Chapter 12 – Consumption Credit

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Learning Objectives

What you should achieve after completing this chapter:

- Understand product knowledge for personal loans, personal overdrafts and credit cards;
- Know how to monitor overdrafts; and
- Understand the credit considerations of personal loans and overdrafts.

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1. Personal Loan

A personal loan is a medium or long-term loan provided for consumer purposes. This loan is usually for purchase of consumer items and investment.

1.1 Types of personal loans

Personal loans can either be secured or unsecured although personal loans are often unsecured. Secured loans are secured against fixed deposits, shares and property.

1.2 Features

The facility is granted to individuals based on their previous borrowing history, current cash flow and whether the facility granted is secured or unsecured.

Interest is normally calculated and charged on a monthly basis.
Interest is normally calculated using the simple interest formula:

Loan Interest = Principal (P) x Time (T) x Interest rate quoted
where P = Balance at the end of each preceding month
T = 30/365 or 31/365 depending on the number of days in the month

The entire facility needs to be drawn down.

1.3 Benefits

Consumers readily embrace a revolving open-ended credit facility as it enables them to make impulse purchases. It also enables the borrower to meet unforeseen or unplanned personal expenses. Overdrafts also come in handy when one is allowed to draw against uncleared effects.

The interest rate is generally lower than the credit card rates.

1.4 Risks of personal loans

The main risks of personal loans are credit risks. Essentially it is the inability to pay the loan due to bankruptcy or death or reasons of job or business losses.

1.5 General terms and conditions

The terms and conditions spelt out in the internal credit memorandum upon which a loan application has been approved, form the basis of preparing a letter of offer. The conditions must be workable, reasonable and must protect the bank's interests. The terms and conditions of a personal loan, among other basic details, are:

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(i) The purpose for which the loan is to be utilised.

(ii) The tenor of the loan. This is fixed period – normally for 3 to 5 years.

(iii) Full details of security pledged.

(iv) Monthly payment of instalments towards the account.

(v) Events of default like:

- Failure to service the interest and instalment;
- Declared bankrupt;
- Death or mental incapacity; and
- Cease employment or termination.

1.6 Application of credit considerations

Personal loans, which are unsecured in nature, are the lowest in preference of payment as against the secured debts of the borrower. As such, the bank has to consider the strength of the borrower's financial position.

Assessing Five Cs of a credit is a possible tool to evaluate the strength of a borrower's position, i.e.

1. Character;
2. Capacity;
3. Capital;
4. Condition; and
5. Collateral.

1.7 Supervision and control-periodic review

The supervision and control of loans are automated. The lender monitors the account through information which is routinely provided by daily, weekly and monthly computer activity reports indicating:

- Interest not serviced;
- Instalments not paid; and
- Exception reports.

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2. Personal Overdraft

A personal overdraft operates through a current account where a borrower is allowed to draw funds to an agreed amount of debt. This is a fast growing facility as it is easy to apply and convenient. Banks today have gone beyond servicing the current account customer to tap into the highly desirable segment of the consumer market by offering personal overdrafts.

2.1 Overdrafts

(a) An overdraft facility allows the borrower to draw bank funds to the extent of a stipulated limit. The outstanding is subject to call on demand by the bank. It is the general practice of banks to review the borrower's eligibility for the facility and quantum on a 12 monthly basis, based on the borrower's creditworthiness.

(b) A temporary overdraft is granted on an ad-hoc basis. This is where the bank grants the borrower an overdraft for a short period normally no more than 30 days.

In Malaysia, an overdraft can only be offered by a commercial bank.

An overdraft can be used for personal as well as for investment reasons.

2.2 Features

The facility is granted to individuals based on their previous lending history, current cash flow and whether the facility granted is secured or unsecured.

Interest charged on the amount overdrawn only.
Interest is calculated on a daily basis and charged on a monthly basis.
Interest is calculated using the simple interest formula:

Overdraft Interest = Principal (P) x Time (T) x Interest rate quoted
Where P = Overdrawn balance at the end of each day
T = 1/365

The loan outstanding and interest is compounded at the last day of each month.

With no fixed repayment on the amount utilised, customers have the option to service the monthly interest or make additional payments towards the principal amount.

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It is useful as standby credit for personal consumption.

The entire facility need not be drawn unlike a personal loan.

A commitment fee of 1% is charged for the unutilised portion of the overdraft for overdrafts exceeding RM250,000.

This is a flexible facility in that repayment can be made to the bank without notice. Generally, a healthy operation of the account is expected.

However, full use can be made of the account until the expiry date of the period granted or when the bank has decided not to renew the facility.

2.3 Benefits

Consumers readily embrace a revolving open-ended credit facility as it enables them to make impulse purchases. It also enables the borrower to meet unforeseen or unplanned personal expenses.

Overdrafts also come in handy when one is allowed to draw against uncleared effects.

The interest rate is generally lower than the credit card rates.

2.4 Risks of overdraft

The aggressive marketing of overdrafts, which go beyond the boundaries of conservative traditional lending, can lead to the decline of control over risks. Nevertheless, banks are able to justify the losses because of higher gross yields and economies of scale.

