markets at will. Many did so and began their projects but some also utilized the monies for other purposes. They did not foresee the virtual death of the capital market. Contrary to their expectations, when they found issues being under-subscribed and devolving, short-term funds such as over-drafts were utilized to complete projects which they had begun. I can understand and sympathise with this approach though I think it is dangerous. If a company has spent Rs 10 crore and needs another Rs 2 crore to complete an installation, it is better to complete it so that it can begin producing and earning profits as opposed to allowing it to be a non-productive white elephant. However, in practice, it is fool hardy to finance a long-term asset with a short-term loan (although at the time it may appear to be a stroke of genius and a way out of a dangerous situation). The two are incompatible and there is a maturity mismatch; when short-term funds became tight, as happened in 1997 and 1998 in India, several companies began to resort to accommodation financing (discounting of bills that were not backed by genuine trade transactions). Once begun it is difficult to get out of such a situation and it also has a snowballing effect. A maturing bill is paid by another bill that is discounted. At each stage charges have to be paid. The result is that one pays much, much more than one would have had one taken a term loan. In addition, one would have saved oneself from a tremendous amount of tension. Then, too, the accommodation financing route can lead to lack of liquidity if the next bill is not discounted, loss of credibility and can, as has happened in several cases recently, even lead to the closure of the concern.

It is important that a prospective client be honest and open with his banker. If he needs to utilize a loan for a particular purpose, he should tell the banker exactly what the purpose is. He should also discuss with his banker his con-

cerns and problems. In a nutshell, there is need for an honest relationship between the two. After all, bankers are there to help and not to hinder. If the banker has a full appreciation of his clients' concerns, strengths and weaknesses and is convinced of the person's integrity, he will even go out of his way, if required, to sanction the loan. It is always better to apprise the banker of all the issues at the outset — especially the more crucial ones. It would be very difficult to explain at a later stage why something of crucial importance was not earlier mentioned. An omission of an important issue may also make the banker wonder whether there are any other such issues that have not been mentioned which may be critical. Honesty and transparency is without doubt the best policy.

Chapter 3

Repayment

The main concern that a banker has when extending loan facilities is the repayment of the monies advanced. This is the question that he will invariably zero in on and it would be prudent for the prospective borrower to advise him upfront on how he intends to repay the facility. As prospective borrowers, Raman Menon, Rusi Daruwalla and Vinod Desai should be able to demonstrate the repayment plan to their respective bankers with facts and figures.

In ideal circumstances there should be more than one source of repayment so that if there is, for some reason, a delay or a problem with one source, the repayment commitment can still be honoured. Bankers, too, if presented with a well structured plan/plans of repayment, would be more willing to listen and advance loan facilities.

Primary Source

The primary source of repayment should be directly related to the kind of loan given. For example, in the case of facilities extended for working capital (overdraft) or to finance trade, the repayment should be from the proceeds of the goods sold. In Raman Menon's case, the primary repayment

must thus be from the sale of garments. If a bridge loan prior to the final allotment of a public issue has been given, the repayment should be from the monies received after the allotment is made. On the other hand, if the bridge loan is given prior to the sale of an asset, the proceeds from the sale of the asset should be used to extinguish the loan.

Secondary Source

Even though there may be a real and quantifiable first source of repayment, there is always a possibility that the loan cannot be repaid from that source. Such examples especially abound in situations of liquidity crunch and demand downswing. For example, a well-known Indian company purchased 41 windmills at a cost of around Rs 1 crore each and was confident of selling them quickly. Due to a credit squeeze the windmills were unsold and the company could not repay the borrowings from the proceeds of the sale. In order to meet its credit commitments, the company sold some property it owned. This was its secondary source of repayment. When companies take working capital finance in the form of overdrafts they normally hypothecate debtors and stock. If repayments are not made from the primary source, the secondary source of repayment can be seized and sold and the proceeds can be used to liquidate the loan. Raman Menon would have, when taking the loan, hypothecated his goods. If he was unable to repay the monies borrowed the bank could seize his goods, then sell them and thus recover its money.

Tertiary Source

The tertiary source is further security for a loan. This is in the form of additional collateral that may be unconnected with the business. For instance, a director could pledge the shares that he owns in certain blue-chip companies as addi-

tional security. Alternatively, the principal shareholders could give their personal guarantees or a well-wisher could give his guarantee. The comfort that a bank derives from the tertiary source is that should the primary and secondary source of repayment fail, it has recourse to yet another source of repayment. It is assurances such as these that help a banker support and recommend a request for a credit facility.

Thus, as additional security, Raman Menon could mortgage his factory or give as additional security shares that he owns. Similarly, Rusi Daruwalla could, for the term loan given to Unisulphur Ltd, give his own personal guarantee.

Refinancing

Another method of repaying a loan is by refinancing — procuring a second loan out of which the existing loan is repaid. This may be either by:

- Taking another loan.
- Accepting fixed deposits. This is not particularly easy during conditions of credit/liquidity crunch when even good companies often default on the payment of principal and/or interest.
- Issuing debentures. Debentures are an acknowledgment of debt and this is a very popular form of raising funds to repay existing loans. The convenience of a debenture is that it is usually repayable only after a minimum of three years. It gives the borrower some time to arrange his finances.

The banker will seek to ensure that the charge is properly registered so that, should the need arise, he can take possession of the asset. There are two kinds of charges — specific and floating. A specific charge is a charge on a specific asset. A floating charge, on the other hand, is a charge

on all the assets, both present and future, of the company. A specific charge has a prior charge however and a banker always prefers a specific charge.

There are times when the asset to be charged is already hypothecated. In such instances the bank can only get a second charge for the facility given. This means that the banker's rights are subordinate to the entity that holds the first charge. In other situations where there are a number of lending banks as in a consortium, the borrower would be able to give the bank only a *pari passu* charge. In this instance the bank's rights are on the same footing as the other lending banks.

No banker will sanction loan facilities unless it knows and is able to verify the sources of repayment because he is in the business of lending, and not in the business of giving away money.

Chapter 4

Covenants

Raman Menon had received a call a short while earlier from his banker congratulating him on his loan request being approved. The sanction letter which was faxed shortly afterwards, however, contained various conditions and the disbursal of the loan was contingent on the conditions being met. Menon was worried and concerned about the nature of these stipulations. He wondered whether he should accept a loan that was conditional.

Conditions stipulated on loan facilities extended by banks, also known as covenants, are imposed by bankers upon a borrower in order to:

- Preserve the financial strength of the borrower.
- Maintain the borrower's ability to refinance itself: the borrower (being a limited company or a business) should be able to continue as a going concern.
- Control the assets: prevent the borrower from selling assets thereby ensuring that assets are not dissipated.
- Ensure that the borrower does not do something that would be detrimental to the interests of the bank.

Covenants, therefore are, from a banker's perspective, extremely important in the structuring of a loan. While a