Management of Commercial Banking
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Lecture 34
Management of Lending Activities 4

Good Morning. So, in the previous class we discussed about the certain issues related to the commercial bank lending or the management of lending process. So, in continuation with that, today we will be discussing some other issues related to that particular activities. And then we can move towards the specific type of loans what the commercial banks provide to the business units and as well as the retail units.

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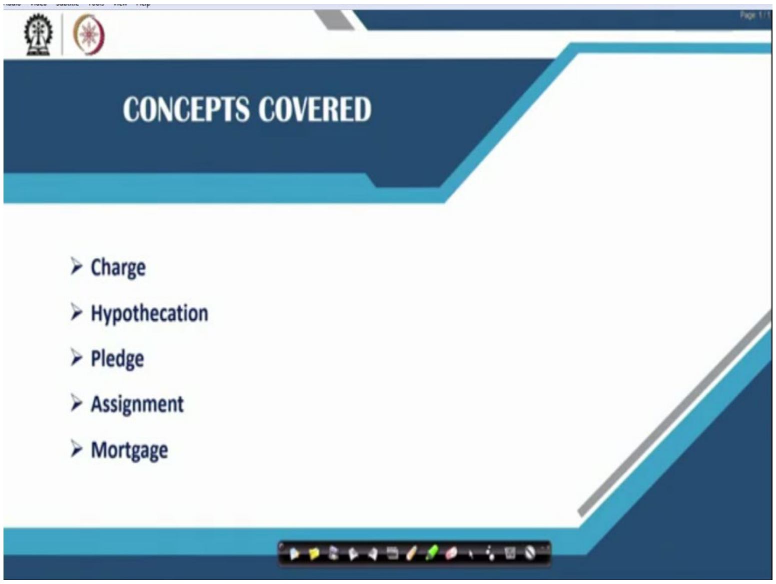

So this is the focus of the discussion with respect to the lending activities, so today we will be discussing about a concept called Charge. Then, there are other concepts but everybody must be always aware about that Hypothecation, the Pledge, Assignment, and Mortgage. So these are the different common words what always the customers or the common man always come across whenever they deal with this commercial banking or in terms of the loan activities of the commercial banking.

So, in this context, in today's session we will be covering up what do you mean by the charge? And what is the concept of hypothecation and what do we mean by the pledge and assignment and the mortgage and what is the use of these particular concepts in the lending activities of the commercial bank. So, this is the discussion what we are going to in today's class.

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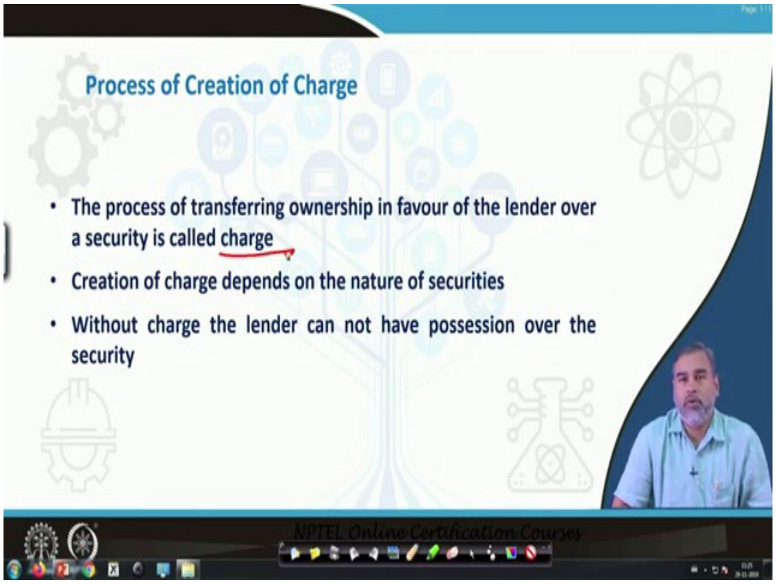

If you see what exactly the charge is, if you recall that in the previous class we discussed about whenever the commercial banks lend or different kind of lending activities takes place for the commercial bank. We have seen that, mostly the commercial bank provide the loans against the collaterals or any kind of asset or security, which can be used as the collateral for that particular type of loan.

But whenever we talk about the collateral, only providing the collateral is not basically enough. So, against that collateral there would be some provision or there must be some provision by that the particular kind of loan which is giving against the collateral. So, if there is any default against that particular loan, then how this particular bank can liquidate that particular asset or what is the process through which this particular liquidation process will take place.

By that the commercial bank can recover the money what the particular customer basically has defaulted. So, this is basically the concept always in general we know whenever we talk about the use of the collateral for getting the loans. So, whenever we talk about this, so, there is a process which works or which basically always try to transfer the ownership in favor of the lender over a security.

