

risky, unsound loan will not become good by covenants, they certainly afford some comfort and a degree of control including providing warning signs should the financial position of the company deteriorate. The number and nature of covenants that can be imposed on a borrower would depend on:

- The antecedents of the borrower — has the borrower borrowed before and if yes, what has his repayment history been.
- The need of the borrower for the facility/loan.
- The kind of facility required.
- The nature of the borrower's business and the industry wherein he operates.
- The borrower's financial health
- The risks involved.

Covenants imposed are always negotiable and negotiated. Banks will always attempt to impose very exacting covenants. Some may be too stiff and impractical. Therefore a borrower must, at the time the facilities are being accepted, ensure:

- That the covenants are reasonable and realistic.
- They will not affect the growth or stability of the company. Very restrictive covenants can retard growth.

Thus, while appreciating the banker's need, the borrower must also safeguard his own interests. He would be extremely shortsighted if he accepts conditions that are detrimental to the interests of his company or restricts his ability to function freely.

Covenants do not serve any purpose if they are not effective. The banker will therefore make certain that action can

be taken for non-compliance of the covenants. The remedies available to a banker in this regard are:

- Taking an additional collateral, thereby strengthening the loan.
- Seizing the assets secured and selling them.
- Procuring further collateral such as a mortgage on another asset or a guarantee (preferably another bank guarantee).
- Restructuring the loan.
- Increasing the rate of interest on the loan (the risk/return factor).

Covenants may be positive or negative.

**Positive covenants** are requirements made on the borrower to perform certain acts. Some of the more common ones are:

1. The borrower must present a monthly statement with information on stocks and debtors. This is usually required if stocks and debtors have been hypothecated for an overdraft working capital facility. The banker uses the monthly statement to check the drawing power and to ensure that the items hypothecated exist and are adequate. Periodically, bankers inspect the clients' factories and offices to physically verify the existence of the assets.
2. The borrower must insure and maintain the assets that have been secured as collateral against the loan. This is to ensure that if there is a fire or some other catastrophe strikes, the borrower does not lose anything.
3. The borrower must comply with all laws and regulations.
4. The borrower must pay taxes regularly.

**Negative covenants**, while they don't force the borrower to perform certain actions, require him to ensure that certain procedures are followed and restrict him from certain acts.

For instance, there may be a requirement that no assets may be pledged or no dividend declared without the permission of the bank.

Negative covenants are designed to protect the lender from the dissipation of assets, to protect his security and, to an extent, preserve the financial strength of the borrower

Negative covenants usually —

1. Restrict actions such as:
  - Payment of dividend
  - Sale of assets
  - Limitations on additional loans
  - Purchase of investments and the giving of additional loans and advances
  - Mortgaging of assets.
2. Help in maintenance of financial strength, usually in the form of ratios, such as:
  - Leverage
  - Liquidity.
3. Impose specific restrictions:
  - On continuity of existing management
  - On the sale of debtors
  - On lending to subsidiaries or group companies
  - On investing in group companies.

Covenants are, in short, safeguards and are always tailor-made to the requirements of borrowers and lenders based on their respective weaknesses and strengths.

Covenants are therefore safeguards imposed by a bank on a borrower to preserve the latter's ability to repay the loan.

## Chapter 5



# Collateral

**A**fter the initial talks Raman Menon had with his banker, Mr Buch of the Manufacturers Bank, he was asked what collateral he could offer the bank for the loan facilities required. It must always be kept in mind that banks seldom extend any facility without collateral and the more liquid, the more realisable (encashable) and the more tangible a collateral is the greater are the chances of the loan being granted easily. It is for this reason that a loan against the security of a fixed deposit is the easiest to procure because there is no risk for the bank — they have in their possession, the entire advance to be extended in the form of actual cash.

What exactly is a collateral? It is the security to the bank as a safeguard for the loan facilities provided to be advanced. It is also, effectively, the bank's insurance: should there be a default, the bank has something to fall back on to recover, in part or full, the amount advanced.

