

Money and Banking
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Lecture – 38

We are with a complex issue called cash credit system that commercial banks in India use to lend money to a company for instance. This is different from a loan. Loans are like the man deposit, accounts deposits or time deposit, account deposits. A money comes accure an interest and I withdraw whenever I want. Loan also when a demand loan or a term loan is given to a company, the money is given to him in an account.

And, it is up to the company to withdraw and use whenever they want? The interest is used on that applicable right from day one. Now, the point is in a cash credit system, you have a different kind of system. There a whole lot of evolution goes on first which also goes on in case of a loan, but they have a system called cash reserve system. How does it work? Every individual borrower would have to submit an application with all kinds of financial statements and sureties, mortgages etcetera, collateral [FL].

Now, under the cash reserve system, every borrower is given a credit limit towards a loan sanction loan, when a loan is sanctioned say 20 crores, a credit limit is given where this is the amount of money that will be credited in his account towards that loan. So, say the credit limits system for a particular company A, when a 20 crores loan has been sanctioned say 10 lakhs every month will be deposited not 20 corers 10 lakhs this is, where the credit multiplier works also. And, now the question is once the limit is set and the money is now put by the bank in my account.

And, suppose I am the company borrowing how much of that limit also I can use or I would use? Would matter I am coming to that point later. First of all how is that limit set first initially a loan is sanctioned on the basis of the current financial status. The value of the mortgage it is given the security or collateral loan has sanctioned. After, the loan has been sanctioned again an evaluation process going on what would be the credit limit [FL] [FL] loan sanction [FL] credit limit how is it judged on the basis of something? They called credit worthiness of me.

My as a borrower the credit worthiness is judged depending upon my financial statements etcetera, and how I behaved with the bank interns of repaying. Loans in the

past when I have taken loans etcetera this all entire thing would be given and then the credit limit is sanctioned now the the the party borrower is withdrawing money now how much money or credit requirement that will be there in the credit limit requires some sort of a valuation of the valuables that a company has here it is just not the collateral.

It comes to something called current assets of the company presently the company how much inventory is there out of that inventory how much is in raw material form how much is in semi finished goods form how much is in finished goods form this is called current assets they take a stock of the current assets, which reflects the current level of economic activity of the company. That will help the bank to judge how much money it will require and after having receive the money under credit limit from that loan it will be in a position also to repay back.

Because, current assets judge the level of well being of the company alright like I am trying to judge the health of an individual. So, currently what kind of food habit he has what are the pathological parameters like blood pressure sugar etcetera [FL] judgment [FL] this is the amount. You work you would be able to do and also the past matters what he has done as a history. So, the credit limit is decided again by a line of action.

Which requires some sort of a mortgage or surety they called surety is like I am taking a stock of the valuables. It has and also a stock of the current level or success or failure all its achievements I look at the current assets which reflects the current sales also. How much raw material stock? Is there how much semi finishes goods they have how much finished goods there. So, how much credit limit he requires for the purpose. It has and not only requires how much he would be able to repay.

Because, withdrawing money towards the loans often coincides nearly with also repaying it like I take a loan from the bank as a consumer loan towards buying a car. The loan get sanctioned, first of all they will give me may be 90 percent 80 percent of the purchase price of the car they will not give the entire my amount of money. This is there general policy 10 percent or 20 percent will have to come out from my pocket. So, suppose they have given 90 percent towards the price of the car 10 percent I am paying from me.

You would not believe me, next month EMI starts they starts asking for repayment schedule does not wait 6 month for me to get into a financial position then I repay loans

are often immediately accompanied by repayments. So, current assets become very important and you know what they do with all kinds of mortgages or securities they asked for they never take the value of that entire market value of that entire way.

Entire asset to determine the loan amount they always have a margin requirement 20 percent 30 percent of the value. They would deduct and that they would look at the 70 percent of that value. And, then say out of 70 percent it is to give him loan worth nearly say 50 or 60 percent again margin [FL] very cautious in lending usually. They are supposed you mortgage a property a land to get a loan for you small business unit they will take the current market price they will not sanction that loan as a value equal to the loan value they will take a margin requirement.

They will cut chop of a value 30 percent 20 percent depending upon which industry you are in, which kind of business you are in and then the remaining value would help them to decide the loan amount. Similarly, in current assets when they take the value of the current assets and decide the credit limit of a borrower which is a loan after has been sanctioned after the loan has been sanctioned. Now, how much money of the loan I can receive again? They have margin requirements of the current assets you understand what I am saying?