That means, on what sense even if the security is used as a collateral then how that particular collateral can be used to recover the loan? So, then that can be used to recover the loan whenever the ownership will be there with the bank or the bank is able to utilize that particular asset to get back certain money. So, in this context, there is a process which works in this particular system and that process is basically called the charge.

So that is why if you see that charge is basically that providing the, what we can say that ownership to the lender by the borrower who have taken this particular loan. So whenever we talk about this or specifically whenever we talk about the charge, the creation of the charge basically depends upon the nature of the securities.

What kind of securities are used as collateral accordingly, the creation of the charge, basically differs. So, we will see that how the creation of the charge is varying across the different kind of assets, which are used as the collateral for that particular loan. Because without this charge the lender cannot have the position over the security.

So if there is no such charge is involved against that particular asset, that any point of time this particular lender cannot utilize or cannot use that particular asset to recover the loans or to recover the money what basically the customer has already defaulted. So, this is the process basically what we call it, which provides the ownership to the lender to be utilized at the time of the default.

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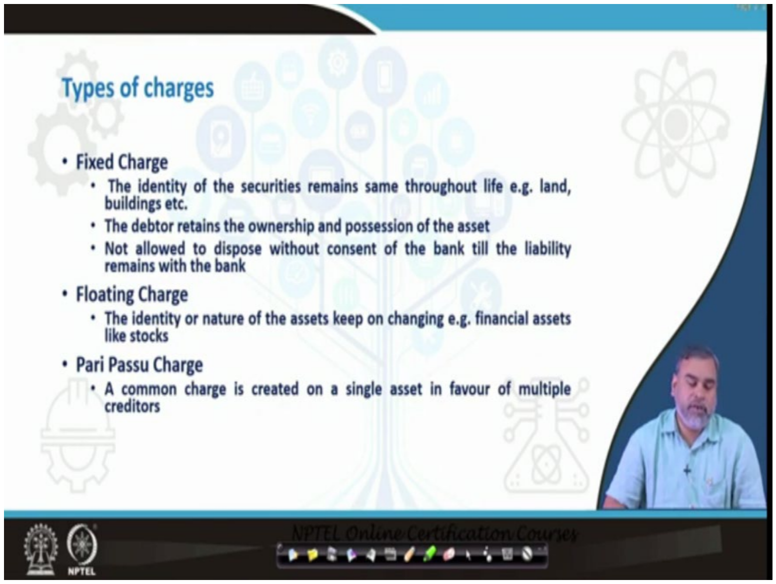

Then, already we said that, there are different types of charges and the different type of charges basically vary on the basis of the nature of securities used. So, one particular charge is called the Fixed Charge. So, if you categorize them, the first category basically we can say that is a fixed charge and here whenever we talk about the fixed charge.

The fixed charge means the fixed charge concept is used whenever the securities which are used as collateral or used as a kind of backup for getting the loans that is not going to be changed over the time or the identity or the nature of that particular asset is not going to be changed over the time.

That means, for example, the land, buildings etc if those kind of assets which are used as a collateral, at any point of time the identity of that particular asset is not going to be changed. So, in that particular point of time, we can say that, whenever the particular customer or particular borrower provide this ownership through that particular process, which is called the charge, then we call it the fixed charge. So, here the debtor retains the ownership.

The concept here is that the ownership is there with the debtor and as well as the particular debtor also possess the asset, the asset will be there with the debtor and as well as the ownership is also will be there with the debtor. But only thing is that at any point of time this particular asset cannot be disposed or this particular borrower cannot sell that particular asset without the knowledge of the bank or without the knowledge of the lender till the liability remains with the bank.

Unless the loan is not recovered and which loan is taken against that particular security, the particular customer or particular debtor cannot utilize or cannot sell or cannot dispose that particular asset without the consent of the commercial bank from where he has taken the loan. Then another type of charge we call it the Floating Charge. So, whenever we talk about the floating charge, what do mean by this?

So, here the identity or the nature of the assets keep on changing. like your financial assets, like the stocks. So, here if the stock is used as a collateral and we know this value of the asset and the nature of this particular asset change depending upon the position what the investor takes against that particular stock and on the basis of the market fluctuations of the price and also fluctuations of the price of that particular stock, the value of the stock also changes very frequently, and it has become more volatile in that sense.

So, in that point of time, the process through which the charge basically is imposed, or basically charge is given. So, in that particular point of time, we call it, it is the floating charge. Then another kind of charge we have that is called the Pari Passu Charge, what does it mean? It means that when a particular asset is used as a collateral for multiple creditors.

For example, if somebody has used a particular collateral to get a loan and again further he has taken another loan and the same collateral has been used, then through that process, how basically the collateral can be liquidated at the time of need, and that process has to be defined and in that particular point of time we call it the Pari Passu Charge. So, these are the three different ways the charge can be defined.

