repaying capacity whichever is the least, for new construction/purchase of new house/flat. (ii).The maximum limit for grant of HBA for enlargement of existing house shall be 34 months' pay in the pay band subject to a maximum of Rs. 1.80 lakh or cost of the enlargement or repaying capacity, whichever is the least.

(ii). The cost ceiling limit shall be 134 times the pay in the pay band subject to a minimum of Rs.7.50 lakh and a maximum of Rs.30 lakh relax able up to a maximum of 25% of the revised maximum cost ceiling of Rs.30 lakh.

4. The rate of interest on House Building Advance is “between 5% - 9.5%” depending on the loan amount.

5. The repaying capacity of Govt. servants who have more than 20 years of remaining service has been revised from 35% to 40% of pay. (Pay means pay in the pay band).

6. The salient features of House Building Advance Rules are as follows-

**1. Eligibility**

* Permanent Government employees.
* Temporary Government employees who have rendered at least 10 years continuous service.
* To be granted once during the entire service.

The criterion for taking home-loans is as follows.

* The loan is provided to any individuals who have regular and stable source of income. This loan can be given to any salaried and self-employed individuals.
* The loan will be provided to Nepalese Citizens only.
* Any house/land, which does not lie in municipal area, will not be financed. However, urban VDC can also be considered with proper justification.
* The land and/or house to be constructed / purchased / renovated / extended / modified should have motor able road (8 feet wide in minimum) access. Such road should be clearly seen in the blue print or be verified by concerned authority (for e.g. ward office).
* All borrowers and guarantor should not be enlisted in “Black List” of Nepal Rastra Bank.
* 3 years work experience is needed for salaried and self-employed individuals.
* In case of business income, financial statement of the company should be audited.
* The borrower must be at least 21years and should not exceed 60 years at the time of maturity. The retirement age must be more than the tenure of the loan.

If both the husband and wife are Government of India employees and eligible for HBA, it shall be admissible to only one of them.

**2. Purpose**

**Example:** HBA is granted for:

1. Constructing a new house on the plot owned by the official or the Official and the Official's wife/husband jointly.
2. Purchasing a plot and constructing a house thereon.
3. Purchasing a plot under Co-operative Schemes and constructing a house thereon or acquiring house through membership of Co-operative Group Housing Scheme.
4. Purchasing /construction of house under the Self-Financing scheme of Delhi, Bangalore, U.P., Lucknow etc.
5. Outright purchase of new ready-built house/flat Housing boards, Development Authorities and other statutory or semi-Government bodies and also from private parties.\*
6. Enlarging living accommodation in an existing house owned by the official or jointly with his/her wife/husband. The total cost of the existing structure (excluding cost of land) and the proposed additions should not exceed the prescribed cost ceiling.
7. Repayment of loan or advance taken from a Government or HUDCO or Private source even if the construction has already commenced, subject to certain conditions.
8. Constructing the residential portion only of the building on a Plot which is earmarked as a shop-cum-residential plot in a Residential colony.

###### Repayment of Advance:

The recovery of advance shall be made in not more than 180 monthly installments and interest shall be recovered thereafter in not more than 60 monthly installments. In case Government servant is retiring before 20 years, repayment may be made in convenient installments and balance may be paid out of Retirement Gratuity.

###### Creation of Second Mortgage:

The Government servants who have obtained HBA from the Government may be permitted to create a second charge on the property provided they obtain prior permission of the Head of the Department and the draft deed of second mortgage is submitted to the Head of the Department for scrutiny. Such a second charge may be created only in respect of loans to be granted for meeting the balance cost of houses/flats by recognized financial institutions.

**Provisions for Safe Recovery of House Building Advance:**

As a safeguard of the House Building advance, the loanee Government employee has to insure the house immediately on completion or purchase of the house. The house/flat constructed/purchased with the help of House Building advance can also be insured with the private insurance companies which are approved by Insurance Regulatory Development Authority (IRDA). However, the insurance should be taken for a sum not less than the amount of advance against damage by fire, flood and lightning, and has to be continued till the advance together with interest is fully repaid to Government.

(ii).The house constructed/purchased with the help of House Building Advance has also be mortgaged in favor of the President of the nation within a stipulated time unless an extension of time is granted by the concerned Head of the Department. After completion of the recovery of the advance together with interest thereon, the mortgage deed is re-conveyed in a proper manner.

## Mortgage Basics for Building a Home

Finding the money to build a new home differs from taking out a conventional mortgage on an existing home, because to build a home, you essentially need three loans: one for the land, one for the construction phase, and one for the permanent financing of the home after it is built.

But the process is not nearly as difficult to navigate as it may seem, as many lenders combine these three loans into two or even one loan. Here is some basic information about the process to get you started:

**Buying land:** Most lenders are cautious about lending money on raw land because it can often be difficult to resell in case of default. Those that will lend may want a large down payment 20 percent or more with a high interest rate. It might be best to pay cash, if you can.