So, these are technical details of few of them what I have learned? And, also they to marginal require you would not believe me current assets also have just thought of the inventories. They also look into how much bill is pending that the company would receive as payment? How much bill the company will have to pay? Which it did not pay say they look into the books very thoroughly these are called books of a company balance sheets etcetera. See, they look into that how much money it expects in the coming few months for the goods.

Because, often goods are sold on a credit system you know commercial bills the payments have not. Come they will come future similarly a company may also have commercial bills, where it is a debt it will have to pay not receive. So, they look into all these things this margin requires etcetera. They have for current asset when they decide the credit limit that means, how much money I can get from the bank every month or every two months? These are called in technical words in technical language this is called primary security.

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The language is probably called this is term that is used primary security current assets [FL] valuation [FL]. They vary from time to time you how much prime executive value will vary it is very variable it is not fixed like a land current assets consist of raw material finished product. Semi finished product receivables payments which will be detected. So, how can I say it is a constant amount it would change?

So, the bank has to very vigilant every month it requires therefore, a feed back on current assets and it can revise the credit limit accordingly [FL] every month it is a flow variable current assets. So, it will change its value value will change every period every unit if the unit can be weak even suppose they take a monthly stock of it therefore, companies borrowers what they do? Is that I have a note here a roughly 75 percent of the current assets they offer primary security banks allow them to be used as credit limit roughly.

The 75 percent of the primary security normal practice I am talking about Indian banks therefore, a bank a borrower is required to submit a stock statement of these assets every month through the bank [FL]. So, the banks the economic becomes after having this is the stock statement of the foreign assets to visit the company and verify [FL] company [FL] current stocks today raise the credit limit [FL] down [FL] bank [FL] extra payment [FL] current assets [FL] sir [FL] form [FL] current assets.

This is the these are the loop holes in a system which creates the avenues for the corruption etcetera and inefficiency. So, everybody if they do their work properly there

would not be any corruption basically people do not do their work for various reasons. One is letter g, one is all kind of political influences etcetera. This swain in by law they suppose to submit stock returns stock of current assets. But, in practice they are not practiced this is exactly what happens this evidence on the ongoing production and trading activities becomes legal document.

And, therefore bank asks for this kind of a thing current assets sometime if the current assets are down then bank may ask for a secondhand surety that means the statement of funds etcetera depends what kind of investment it has made elsewhere. And, all kind of second surety to continue with that loan it can terminate the loan also suppose current assets value is well down. So, the credit limit would be down then the bank will go the current assets are down what else can show us to keep your credit limit here otherwise you will pull it down.

So, there is called second surety it may come for it may asked for then the funny thing is that there is loan system which you know banks give loans. But, this also be usual called loans, but this is not loan this is called cash credit system. And, cash credit system and loans they are differences which will now become more clear to you. And, if you will see that a very interesting thing arise here that is banks prefer loans, because loans [FL] sanction [FL] account [FL] interest day one [FL] counted [FL] loan [FL] interest [FL] EMI [FL] cash credit system [FL] administrative [FL] loan sanction [FL] current asset [FL] credit limit [FL] credit limit revise.

[FL] every month on the basis of stock statements of current assets, and there rules for all sorts of manipulations etcetera corruption inefficiency. And, the interest that is charged is not on the loan sanctioned interest is charged how much of that credit limit the borrower actually utilizes [FL] credit limit [FL]. Now, borrower is very happy [FL] credit limit [FL] withdraw [FL] interest [FL] withdraw [FL] borrower [FL] withdraw [FL] bank [FL] time calculate [FL] company [FL] credit limits [FL] withdraw [FL] withdrawal amount [FL] interest [FL] not the loan amount not even on the credit amount credit limit amount. It is on the amount actually utilized by the borrower from that credit limit horrendous huge amount of extra work bank efficient have to do. So, banks never like cash credit system, but it has remained the practice in India borrowers always love that system, because they can then buy pass interest payments on the entire loan it.

Depends upon, how much money they use actually from that loan alright? So, there goes conflict situation. Now, let me compare the two many people does not know about the cash credit system everybody things banks gives loans just not loans there is lots of things. Now, I come to large two pages before I go over to cooperative banks this will be my task for about 1520 minutes. Let, us see whether you understand this task or not and do not escape from this room doctor shah will evaluate my course, then you can escape and write whatever you want and then when she goes out.

