e-Resources Module-I

Paper No. : DSE-xiii

Paper Title: Money and Financial Markets

Course: B.A. (Hons.) Economics, Sem.-VI Students of S.R.C.C.

MARGIN REQUIREMET OR DOWN PAYMENT

Dr. Rituranjan

The credit markets in actual practice are typically characterised by asymmetric information that could lead to a risk of default on loans. Under these circumstances, it is advisable for a lender to somehow bridge information asymmetries and insulate from the adverse consequences of an actual default on loan whether arising out of moral risks or instead trade risks. It is against this backdrop that security-oriented credit was developed as a viable option. But too much insistence on collateral security is biased against poor borrowers whereas primary security alone does not generate any stake of the borrower in the project for which loan is sought. In view of this, lenders insist on a margin requirement or down payment over and above primary security which neither turns out to be as stringent as secondary or collateral security nor as lenient as merely primary security. With a view to overcoming any possible risk of default, however, the lender must set the margin requirement or down payment very carefully. More specifically, down payment shall be set in such a manner that at any point of time over the entire life of the loan, the market value of primary security must not fall below what the borrower owes to the bank otherwise defaults on the said loan are likely to occur.

Owing to asymmetry of information in credit markets, the lenders typically face a *risk of default* on principal amount along with associated interest rate while giving a loan. With a view to avoiding *adverse selection* and *moral hazards*, the lenders typically try to bridge information asymmetries and wish to insulate themselves from the adverse consequences of an actual default on loan. For instance, insisting on *credit reports* and building a *tough reputation* as a lender are some methods to avoid and discourage adverse selection but these methods have visible limitations in as much as they have limited applicability and are not fully reliable under all circumstances.

Moreover, as the risk of default could itself be a *moral risk* or instead a *trade risk*, it becomes imperative to resort to security-oriented credit. So long as the lender insists only on primary security, it does not face much criticism as the assets mortgaged or pledged by the borrower are financed out of borrowed funds. But in case, the lender insists on a *collateral* or *secondary security* over and above *primary security*, it goes against the basic spirit of credit policy whereby loans shall be given on the basis of the credit-worthiness of the project for which they are sought rather than the credit-worthiness or financial status of the borrower. For instance, if a poor rural artisan or farmer is demanding a loan for a genuinely productive economic activity, then he should not be denied a loan only because that person cannot furnish a collateral security as too much insistence on secondary security in such a case would amount to a pro-rich bias in credit policy which in turn is undesirable on any count. After all, the credit policy cannot be allowed to focus only on borrowers who are already rich enough to furnish a secondary or collateral security. Following the same line of reasoning, a rich borrower shall not be given a loan simply because that borrower can furnish a collateral as what is most important is the productivity and commercial viability of the project for which the loan has been applied for. Viewed from the perspective of lender, however, merely a primary security does not create a "stake" of the borrower in the project for which loan has been sought and thus in due course, it could quite conceivably lead to the problem of moral hazard in loan-making.

It is against this backdrop that lenders have devised the concept of "Margin Requirement" or "Down Payment" as a *via media* or *effective compromise* between the two extremes of primary security and collateral security. More specifically, under margin requirement, the full amount of loan sanctioned is not granted to the borrower but rather it is insisted upon that a part of the loan is financed by the borrower from his or her personal sources and given as down payment. For example, if a loan of Rs. 10 lakh is approved and *margin requirement* is fixed at 10%, then only Rs. 9 lakh will be the given by the lender while Rs. 1 lakh will have to be financed and offered as *down payment* from the personal sources of the borrower thereby generating his or her stake in the project under consideration.

The borrower cannot possibly escape the bite of margin requirement since the value of the primary security has to be equal to the quantum of loan sanctioned at the time of taking the loan. For instance, if a borrower has been sanctioned a loan of Rs. 10 lakh to purchase a vehicle and margin requirement or down payment is 10%, then he is not allowed to pledge or hypothecate a vehicle worth Rs. 9 lakh as primary security at the time of getting the loan.