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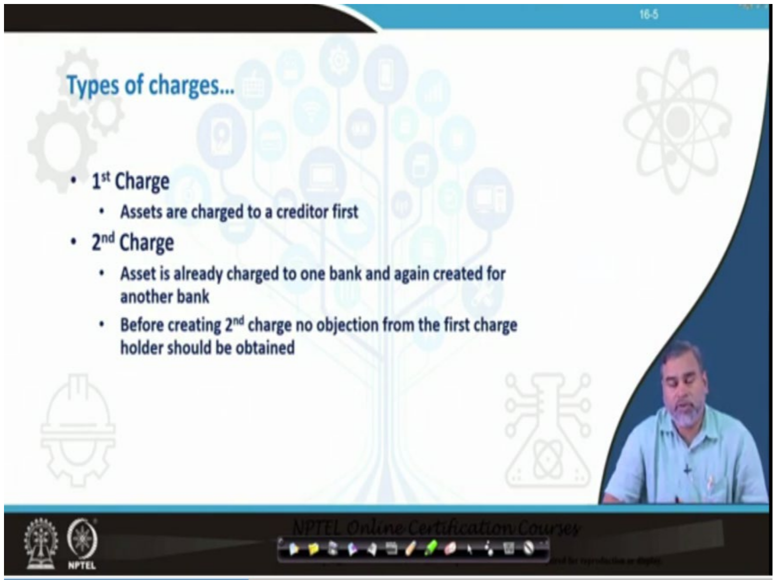

But in other way if you see that how this charge are defined that one point of time we can call it the, the 1st charge and we can call it the 2nd charge. The, if the asset are charge to the creditor first, the particular bank, who has given the loan for the first time, and whenever the loans are basically provided to them and on which process this particular ownership has been transferred to that particular first bank or first lender, we call it the 1st charge.

And if the asset is already charged to the one bank and again created for another bank for some particular reasons, then we can call it, it is the 2nd charge. But only one concern we have to keep in the mind, whenever we are using the 2nd charge or the concept of 2nd charge only will arise whenever the 1st charge holder has no objection. So, that is why before creating the 2nd charge, the no objection of the 1st charge holder should be obtained.

So, unless the 1st lender is not agreeing upon in this particular process, then the 2nd charge cannot be created. So that is basically applicable in the context of the multiple lenders for a single asset, whenever they use it as a collateral, then the concept of 1st charge and 2nd charge comes into the picture. So, this is what basically the different types of charges what the banks basically, the lending process basically always involves.

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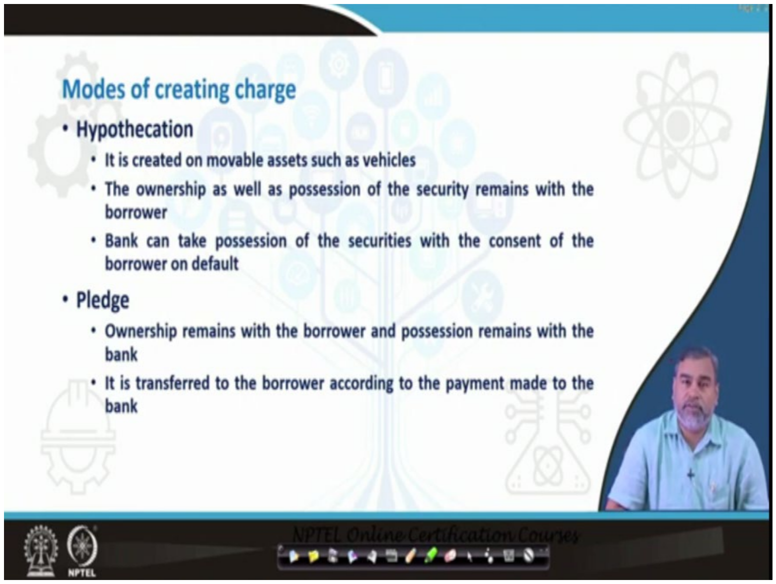

And next thing is that how we can create the charge, what are those different modes? What are those different modes of creation of the charges? So, whenever you talk about the modes of creation of the charges, the first thing basically comes to our mind that is basically the hypothecation. So, whenever you talk about the hypothecation, what do mean by the hypothecation? It is basically created on the movable assets, like the vehicles.

If somebody has taken a vehicle loan, then you might have already seen that whenever we get this registers and documents of that, it is always written that hypothecated to a particular bank. And that is why the hypothecation process basically works for the movable assets, mostly the vehicles and all. And here what are the characteristics of the hypothecation?

The characteristics of the hypothecation is the ownership and as well as the position of that particular security or particular asset remains with the borrower. The particular asset which is used as a collateral, that particular asset and as well as the ownership that will remain with the borrower. But, the bank can take the position of that securities with the consent of the borrower on default.