It is important for a prospective borrower to realize that there is no such thing as a standard collateral. The nature of the collateral, the amount and the percentage of the loan advanced that it covers, will vary from borrower to borrower and from bank to bank.

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However, the following are some typical collaterals:

- The collateral sought for an overdraft and working capital facilities is the hypothecation of book debts and stocks. The amount advanced will usually be a percentage of the total value — the percentage held back is known in banking terms as the margin. This margin is an additional safeguard for the bank because often when goods are sold in a hurry — a quick, forced or distress sale — the real, fair value of the goods is not realized. The margin on stocks is usually between 25% and 40% and this depends on the company and the industry it operates in.

This means that if the total value of stocks held is Rs 100,000 and the margin is 25%, the amount that the bank would permit the borrower to draw on an overdraft is Rs 75,000. This is known as the drawing power. For debtors this margin is usually higher and can be as high as 50%. In calculating the drawing power banks will insist on a debtors' ageing list and debts over 90 days are excluded from the calculation of the drawing power.

- If funds have been advanced to purchase machinery or some other fixed asset, the bank usually insists that the asset purchased be hypothecated or mortgaged to the bank.
- With regard to unfunded facilities such as the issuance of a guarantee or a letter of credit, banks usually ask for cash collateral or margin money. This varies from nil to 20% of the value of the facility — the amount depending on the intrinsic strength of the borrower and his need for the facility.
- Additional collateral is often sought by banks in the form of shares of good blue chip companies.
- In case the borrowing company is part of a larger entity (a subsidiary or an associate company or a branch of

multinational), banks, often ask for a guarantee or a letter of comfort from the parent company. This is basically to ensure a moral commitment as it is often difficult to hold the parent company down on this or take it to court.

- While we are talking of guarantees as collateral, banks also ask for the personal guarantees of directors. In the case of private limited companies, directors often give their personal guarantees supported (at times) by a statement of their net worth. Directors of public limited companies have also been known to give guarantees though not very often, the argument being that the company is a legal entity in its own right with several thousand shareholders and the directors are often paid employees. In such a circumstance they argue that there is no reason why they should be personally committed to pay all the debts of the company.

In order to successfully enforce on the collateral, banks, almost always, insist on these being registered. This is to lay claim to their right and to put on alert any subsequent lender that the particular asset has already been hypothecated/mortgaged.

When the asset (such as stocks) is already hypothecated to another lender, the new lending bank seeks a "*pari passu*" charge with the other lender/lenders. This is to make the new lending bank's rights equal to that of the banks who have already got the asset as collateral.

If the collateral's value fluctuates widely as in the case of shares, banks insist upon periodic valuations and topping up may be required from time to time if there is a deterioration in value. Similarly, when the collateral is at the clients' premises, for example stocks or machinery, periodic collateral checks are undertaken by the bank to satisfy itself on the existence and the value of the collateral.



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A borrower must always remember that collateral is viewed by bankers only as additional comfort and they would never, unless forced to do so and that too only after every other method has failed, seek to enforce their right as it could affect the viability of the concern.

## Chapter 6



# Know Your Client

**“K**now your client” is a cardinal rule in banking. This means exactly what it says — the banker will leave no stone unturned to find out as much as he can about the client and his company. Towards this end no information is too small or too immaterial for the banker since it will fit into a larger picture and the fate of the loan extended may depend upon it. It has to be always remembered that even though a project may appear sound, the documentation perfect and the financials impeccable, if the intent is to cheat, it could cause severe losses to the bank. Banks are always aware that a dishonest man is also a very clever man who has the advantage of knowing that the innocent banker has faith in his integrity while he intends to cheat the banker and even has a scheme to cheat him.

A few years ago an apparently wealthy businessman approached the Bangkok branch of a large foreign bank to open a letter of credit to import certain items from Hong Kong. The amount was large. The businessman appeared respectable. The young banker who was approached, in his eagerness to capture additional business to meet the demands of a very tough budget, complied with the request. The banker convinced himself that the risk was small as the