The main risks of overdrafts are credit risks. Essentially, it is the inability to pay the overdraft due to bankruptcy or death or for reasons of job or business losses.

2.5 General terms and conditions

The terms and conditions of a credit memo form the basis of preparing a letter of offer. The conditions must be workable, reasonable and must protect the bank's interests. The terms and conditions of an overdraft among other basic details, are:

(i) The purpose for which the overdraft is to be utilised.

(ii) The tenor of the overdraft. This is fixed period normally for 12 months subject to review.

(iii) Full details of security pledged.

(iv) Minimum monthly credits in the account to ensure healthy operations

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(v) Events of default like:

- Failure to service the interest;
- Excess over the overdraft;
- Declared bankrupt;
- Death or mental incapacity;
- Cease employment or termination; and
- A breach of maintenance margin (share financing).

2.6 Supervision and control – periodic review

The supervision and control of overdrafts are automated.

The lender monitors the account through information which is routinely provided by daily, weekly and monthly computer activity reports indicating:

- Excesses in the account;
- High ringgit value cheques;
- Interest not serviced;
- Inoperative accounts;
- Low credit turnover; and
- Exception reports.

The expiration of the facility acts as a control point to help reduce delinquency and losses.

3. Credit Cards

3.1 History of credit cards

Credit cards originated in the United States of America (USA). The Diners Club Card was the first modern form of credit card used as a cashless means of payment. Historically, these cards were predominantly accepted at restaurants, entertainment outlets and by travel industry. Thus, it was not surprising that they were commonly referred to as Travel and Entertainment Cards (T&E). Following the success of Diners Club, the American Express Card was launched a few years later. Today, these cards are better known as charge cards, in order to differentiate them from **true credit cards**.

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The earliest form of the credit card was a system of credit which allowed customers to charge their local retail purchases. The merchant then deposited the charges at a bank (or financial institution), after which the bank reimbursed the merchant for the sale and collected payment from the customer. For a customer to obtain this facility, an application for creditworthiness must be submitted, after which a card is issued upon approval. Merchants copied information from the card onto a sales slip and called for an approval for each transaction over a specified limit. The bank would then credit the merchant's account for the sale minus a discount to cover the cost of providing the loan. This process was later enhanced by adding the services of revolving credit. This gave the cardholder the choice to either pay off their balance or maintain a balance and pay a finance charge. Thus, evolved the true credit cards as we enjoy them today.

3.2 Visa and MasterCard

At present, the majority of credit cards are issued under the license of large payment organisations, in order to enjoy the benefits of brand recognition, worldwide acceptance, and a common infrastructure. The most well known are Visa and MasterCard, which are worldwide payment service organisations composed of member institutions, often banks and other financial institutions.

It is important to note that they do not issue credit cards themselves, evaluate or set credit limits for applicants/cardholders or undertake the billing of customers for charges. Instead, they manage their respective brands by advertising and promotion programmes, developing new products, conducting clearing and settlement processing of transactions and by setting and enforcing rules and regulations governing their cards.

Upon becoming a member, a bank is licensed to issue cards to its members. These banks are also required to provide cash advances on these credit cards through their tellers. As members, banks are issued a Bank Identification Number (BIN) and pay membership dues and assessments.

3.3 Parties involved in a credit card transaction

Apart from the payment organisations, credit card transactions involve two other parties, known as **acquirers** and **issuers**.

The **acquirer** contracts the merchants to accept merchant sales slips, provide authorisation terminals, instructions, and support, and handle the processing of credit card transactions. The acquirer usually charges a fee or "discount rate" for handling the transactions.

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The **issuer** is responsible for the cardholder account program which include all aspects of cardholder account activities ranging from acquiring new customers to billing current ones. The issuer is the party which performs the necessary credit checks and provides the card itself.

Some financial institutions are both issuers and acquirers.

3.4 Clearing and settlement

The payment organisations such as Visa and MasterCard maintain a flow of funds between issuers and acquirers. **Clearing** refers to the exchange of financial information. **Settlement** refers to the exchange of the actual funds for the transaction and the associated fees. These essentially occur simultaneously via the payment organisation's interchange system. In essence, the issuer pays the acquirer for the transaction. When this occurs, the issuer deducts fees from the transaction amount and then pays the net amount, which are known as interchange fees, to the acquirer.

Each payment organisation owns and operates their own international processing system, which connect thousands of banks around the world. These networks are used to transmit information about credit card transactions between member institutions.

3.5 Transaction process overview (refer to Figure 12.1)

(It is assumed here that the issuer and the acquirer are different institutions)

(1) The customer purchases goods or services from the merchant.

(2) The merchant transmits the transaction to the acquirer. This is usually done via an authorisation terminal, which digitally reads all card details via a magnetic stripe reader. This transaction is routed to the issuer to verify the validity of the transaction, after which it will send an authorisation code back to the merchant via the acquirer.

(3) The acquirer then submits the ticket electronically to the issuer for payment, via the clearing and settlement systems.