If the borrower is on default or the borrower is not able to repay this particular loan, and the bank is allowed to sell that particular asset or can liquidate that particular asset, but they have to take the consent from that particular borrower. A typical notice has to be issued, that there is a default against this particular loan and this particular asset which is used as the collateral against this particular loan that is going to be utilized to recover that particular default amount what the customer already has made. So, in this context in the process of hypothecation the ownership as well as the position is with the borrower only or the debtor only.

But at the time of requirement whenever there is a default the bank is able to utilize that particular asset to recover the loan. Then once it has become hypothecation also lead to Pledging and what do you mean by the pledge? The pledge is, again the ownership remains with the borrower but the position remains with the bank. In the context of the pledge, the ownership remains with the borrower, but the position remains with the bank.

So, it is transferred to the borrower according to the payment made to the bank. So, any kind of goods, ornaments and all these things, this basically, if somebody wants to take any loan against that particular assets, then there basically what happens the bank takes that particular asset, but the ownership is the borrower.

Once the particular amount of money will be repaid or the loan amount will be repaid and at any point of time the customer can go and get back that particular assets whatever the bank has already possessed against that particular loan. So, that is another way of creating the charge or making the charge by the commercial bank, which is called the pledge.

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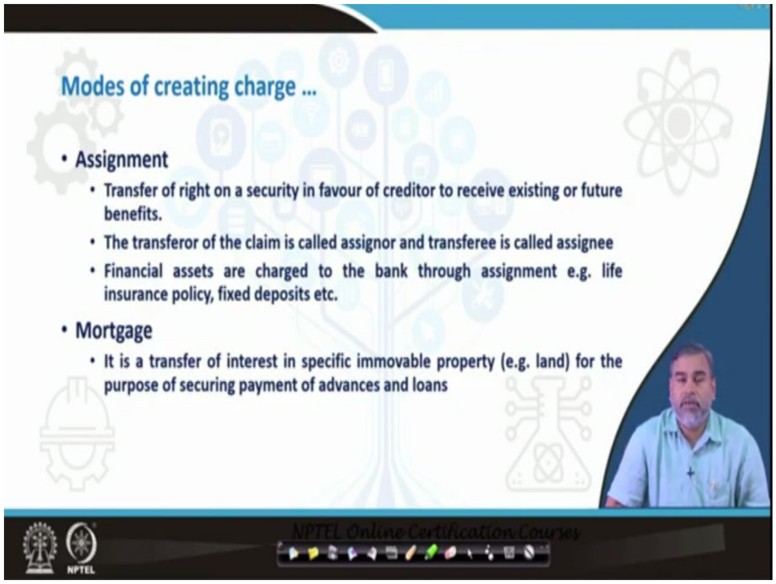

Apart from this we have another kind of mode which is called the Assignment. Whenever we talk about the assignment here, the transfer of right on a security in favor of the creditor to receive the existing or the future benefits. For example, mostly it is happening with respect to the financial securities or financial assets.

If the financial assets are utilized as the collateral, then for example, somebody has an insurance policy. If the insurance policy is the collateral for that particular loan, then what happens that if the particular customer is in default or the customer is not able to repay the loan, then what will happen that this particular bank can utilize that particular maturity amount of that particular insurance policy whatever the customer has, which is going to be matured in the future.

But the customer cannot get back that particular money, it will go to the bank directly. So, because of that there are two parties which works here. Apart from the bank, one is the transferor which is called the assignor and the transferee, which is called the assignee. The assignee is the insurance company. So, the insurance company will be informed that this particular asset is considered as a collateral for this.

So, if any kind of default arises, then this particular amount of money which the insurance companies should have been paid to that particular customer, instead of paying to the customer, they will pay it to the commercial bank. So, the financial assets basically charged to the bank through the assignment like life insurance policy, fixed deposit etc which has not matured which may be matured in the future.

But if there is any kind of default, then the total maturity amount will be transferred directly to the bank account and it will not be given to that customer after the maturity. Then another type of mode of creating charge is, the Mortgage. The mortgage is basically mostly used for the immovable property. The immovable property means we are talking about the lands, we are talking about the buildings, we have to call it the machinery sometimes, heavy machineries and all.

So, here basically what happens that if any kind of loan is taken against that, then already we said that it is again related to the fixed charge basis and here what happens that any point of time the nature of the asset or the identity of the asset is not going to be changed. And accordingly if there is any kind of default against that particular loan, then the particular ownership can be transferred to that particular lender and the lender can utilize that particular asset to recover the loan amount whatever the customer has or the customer has already defaulted.

So, this is another way of creating charge which is called the mortgage. So, these are the different ways the charge can be created. And the process of providing the transferring the ownership to the lender is basically called as the charge. So, depending upon the different type of assets, the concept of the charge varies or the types of the charge varies.