I will evaluate her course, and then she will start teaching today two evolutions will take place between my lecture and her lecture environmental economics [FL] evaluation [FL]. So, the other students can go, after my course evaluation if you are not in doctor Shah's course alright. Now there are a number of reasons why borrowers refer cash credit over the alternative forms of borrowing from banks? Why borrowers pay for it an interest is payable on the amount withdrawn and not on the limit sanctioned by the bank.

I just told you I will pass on this notes to you interest is paid on the amount withdrawn bank [FL] interest [FL] security can vary with the amount withdrawn current assets security primary security etcetera [FL]. Even, if I show less it does not matter the credit limit they would reduce it does not matter to me suppose I am in the situation [FL] interest [FL] then borrowing account can be continuously renewed although. It is a short term advanced repayable on demand borrowing account can be continuously renewed I can always negotiate with the bank to you [FL] increase my credit limit depending upon current assets values a lower rate.

So, I have flexibility there alright. So, borrower loves a cash credit system as a company to take money from a bank have a bank do not necessary like cash credit system of lending for a number of reasons. Just, an opposite reasons banks have no control over the actual utilization of cash credit limits, because the borrower would use it banks have no control. So, people have to wait and see how much they are using? And, then they put the interest costs were the money has been already credited to its account. Since, the borrower can deposit their day today surplus cash and reduce the outstanding amount of credit withdrawn.

And, also save on the interest costs the task of cash management is effectively passed on to the banks by the borrowers very interesting point [FL] account [FL] loan [FL] loans

[FL] credit limit [FL] lakh [FL] company [FL] withdraw [FL] deposit [FL] bank [FL] headache [FL] not by looking at the balance amount. How much actually have been deposited? They have to take into account, because if they have withdrawn and immediately they have deposited in some sense.

When you deposit the money the personal deposits will get the interest, not paying interest if you withdraw money as a loan from the bank you have to pay interest, but sir they will come say we withdraw in the morning by the afternoon. We withdrew one lakh by the afternoon. We deposited the 50000 money [FL] company [FL] deposit [FL]. So, effectively we withdrew 50000 only, this whole management [FL] the bank will have to do because depending upon how much I withdraw cash? The interest will be charged [FL] at usual practices at the end of the month the cash balance is taken. Now, you have practices if you have a savings account or any account the savings account in particular these are demand accounts where these transactions takes place.

These are not fixed deposit account I cannot withdraw money from fixed deposit account banks clears savings accounts current accounts for your loan to which you can use for your company. Now, usually the balance amount is counted at the end of the month when the interest is charged. Now, through out of the month [FL] withdraw [FL] withdraw [FL] deposit [FL] end of the month [FL] balance [FL] that is the net after all the withdrawals. And, all the deposits and suppose the net is not different from the last periods net, but actually I have taken use the loans. The interest is zero in terms of incremental interest, no interest has been paid you understand.

And, all this counting accounting banks they pass the buck to the count [FL] and banks do not have energy to count every day what they do at the end of the month? They look out the account balance and they put an interest. So, in savings account balance suppose I have 20000 in beginning end of the month. I have only 20000 the interest that will be given to me on my account deposit savings account by the bank is on the 2000 rupees what I had in the beginning? Is not for the interest is charged.

They do not do everyday calculation of interest with in the month they taking the month end balance in my account. And, put the interest similarly for a borrower a loan taker month end balance, they take interest [FL] deposit [FL] month end [FL] amount [FL] effectively no incremental interest [FL] interest last period [FL]. But, effectively what I

have done? Have I have used bank money in my business, but since I have deposited also I am not paying any extra interest.

So, this creates havoc a banks work increases multi fold to keep track of this, and another thing is you understand bank is a profit maximizing institutions. If it accepts deposits it will pay interest, but if it gives the loans it will take ask for interest charge interest. Now, if bank knows there are there is surplus cash coming into an account, where I have actually given the loan and if it does not keep track of it effectively.

It does not utilize the surplus cash to earn something by investing somewhere call market [FL] because it was a loan account, but money got deposited also in any account money can be deposited a loan account whatever is called a savings account [FL] number [FL] account [FL] business [FL] withdraw [FL]. So, suppose extra cash got deposited I am just saying my withdrawal last month was 2 lakhs. This month is he says no withdrawal and on top of that 50000 more I have deposited. So, effectively I have to pay less interest.

