ARTICLE ON FINANCIAL RISK
(Part-2)

European and American bank failed because many borrowers defaulted to repay the installment of loans when the interest rate increased. Money blocked into the system. Then government came with bailout plan in case of USA and IMF in case of European countries.

Later on, to recover faster they started to lend at such rate which are almost equal to zero interest rate but there was very low demand initially. Now these governments have started to bring the money into the system but due to lower demand the recovery is very slow. It means the source of income is very low (in the form of interest) and at the same time the bank need to pay something on the deposits it have from other banks, government or public.

To minimize the burden Government extended credit at zero rates so that the same could be given to public at very low rate and in other words these governments tried to create the demand of money in the system.

On the same lines every bank/financial institutions may fail if there is no system of recovery of the loan/advances extended by them. Major income of the banks is the interest income it earned on loans/advances. Hence again there should be regular flow of interest income along with other sources.

To lower the risk of Credit, the Reserve Bank of India along with government regularly issue directives to which the banks should adhere before release of loans and guarantees. These directives are basically step taken in the form of credit policies so that the credit facilities should be extended to the genuine one and transparently.

Following is the tentative list/methods which the bank normally follows before and after disbursement of loans:

- Track record and past history of repayment of loans of the borrower/guarantors must be checked. It depicts the honesty and the interest of the loan seeker. The name of company along with the name of directors should be checked from the list of Defaulters published by Reserve Bank of India and CIBIL.

- **Risk-based pricing**: Lenders generally charge a higher interest rate to borrowers who are more likely to default, a practice called **risk-based pricing**. Here the lenders consider factors relating to the loan such as loan purpose, credit rating, loan-to-value ratio and estimate the effect on yield (credit spread). For example on the basis of the internal rating the bank will increase the interest rate by adding the credit spread & premia in the Base Rate/BPLR.

- **Covenants**: Lenders may write stipulations on the borrower, called **covenants**, into loan agreements:

    - Periodically report (say quarterly) of the financial condition/position. It includes FFR-1 & FFR-2, Stock statements etc.

    - Refrain from paying dividends, repurchasing shares, borrowing further, or other specific, voluntary actions that negatively affect the company's financial position

    - Repay the loan in full, at the lender's request, in certain events such as changes in the borrower's debt-to-equity ratio or interest coverage ratio

    - Give a condition that current ratio, debt: equity ratio, TOL/TNW, DSCR, Interest Coverage Ratio etc should be within acceptable levels as per guidelines. If there is slippage i.e. company fails to maintain the accepted ratios, bank normally gives some time to correct the position. If the default is continuing one, penal interest is charged as prescribed at the time of sanction.

    - Penal clauses in case of delays/non-repayment of installments, failure in servicing the interest, non-submission of documents etc.

    - Bank need to ensure that the promoter has brought-up their contribution before release of the term loan or as per terms decided at the time of sanction. Also unsecured loans (without interest) is taken as quassi capital but the same should be as approved by the sanctioning authority and must reflect in the sanction letter. However bank asks for an undertaking that the said unsecured loan will be interest free and will not be withdrawn during the currency of term loan.

    - Bank should ensure that the promoters has brought up the margin money required/proposed at the time of the proposal should be inducted as the bank normally do not extend the loan for working capital margin. But few banks just check the Debt: Equity norms only which if falls as per prescribed norms of the bank. In this case the margin money need not be financed by the promoters themselves.

    - Fixed assets coverage ratio should be as per prescribed norms of the bank/RBI. Higher the ratio better it is. It indicates the value of security offered by the company against outstanding loan as any point of time. It depicts the amount which the bank may recover if the company fails to repay the loan. Hence it is normally suggested to take valuations from 2 valuers (registered with bank), in case of big ticket loans, before disbursement of the loan so that a fair value may be derived. Also there is system to take fresh valuation every year but it varies bank to bank.

  - Borrower should obtain prior approval for investment of funds outside business by way of ICD, investment in associates concerns etc or any other outside investment. In the loan covenant, borrower is to empower the financing bank to levy penal interest and/or recalling of the advance at its discretion without any prior reference to the borrower.