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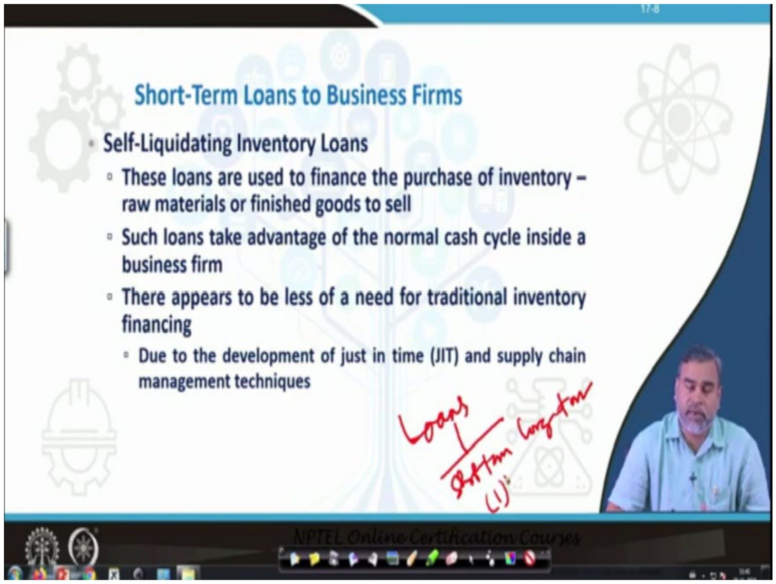

Then we can come to the different type of loans what are the commercial banks provide to the different business units. So, if you talk about the different types of loans what they provide in terms of their term to maturity, the loan can be divided in terms of use or the loan can be divided in terms of the maturity or the time period.

But broadly if you want to divide it, then total loans can be, total loans whatever we have, we can divide it as short term and we have the long term and against in the context of within the category of the short term loans, we have different type of loans and the different type of loans are basically categorized on the basis of the different uses.

So, on the basis of the use of that particular loan, the categorization has been made and for both long term as well as the short term. So, let us discuss that what are the different type of short term loans the business units always ask? The first one is the Self-Liquidating Inventory Loans by name itself if you see these loans are mostly used to finance the purchase of the inventory.

Inventory means it can be raw materials, it can be finished goods to sell. It can be the stocks, there are many ways the inventories can be defined and whenever the loans are used to purchase those kind of inventories, then here the purchase is already clear. That the particular loan has been disbursed to use it for buying this raw materials or buying the finished goods and all these things selling the finished goods and all, then we can call it the self-liquidating inventory.

Generally short loans basically take advantage of the normal cash cycle inside a business firm. And todays context if you see, traditionally this particular loan amount has a lot of advantage and basically the business units are always behind the banks to get that particular self-liquidating inventory loans.

But in todays context if you see because of the development of different technology and as well as the supply chain management aspects, if you find that the demand for this kind of loan is relatively less, because bank, now the lenders basically are ready to provide the loan but the demand from the demand side if you observe the business units they are well-equipped to basically manage that inventories in such a way by that the demand for that kind of activities or loans will be relatively less.

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Then we can come to what are those other type of short term loans what the business units always demand. Next one is the Working Capital Loans. The working capital by definition itself is very short-run, it is basically maturity period varies from few days to 1 year, maximum 1 year and here it basically secured by the account receivable or by the pledges of the inventories.

So, the working capital loans are basically secured what are the commercial banks provide and the security which is used against that particular secured loan is the account receivable or the pledge of the inventory. And another thing is that the working capital loans basically always carry the floating interest rate.

Depending upon the market fluctuation whenever the interest rates changes the loan against that working capital loans also will change and as well as a commitment fees is also charged on the unused portion of the credit line and sometimes on the entire amount of the funds made available to them.

So, it depends upon the requirement of that particular business unit that when this particular loan is required to them, and accordingly they ask for this particular loan to the commercial bank, then finally the lending can take place by the commercial bank on the basis of the request of the banks.

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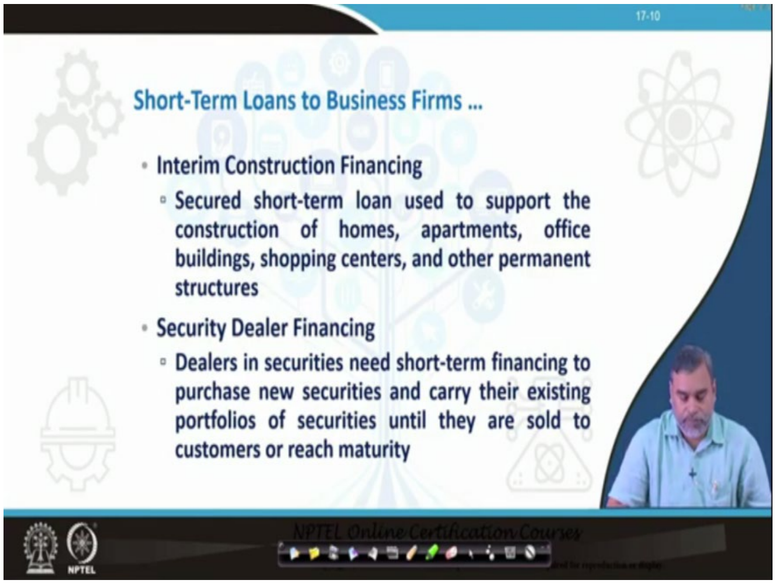