Now, so bank from banks point of view it is loss of income, because if it has received more money than giving out loan. It should utilize that money to make money by putting elsewhere giving it a loan to somebody else investing. It giving you the money in the lock call market. So, effectively banks also lose money this kind of a system alright. And of course, there are problems that sometimes this answer into which always exists in the real world economic world is that limit has been sanctioned.

And, I as a bank got used to these 10 borrowers how they utilize their cash limits credit limits I get used to this. So, I know how much money they typically require in their businesses suddenly something went wrong, and the majority of you started using more money from that cash credit system. Suppose, from that account you started using more than that can create a problem with the remaining cash that I have, because I was not expecting that to happen.

This kind of answer it is always there, if I do not go and do my business on the basis of the actual limit values, but I look at your habits where you are using less of that limit money this has been habit. But, suddenly you changed something happened in the economy then there be a problem with managing my own cash, because I was not expecting that to happen. So, a cautious thing would be which you human begins are not.

If they see that the rain starts year in the month of July mid July they get used to that, because that has been happening. So, the plan according to what they would do in June early or July first week, but if suddenly starts raining heavily in July first week then they will have to deal with that as an unexpected problem. So, if credit limits are utilized to much which usually companies do not do then the banks have the problem in managing their cash to, because they always create.

A credit multiplier from a base money the deposit money comes in and that they promise a loan amount sanction, loan which is a multiplier of the base amount, which can be huge and then they slowly release this base cash towards the various credit limits and sanction loans. Now, if there is extra withdrawing going on it can be create for me for other activities like normal withdrawal of cash. So, what they do with a good banking system they would go to the central bank withdraw cash etcetera, and that can happen alright next point few more points.

I want I just want to mentioned I would just read out few things once the credit limit have been set primary securities have been accepted current account values. Current assets values not current account current assets value have been accepted banks have no control on the end uses of this credits. This is very unfortunate, after your sanctioned limit and the current assets value has been taken into account all that you have done. Now, what actually the borrower would do with the money?

You have no control on it exposed you may check what they have done some times? That is also very difficult to find out there is the company dealing with cash all the time. So, how much money actually banks money have gone into something? How would they know bank [FL] money cash [FL] [FL] cash [FL] Indian currency? So, they do not have actual control on the end use. This is where another problem n p arises, because they borrow money for some purpose. They use it for some other purpose, and often what they do?

They are so smart, they use it in the share market to make some quick gain though the loan was for manufacturing or they book money to hold the credit became very important. They show you that they want to expand their plant size, they will get a loan from you, but actually they use that cash not to expand the plant size [FL]. They doing

something else, otherwise [FL] case why how will it arise [FL] could not have taken money from a bank saying I would put the money in the stock market.

He took the money from the bank and bank managers colluded, because he showed something else for which he need the money. Bank will never give you money especially in the stock market, because this public money bank has, how can it given it to you. Bank itself cannot invest in the stock market even if they want. They can open a mutual fund company a subsidiaries separate business which banks do in India commercials bank.

How would [FL] case would have come in early nineties? He lied to the banks and bank managers knew about it did not do anything [FL]. So, they do not have a end use control that what I am saying? This cash credit accounts become a permanent source finances to the borrowers often the borrowers use this finance to speculate in the stock market or to acquire the assets of another company or in the new company [fl]. Since, bank cannot have a full proof system of evaluation inspection and super vision of primary securities without obstructing the day to day running the business of its client.

And, its own increasing costs of loan making super vision a dishonest borrower can always a bank a dishonest borrower can easily a bank do not have the energy money expertise to control everything. It can check out some superficial data financial statement current assets past experience with this customer sometimes they get a warning they ignore it fellow banker. What be careful about that borrower? They ignore it for whatever reason it may be it is not easy not difficult at all to cheat a bank particularly with the cash credit system.

You do not know what money you are doing? What you are doing in loan [FL] buying the property or house? Is one time purchase, you can always go and check and that property offering the collateral much easier [FL] sign [FL] payment [FL] company [FL] actually they bought. So, I know it has been bought you already using the car, but the money I has the bank is paying. And, you have paying EMI for 10 years or something much easier in case of cash credit system. In a company what the company does with the money?