**Building the home:** In order to build, you'll need a construction loan, which isn't available through all lenders. Those that do will require blueprints and specifications, appropriate permits, and a licensed bonded contractor before they will consider lending for construction. This type of loan allows the contractor to make draws on the total amount of money as each phase of construction is completed. The lender may want to inspect the property to insure that the work has been done.

**Permanent financing:** Once the home is completed, construction financing ends — which means that loan must be paid off. Usually, this happens with a permanent loan, the same way any real property is refinanced.

When each of these three loans is accomplished separately, there are three closings and all of the attendant closing costs, legal fees, and taxes. Combination financing, which ties together all or at least two of the loans, minimizes these costs and paperwork.

One unique approach is a rollover loan, which allows money for the purchase of land, construction of the home, and permanent financing, all in one package. You need to qualify only once and pay only one set of closing costs. Or you may be able to tie only the construction and permanent loans together, if you've already purchased the land or intend to pay cash for it. In some cases, you may be able to use the equity in the land as a down payment for a construction-to-permanent loan.

Every lender is different in their approach to construction-to-permanent loans. To get the best rates and the most appropriate lending plan, shop around and compare. The Web is a good place to start investigating some of the various options and get an idea of what kind of terms you can expect.

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| ***Activity 5.3***  *Select one bank and investigate the default customer. You need to make presentations of your investigation result.* |

Summary

A number of factors can influence the choice of credit terms, which may well be specific to the trade or product. Most businesses have an environment of traditional custom and practice. However, some factors are common to all businesses, and for most sellers.

One of the primary functions of the commercial banks is lending. Lending of funds constitutes the main business of bank. The major portion of bank funds is employed by way of advances. The bulk of its income is derived from loans and advances. Bank makes loans and advances to traders, businessmen, industrialists and agriculturists to meet their financial requirements. Security is obtained by the bank as an additional cover against default by the borrower in repayment of bank's dues. Charging of security means making such security available to the bank and involves certain formalities.

Charging should be legal and perfect so that it is possible to realise the security if such a need arises. While extending credit, banker must secure his position. A wide range of securities e.g. Land, Building, Goods, Share Certificates, Life Policies, Fixed Deposit Receipts, Title Deeds etc. are accepted by banks as cover for a loan. Not only that the banker should insist on good securities proper charge should also be created on the securities in order to make them available as and when needed. Creation of charges on securities means making it available as a cover for an advance. Hence, the method of charging securities should be legal, perfect and complete. The important methods of charging securities are; pledge, lien, hypothecation, assignment and mortgage.

As observed, the employment of funds is not an easy task. L While, lending his funds a banker is required to follow a cautious policy and conduct his business on the basis of the well known principles of sound lending in order to minimize the risk. The main principles of sound lending includes; safety, liquidity and profitability.

Stock exchange securities include securities in which dealings take place on the stock exchanges. They can be classified into three categories: ***Government securities, Semi-government securities*** *and* ***corporate securities*** they include securities issued by the Central and the State Governments, semi-government and public limited companies respectively. To summarize, financial statement analysis is concerned with analyzing the balance sheet and the income statement of a business to interpret the business and financial ratios of a business for financial representations, business evaluation, in addition to financial forecasting.

***Review Questions***

1. *What are the factors that influence the choice of credit terms?*

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1. *\_\_\_\_\_\_\_\_ is the bailment of goods as a security for payment of a debt or performance of a promise.*
2. *Define what is bailment mean in our context?*

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1. *\_\_\_\_\_\_\_\_takes away control over the goods from the borrower.*
2. *\_\_\_\_\_\_\_\_ is a charge on a property for a debt where neither ownership nor possession is passed on to the creditor*
3. *List and explain the modes of creating charges on securities.*

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1. *Which one of the following is a modes of charge associated with immovable property.*
2. *Lien B. Mortgage C. assignment D. Hypothecation E. None of the above*
3. *List and explain the general principles of secured advances?*

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1. *Which one of the following assets provide better security to a bank*
2. *Agricultural products B. Manufacturing products C. Goods and commodities* 
   1. *None of the above*
3. *What are the risks in granting advances against documents*

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1. *List down the advantages of goods over the other forms of securities*

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1. *What are the precautions to be taken in granting advances against real estate*

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***Self check table for students assessment***

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| ***No.*** | ***Do students grasp objectives/competencies*** | ***Yes*** | ***No.*** |
| *1* | Explain the meaning and objectives of credit analysis |  |  |
| *2* | Describe the factors considered in credit analysis |  |  |
| *3* | Describe the sources of credit analysis |  |  |
| *4* | Mention the models of creating charges on securities and |  |  |
| *5* | Explain the secured loans and advances. |  |  |