Then we have another type of loans which is called the Interim Construction Financing. Particularly business unit sometimes also ask the loan for the interim reasons and it is also again a secured loan. And why this particular loan is demanded or loan is required? The loan is basically demanded to support the construction of the home, the apartments, office buildings, shopping centers and other permanent structures.

So, if the particular loan is given to the business unit for any specific reasons, which is related to construction related activities, then we can say these are the interim construction financing which is sometimes also considered as a long term financing but sometimes also the loan is taken for some reason or providing this or making this land and making this construction and all. But in the meantime, the extra funds are required to complete that particular process.

Then the business units can go for interim construction financing to make these construction activities for the business. Then another type of loan we have that is called the Security Dealer Financing. So what do you mean by the security dealer financing? Here, the dealers in securities need the short term financing to purchase the new securities and carry their existing portfolio of the securities until they are sold to customers on maturity.

So, the question here is that the banks also provide loans to the security dealers for investments in the financial markets. So, whenever we are any kind of security dealers, they need certain money from the commercial bank for the financial markets activities or investment in the financial markets, then also there is a provision the loan can be given against certain collateral.

And here what is happening, that the loans basically given whenever the bank will be convinced that for what kind of purpose the loan is demanded, then how that particular loan is really going to be useful for that particular business units and what is the potential of generating the return of that particular loan.

Although it is short term, but still because it is used only to carry out certain activities which is relatively risky in that particular context also we have to be very careful, the banks are also very careful that whether the loan will be given against that particular security or not. And after the proper assessment if the loan will be given then mostly it is given on the basis of the potential return of what can be generated out of that particular security by the business units.

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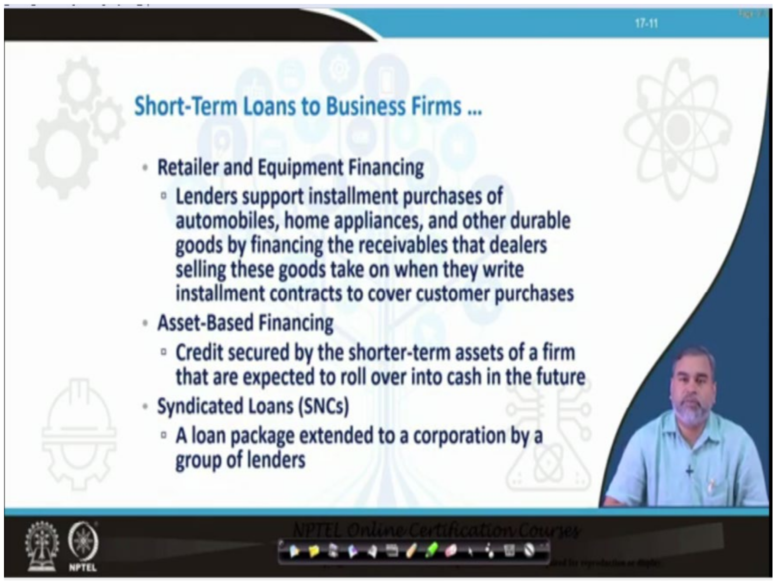

Then we have another kind of loan called the Retailer and Equipment Financing. So, here basically lender support the purchase of the automobiles, home appliances and other durable goods. By financing the receivables, the dealer selling these goods taken when the right installment contracts to cover the customer purchases. Then another kind of financing, short term financing the banks also do that is called the Asset Backed Financing or Asset Based Financing.

So, here this particular financing is made whenever this is basically this loan which is given for in this particular category, it is secured by the shorter term assets of a firm that are expected to roll over into the cash in the future. So, if the bank has certain kind of short term assets, which is going to be matured in the future. So, again those kind of assets can be used as the collateral or can be backed off assets which is used to get this asset based financing from the commercial banks.

Then another type of loan which is quite popular that is called Syndicated Loan. So in the context of syndicated loan, a loan package is basically extended to a corporation by a group of lenders. Basically, it happens to the big corporates so whenever they need a huge amount of the money for their business activities, it may not be possible by a single bank to provide this much amount of money.