There is, however, a possibility that over time the value of asset pledged or mortgaged as primary security may go down. To the extent it happens, it may act as a disincentive for borrowers to repay the loan. In the limiting case, when the value of asset pledged as primary security falls even below what the borrower owes to the bank, the borrower is likely to default as margin requirement or down payment has lost its meaning in such an extreme situation. For example, let us suppose that a housing loan of Rs. 50 lakh is given for 20 years with a margin requirement of 10% to a borrower to purchase a flat. Evidently, the down payment is Rs. 5 lakh in such a case and the loan of Rs. 45 lakh is to be repaid by the borrower over a period of 20 years. Now let us suppose that after 3 years, out of this Rs. 45 lakh of disposable loan, the borrower is left with only a liability of Rs. 40 lakh still to be repaid to the bank. If the primary security *i.e.* flat worth Rs. 50 lakh at the time of seeking the loan would have at least retained its value over these 3 years, it is obvious that the borrower has an incentive to repay Rs. 40 lakh of pending loan so as to get back the flat worth Rs. 50 lakh.

If, however, due to a sudden decline in real estate prices after 3 years, the actual worth of that flat falls below Rs. 40 lakh then the borrower would be left with no incentive to repay Rs. 40 lakh in order to recover something worth less than Rs. 40 lakh. It is precisely for this reason that despite the provision of margin requirement or down payment, defaults on loan may occur in cases where the market price or actual worth of assets pledged as primary security are subject to sudden and abrupt declines over the life of the loan.

This clearly suggests that with a view to avoiding loan defaults in cases where loan is utilised to purchase assets whose prices are subject to sudden downward revision, we must follow a *ground rule* for setting up margin requirement *viz.*, *at any point of time over the life of the loan, the value of primary security shall not fall below what the borrower still owes to the bank*. For example, if it is apprehended that value of a Rs. 50 lakh worth flat may go down to Rs. 40 lakh after a few say 3 years due to sudden decline in real estate prices, then the margin requirement should be kept at a relatively high level such as 25% even to begin with. In that case, while pledging a flat of Rs. 50 lakh value, the borrower would have got a disposable loan of only Rs. 37.5 lakh and within 3 years, if he or she has already repaid Rs. 5 lakh then what the borrower owes to the lender is merely Rs. 32.5 lakh. Evidently, despite the possible decline in real estate prices, so long as the present value of the flat has not fallen even below Rs. 32.5 lakh after 3 years, the borrower is not likely to default.

Using the aforementioned “ground rule” we can also understand why the lenders insist on a higher margin requirement or down payment in case the loan is utilised to purchase a second-hand vehicle rather than a brand-new one. For example, let us suppose a loan of Rs. 10 lakh with a margin requirement of 10% is given to a borrower for purchasing a brand-new vehicle which is to be repaid in 5 years. It is worth noting that under such a situation, *de facto* only Rs. 9 lakh are to be repaid by the borrower over the entire span of 5 years. Thus, on account of regular *wear and tear* or *foreseen obsolescence*, the market value of the brand-new vehicle cannot be reasonably expected to decline to such an extent as to fall below what the borrower owes to the lender at any point of time over the entire life of the loan. Consequently, the borrower is not likely to default as it is always advisable to repay a loan to recover a pledged asset worth more than that amount of repayment.

If, however the concerned vehicle is not brand-new but rather a second-hand one, it is quite conceivable that due to the underlying *asymmetry of information*, it may turn out to be a “lemon” or useless even within a short span of one week. For instance, if within one week, the borrower finds that the second-hand vehicle purchased for Rs. 10 lakh with a loan having margin requirement of 10% *i.e.* a down payment of Rs. 1 lakh is only worth Rs. 7 lakh then the concerned borrower is likely to default on the loan. Had the margin requirement been kept at a much higher level of say 40% or down payment of Rs. 4 lakh in such a case, the borrower would still have preferred to repay Rs. 6 lakh so as to recover the second-hand vehicle worth Rs. 7 lakh!

This clearly suggests that in comparison to the purchase of brand-new vehicles, when the loans are given for the purchase of second-hand vehicles, it is advisable for lenders to insist on a higher level of margin requirement or down payment in order to avoid the possibility of default on the loan under consideration.