(4) The acquirer credits the merchant for deposits (net of interchange fees).

(5) The issuer funds its customer's purchases (net of chargebacks, returns, and agreed to fees).

(6) The issuer bills the customer.

(7) Finally, the customer repays the issuer for the goods or services originally purchased from the merchant. The issuer has already paid the acquirer the transaction amount, less the interchange fee.

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From the customer's point of view, it would seem as if the payment is made through the issuer for the goods or services originally purchased from the merchant. In fact, the cardholder is actually repaying a loan from the issuer.

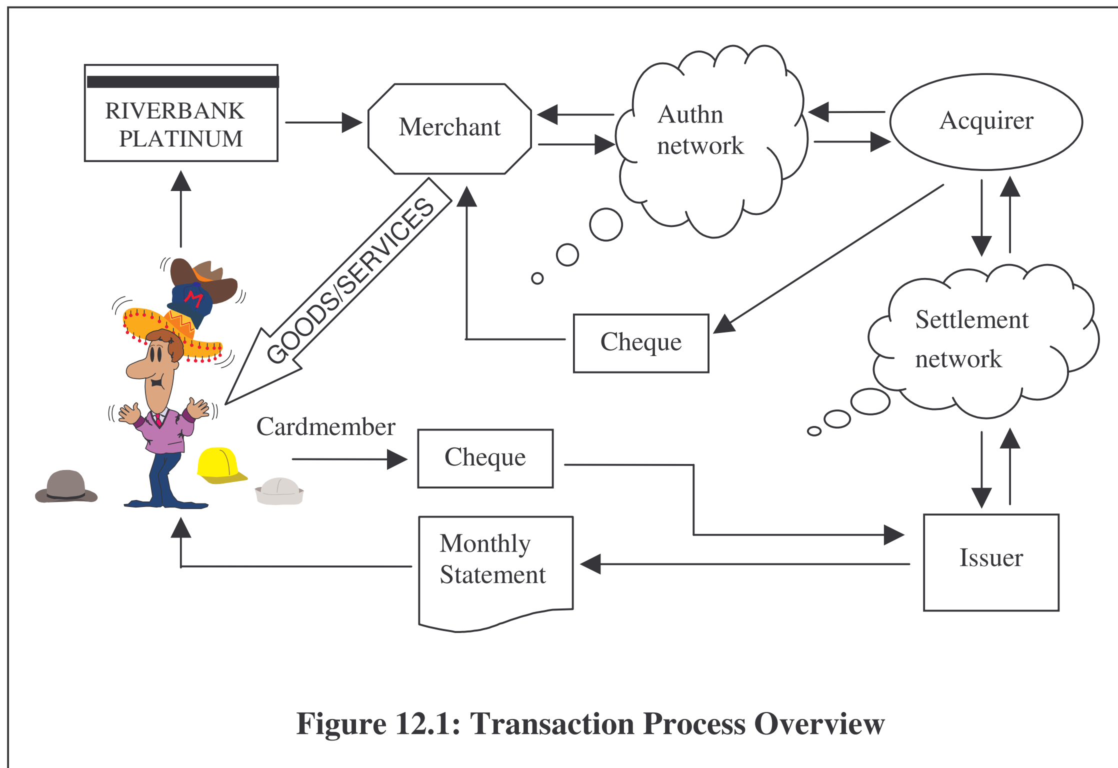

Figure 12.1: Transaction Process Overview

3.6 Chargebacks

When an issuer disputes a transaction, either at the request of the customer or for reasons of its own, the matter is handled through a chargeback or compliance case. In a **chargeback**, the issuer returns a transaction to the acquirer, and the acquirer returns the payment previously made in interchange. Chargebacks result either from customer disputes or from rules violations by the merchant or acquirer. They help enforce operating rules and correct transaction errors.

The initial chargeback is always initiated by the issuer. It can result from the issuer finding an error in the transaction, or it may result from a cardholder complaint.

There are standard procedures and time frames for submitting and processing chargebacks.

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3.7 Differences between charge cards and credit cards

The transaction process flow for both charge cards and credit cards is identical but managed by different organisations. There are key differences between credit cards and charge cards such as the following:

(a) A charge card has no pre-set limit while a credit card is assigned a pre-determined credit limit.

(b) A charge card is a non-revolving facility as compared to a credit card. Charge card holders are required to make full payment on the outstanding, while credit card holders have the option to make a minimum payment (currently 5%).

(c) Charge card holders are not charged interest but instead, a service charge is imposed as a penalty for partial payments as compared to banks which charge interest on the unpaid outstanding.

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Practice Questions

1. What is the purpose of extending personal loans?

2. What are the risks of personal loans?

3. How is a personal loan monitored in a financial institution?

4. What is a temporary overdraft?

5. How is the interest on an overdraft calculated?

6. When monitoring an overdraft, what common reports are generated for the officer to view?

7. What role does technology play in enabling the credit card business today?

8. Name the various parties involved in a typical credit card transaction and elaborate on their roles.

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