- **Credit insurance** and **credit derivatives**: Lenders and bond holders may hedge their credit risk by purchasing credit insurance or credit derivatives. These contracts transfer risk from the lender to the seller (insurer) in exchange for payment. The most common credit derivative is the credit default swap.

- **Tightening**: Lenders can reduce credit risk by reducing the amount of credit extended, either in total or to certain borrowers. For example, a distributor selling its products to a troubled retailer may attempt to lessen credit risk by reducing payment terms from net 30 to net 15.

- **Diversification**: Lenders to a small number of borrowers (or kinds of borrower) face a high degree of unsystematic credit risk, called concentration risk. Lenders reduce this risk by diversifying the borrower pool.

- Each bank has its own system to restrict itself to the maximum exposure to a particular sector and to a particular Group of companies. Also there are regular notifications released by Reserve Bank of India (RBI) which restrict the exposure of banks in particular segment/sector. For example during financial crises, the banks close the window to extend funding to Real Estate companies.

- Reserve Bank of India by introducing Basel-II norms, CRR hike, Change in repo and reverse repo rates and other methods put pressure on banks on the basis of the market conditions. It is very important tool in the hands of RBI to control the liquidity and vice versa.

- Insurance of the properties mortgaged with the bank with endorsement in its (bank) favour. All the properties whether mortgaged in the form of collateral and/or primary.

- The client needs to submit on monthly basis the stock statement and debtors statement which is reduced by trade creditors. The bank than calculate the Drawing

Power (DP) by taking margin @ 25% of stocks & creditors and 40% on book debts. The figure should be equal to or more than the working capital limit enjoying by the client. Also bank officials conduct a regular visit and annual stock audit is done by a Chartered Accountant who is registered with bank. Hence it is important in the hands of the branches to check the fraud timely which must be reported timely to the higher authority.

- The stocks need to be insured and the same is endorsed in favour of bank. The policy must cover all the items which are hypothecated to the bank. Sometimes branch gets the insurance policy directly and debits the current account of client.

- Along-with periodical stock statement and debtors statement, data relative to sales, profit, production so that the same could be compared with the proposed one. Any significant variation in the same should be explained and backed with justification.

- In cases where rent discounting and cash flow discounting is done, an Escrow arrangement is made with the party (the applicant company and the debtor company) in which the cash will flow into that Escrow Account only. The bank will have charge on this account and the borrower will withdraw the money only for the purpose specified at the time of sanction subject to prior intimation to the bank. Basic nature of such type of accounts it that the cheque books are not issued and every time while withdrawing, a request is made to the bank with the purpose.

- If the branch is extending funding to Greenfield project and the project is located far away. In this case the bank appoints a local branch which will visit the progress of project on regular basis and submit the report to the respective circle office and branch. The monitoring branch has the responsibility to bring in notice any irregularity found doing visit and need to report immediately.

- Bank asks for collaterals in addition the primary securities (project land and building, plant & machinery). It is just to put an emotional pressure and attachment of promoter with the project. It secures the bank as well as it ensures the interest of the promoter in the project.

- A personal guarantee of the promoter-director is taken which binds them personally, their wealth and bring commitment with the project.

- In case when the company is setting up an industrial unit, it needs to take several approvals and licences from the local authorities. Normally the bank ask the following documents before the release of the loan:

- Land should be industrial land or commercial or residential (for real estate developers)
- Factory Licence or licence to develop the land for residential/ commercial purpose in case of real estate developers
- Approval to import the plant & machinery
- No restriction on the import of the basic raw materials
- Building should be subject to approved layout plans and building plans
- Clearance/NOC from Ministry of Environment and Forest (MOEF)
- Electricity and water connections

Note: The above list is not exhaustive one. The approvals depend subject to the kind of project and the state in which the project is being proposed to set-up. For example if a real estate developer wants to build-up residential colony in Rajasthan, it needs to take a clearance in the form of 90B.

For any query or assistance, kindly call or send a mail undersigned.

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