Primary Security vs Collateral Security

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What is Security?

One of the major functions of a bank is to provide credit to the customers for various purposes such as home, vehicle etc and a bank's strength and solvency depends on the quality of its loans and advances. Security resembles an insurance against emergency. It provides a protection to the lender in case of loan default as the lender could acquire the security if the repayment is not done by the borrower.

What are Secured and Unsecured loans?

An arrangement in which a lender gives money or property to a borrower and the borrower agrees to return the property or repay the money, usually along with interest, at some future point in time is called a loan.

A loan can be broadly classified as a secured and unsecured loan.

Secured loans

Secured Loans are those which are protected by some sort of asset or collateral, for example – mortgage, auto loan, construction loan etc. If the lender is unable to repay the loan, the borrower has the right to sell off the asset to recover the loan.

Unsecured loan

Unsecured loans include things like credit card purchases, education loan where borrower don't have to provide any physical item or valuable assets as security for the loan. If a person is not able to repay this type of loan it leads to a bad credit history which creates problems in future when he tries to get a loan from other lenders or the lender may appoint a collection agency which will use all its possible tools to recover the amount.

Basis for comparison	Secured loan	Unsecured loan
Asset	Compulsory	Not compulsory
Basis	Collateral	Creditworthiness
Risk of loss	Very less	High
Tenure	Long period	Short period
Borrowing limit	High	Less
Rate of interest	Low	High

What is the importance of Asset/collateral?

For lender: It reduces the risk associated with the loan default as in the case of insolvency of the borrower the lender could sell off his asset to compensate the loss occurred. Moreover, the borrower will make payments if he doesn't want to lose his pledged security.
For borrower: Secured loan has a low rate of interest and give more time to repay the loan so a borrower with low income can easily afford it. Secondly, if a borrower has bad credit or limited income, most of the financial institutions are reluctant in providing a loan but if he pledges collateral, the lender may be more willing to approve his application.

Types of security

There are two types of security

Primary Security

When an asset acquired by the borrower under a loan is offered to the lender as security for the financed amount then that asset is called Primary Security. In simple terms, it is the thing that is being financed.
Example: A person takes a housing loan of Rs 50 lakh from the bank and purchases a residential loan. That flat will be mortgaged to the bank as primary security.

Collateral Security

If the bank or financial institution feels that the primary security is not enough to cover the risk associated with the loan it asks for an additional security along with primary security which is called Collateral Security. It guarantees a borrower's performance on a debt obligation. It can also be issued by a third party or an intermediary.
Example: A person takes a loan of Rs 2 crore for the types of machinery. So to secure itself in the case of default by the borrower it asks for mortgaging residential flat or hypothecating jewellery, which will be termed as collateral security.
RBI has advised the banks not to obtain any collateral security in case of all priority sector advances up to Rs. 25000. In other cases, it is left to the mutual agreement of the borrower with the bank.

When collateral security is required?

Collateral security is not required in housing loan, car loan, personal loan etc. It is required by lenders in corporate loans like cash credit because in cash credit primary security such as stock and book debts can be sold any time by the borrower so an additional security in shape of immovable property or some other assets are taken to secure loan.

What are collateral free loans?

Loans that are disbursed without collateral or security, which limit the lender's exposure to risk, are called collateral free loans. This facility is provided under Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE), where micro and small enterprises can be extended loan upto Rs. 1 crore without security. This scheme was launched to solve the problem of lack of funding that these enterprises face as well as to boost their development.

Advantages

- No collateral or third party guarantee is required
- The subsidised rate of interest.
- Flexible repayment tenures up to 5 years.
- No track record required.
- Quick and hassle free processing of applications.
- Letter of credit/bill discounting up to 180 days.

Similarly, MUDRA (Micro Units Development and Refinance Agency) bank provide collateral-free financial aid up to Rs. 10 lakhs to sole proprietors or entrepreneurs carrying on Small and Medium enterprises.