Nobody, knows very difficult banks stand in India 10 to fewer favor big an establish borrowers, why because they have this miss nova this feeling false confident. That is

there is reliance borrowing from me or some company X is borrowing from me there cannot be any default king fisher [FL] 1000 of crore [FL] bank. So, leave out the smaller new borrowers who lose out also in the business because you know I bank I less give the loan to establish company why there is?

So, much of return that will come who knew kingfisher wont function properly who knew that you tell me 5 years back who knew that king fisher would have problem nobody in India because Vijay Mallya other business does, so well and king fisher has such a good reputation of the service quality. That is very actually got fooled he spent too much he did not pay attention to the costs revenue, whatever he was learning that is why he got actually cheated or fooled.

And, the company is not doing well running at a loss main addition to environment factors. Global factors [FL] effect [FL] everybody is getting effected I mean jet getting effected other airlines India getting effected [FL]. Now, next another very exiting point with multiple banking facilities you can go to many banks firms can borrow over borrow miss use the facility. And, when you have a practice for social banking for large companies large companies are very easy too large companies are you all always asset to large companies were cheating.

And, when you look at the non p a n p a the buck of the n p a in India if you look at the data I wish I do not have that I wish I got that the clipping with me. I do not have it with me newspaper clipping the biggest default the largest default in India to banks. So, created the maximum amount of NPR not small companies, one whom you usually do not have confidence at the large companies. What a cash reduce situation? The banks thing is safe to invest in a big company they also consolation funding.

So, everybody trust them the 34 banks go ahead to make business with kingfisher face them. And it becomes the largest NP creator what a cash reduce situation look at this I mean cash credit system etcetera, becomes much more difficult alright. So, [FL] cash credit system makes the difficult banks to adjust the credit limits over night. And RBI often used to have restrictive policies. It becomes more is hell in bank working in a commercial bank. I tell you it is hell in commercial bank. So, much work usually I have seen banks operate more number of extra hours than the normal company unless.

They have a manufacturing unit which does a 24 hours shift. It does some time car automobile plant assembly plant etcetera, sometimes did not shut down like thermal power plants. They cannot shut down if they run 24 except the work force changes shift, but I have seen other than that only place where lights are on at night are banks they have the, so much extra work to do RBI [FL] policy announce [FL] cash [FL] selective control [FL] limits revise.

And, then were lakhs of borrowers and to revise the credit limit of all these borrowers overnight it cannot be do not its literally manual work may be computerized information system. You have, but you have to sit in front of the terminal get the print outs and check one buy one. Huge amount or what as the banks never like cash credit system? RBI never withdrew cash credit system, and banks always like loan systems, but borrowers love it. So, does story goes the same story continues year after year finally a small point.

But, I would not come to this and then I will come tomorrow and talk about cooperative banks, which are absolutely completely different kind of business completely different concepts not commercial banks. So, I need to talk about cooperative banks you never new probably cash credit system, probably you never new loans you heard banks gave. So, I will talk about cooperative banks which you never heard probably. So, I need to tell about them, and you know like an individual account holder here.

SBI company is also have overdraft facilities bank government has overdraft facilities government does not have money in RBI account or elsewhere wherever it is allowed to open an account. It can utilize the overdraft facility, you know overdraft you know overdraft right when you do not have the minimum balance bank lends you temporarily. So, let me complete this she has forgotten to bring the papers whatever it is.

So, she will do this evaluation tomorrow no problem. I will do is there do you know if there any student outside economics students in your course in the environmental economics course, no body I will do yours. So, time is nearly up overdraft facility I guess you know. So, companies also get overdraft facility, but it depends upon the trust of the borrower if you. Trust the borrower you are doing business with it for a long time it will do that, so this bank activities I told you.

But, in the last the slide I do not have in the loan credit cash credit system, you had also the bills another type of advance is banks gives other commercial bills discounted and

purchase, which you studied in the previous topic banks get involved with lending money in another kind of business. One is loan. One cash credit system the other one the slide is not here today other one is bills purchased, and discounted you know that commercial bills.

I explained that last topic you have a every dead look on your face to remember the commercial bills I talked about in the previous topic commercial get involved in purchasing bills. And, discounting bills I showed you data. So, this is the third kind of activity where bank to lend money by purchasing a bill or by discounting a bill I talked about that in the previous topic. So, that closes commercial bank activity, so all that I have to do tomorrow is to talk about the last section which every interesting very different cooperative banks.