Therefore, a syndicated loan can be created through which a loan package is extended by different kind of lenders or different group of the lenders to a single corporation for their investments in the future. So, that is called the syndicated loan.

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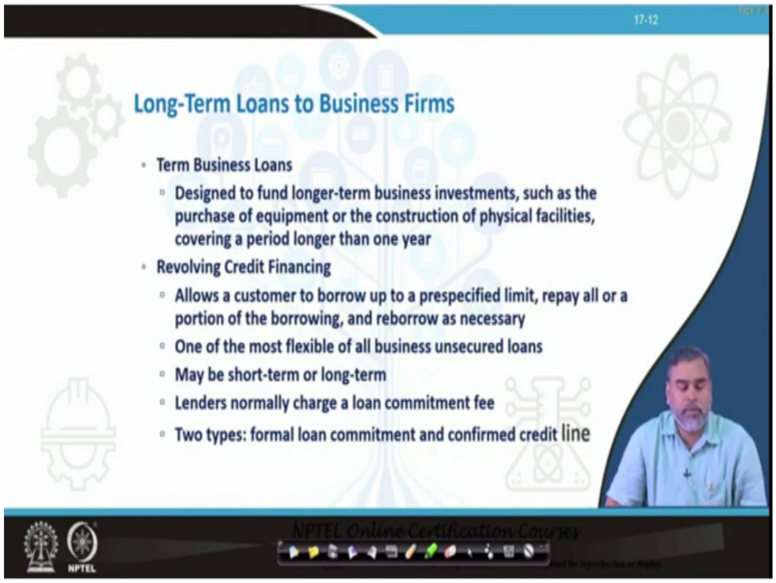

Then, we have the Long-Term Loan. So, the basic objective of the long term loan is basically to create the capital and as well as to make some fixed investments for the companies. So whenever talk about here also we have two things, so we have the different type of long-term loans are available by the commercial bank, one is the Term Business Loans.

It is basically designed to fund the longer-term business investments, such as the purchase of the construction of the physical facilities and maybe making the buildings or buying this or establishing this factory in terms of the very heavy machineries and all. So, in that context the loan can taken reasonably for a longer period, but if any loan which is taken against that in for this kind of activities and whose maturity period is more than 1 year, we can call them that is the term business loans.

Then another type of loan we have the Revolving Credit Financing. In the revolving credit financing basically what is the concept here, the revolving credit financing allows the borrower up to a pre-specified limit. Repay all or a portion of the borrowing and re-borrow as necessary. It is just like the credit cards. So, in the credit card we have given a particular limit and once we are used that particular limit within a certain period of time we have to repay this particular loan and again repay that particular amount.

Again you can re-borrow that thing whenever there is necessity or there is a kind of requirement. So, this is one of the most flexible for all business unsecured loans and remember this is unsecured loan. it may be short term, it may be long term and lenders normally charge a loan commitment fee against this particular loan and we have two types of credit financing, revolving credit financing always we observe.

One is formal loan commitment and the confirm credit line. So, these are the different ways the revolving credit financing works for the commercial bank.

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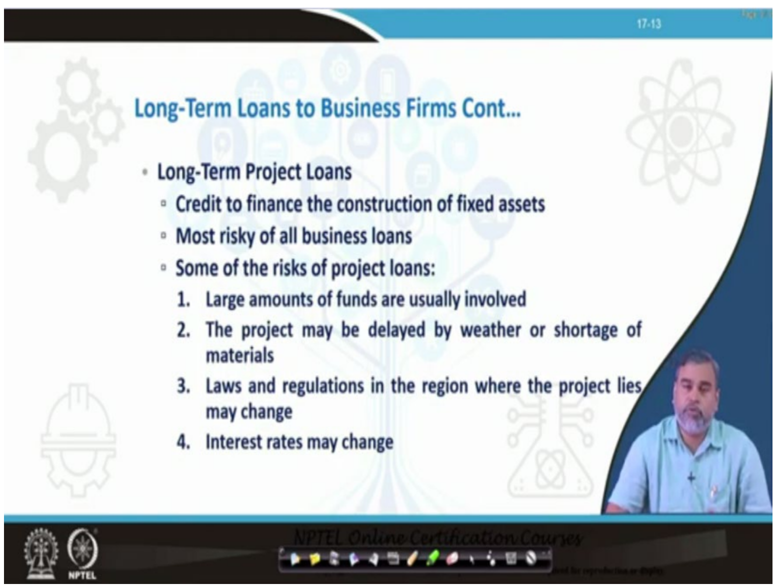

Then sometimes also commercial bank takes the loan for the long term projects, the long term projects means it is to finance the construction of the fixed assets. This is a very risky kind of business loan, because the project might have a future prospects to generate the cash flow it may not have and another problems are or maybe risk related to this project loans are it includes or it basically involves a large amount of the funds.

And the project may be delayed by whether a shortage of the materials and all these things, the project is delayed then obviously bank also getting affected by that. Laws and regulations in the region where the project lies, that also may change. If that thing also will change then that will affect the progress of the project and accordingly other things gets affected, then interest rate also may change.

So, these are because it is long term that it is also highly prone to the interest rate risk in the market. So, we can say that regulatory policies rules and regulations, then natural calamities or any other reasons, which basically affect the establishment of the plant or maybe care to carry out that particular construction of the particular project, then we are exposed to certain kind of risk and over the period of time the interest rate also may fluctuates.

So, these are the different type of risk what we face whenever the lenders provide the long term loans. So, these are the different type of loans what the business units always demand whenever they want this kind of financing for their investment activities from the lenders and the business financing, the bank financing towards the business sector is one of the most prominent financing courses by the corporate sector or by the companies.

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Then sometimes also the banks provide the loan for the acquisitions, mergers and as well as the leveraged buyouts. What is leveraged buyout? It usually involved the acquiring a controlling interest at another firm with a great deal of depth to finance the transactions. That is why they have leveraged out that particular thing bought out that particular entity through this leverage.

So, for that also the banks can provide the loan, while looking at the actual potential of that particular company in the future. So, these are the different type of long-term loans and already we have discussed about the different types of short-term loans, what the business units demand from the lenders or mostly the commercial banks.

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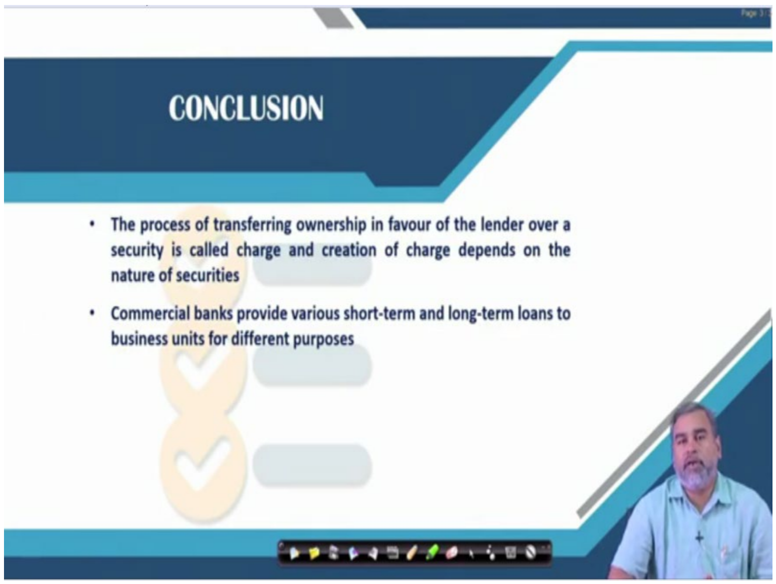

But basically we have seen the process of transferring the ownership in favor of the lender over a security is called basically charge and charge creation depends upon the nature of the securities.

And there are varieties of loans both short-term and long-term loans are provided by the business, by the commercial banks to the business units for the different purposes and the different types of loans are defined on the basis of the use of that particular money by the business units. So this is what about the different type of loans what the commercial banks always provide to the business units for the future investments.

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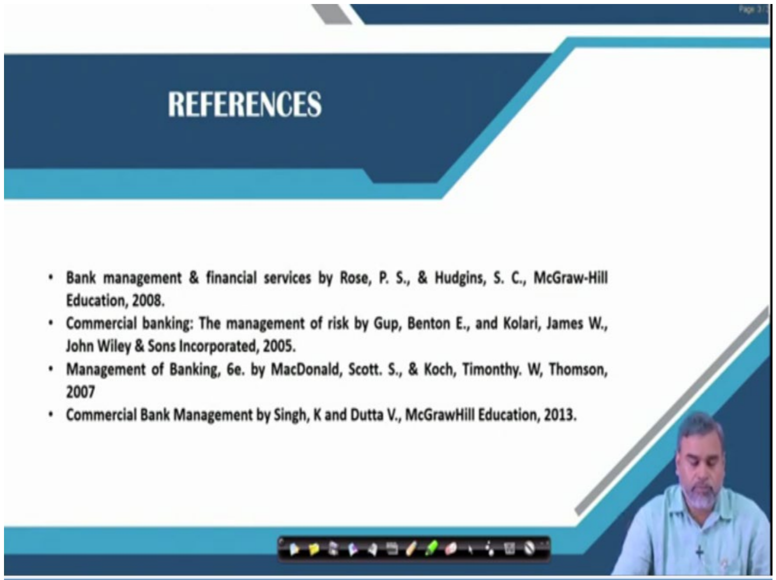

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