

Table of Contents

1.0	Commercial Lending	3
1.1	Term Loans	3
1.1.1	Project Loan	3
1.1.2	Corporate Loan	3
1.2	Working Capital	3
1.3	Corporate Bonds	3
2.0	Commercial Lending - Major Business Entities	3
2.1	Lender/Originators	3
2.2	Secondary buyers	3
2.3	Derivative Dealers	3
2.4	Borrowers	3
2.5	Regulators	3
2.6	Rating Agencies	3
2.7	Stock Exchanges	3
2.8	Collateral Insurers	3
3.0	Commercial Lending - High Level Processes	3
3.1	Loan Origination	3
3.2	Securitization/Sell-down	3
3.3	Loan Portfolio Management	3
3.4	Loan Servicing	3
4.0	Commercial Lending - Business Segments	3
5.0	Commercial Lending – Products & Services	3
5.1	Syndication Services	3
5.2	Loan Servicing	3
6.0	Structured Finance	3
6.1	Securitization	3
6.2	Credit Derivatives	3
7.0	Common Processes and Enablers	3
7.1	Credit Appraisal and Risk Assessment	3
7.2	Security Creation and Collateral Management	3
7.3	Documentation	3
7.4	SWIFT Messaging	3
8.0	Other Commercial Financing Methods	3
8.1	Leasing	3
8.2	Factoring	3



8.3	Forfaiting	3
8.4	Revolving Lines of Credit	3
9.0	COTS Products for Commercial Lending	3
9.1	ACBS	3
9.2	LoanIQ	3
9.3	AFSVision	3
Appendix1: Glossary of terms:		3



1.0 Commercial Lending

Commercial Lending refers to various forms of lending assistance provided by banks typically to limited companies. Banks lend to such entities on the strength of their balance sheet and business cash flows. Compared to other forms of financing, like asset based, commercial lending is pre-dominantly risk based financing, where banks lend based on the strength of the projected cash flows and based on the bank's comfort and past experience with the concerned industry/sector.

These commercial loans are provided for various purposes including new projects, capacity expansion or plant modernization, daily cash flow requirements (working capital) etc. Depending on the nature of the requirement, the loans may be either long-term or short-term in nature, secured or unsecured etc.

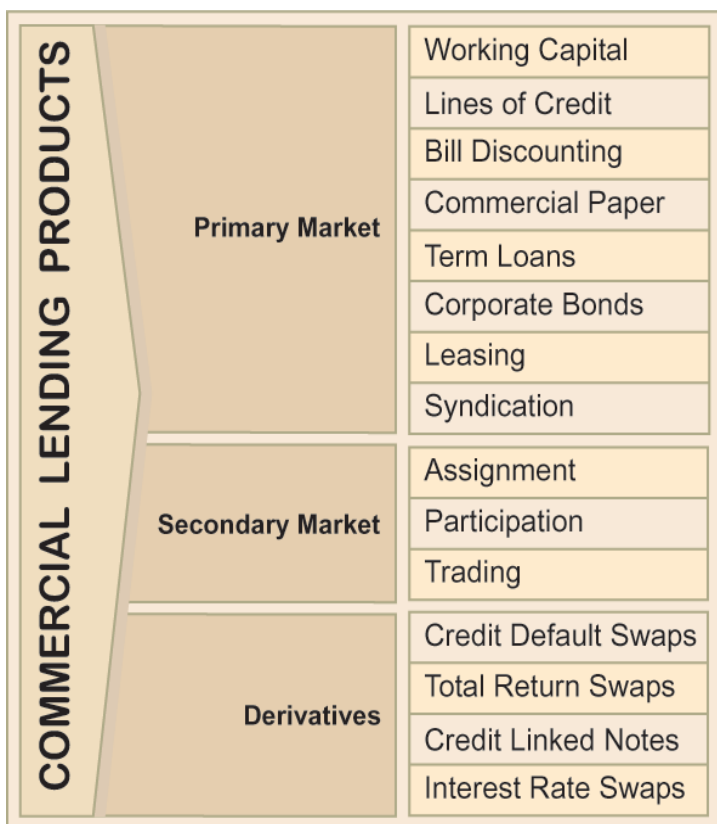
Furthermore, the following products are also normally associated with a corporate's dealings with banks:

- Commercial Real Estate Financing
- Letter of Credit
- Bank Guarantees
- Corporate Credit Cards
- Supplier & Dealer loans

However, since the processes and procedures for these products are significantly different from commercial lending products, all these have been excluded from the present scope of coverage.

In this document, we would be covering the following suite of commercial lending products-terms loans, working capital facilities, corporate bonds, structured finance and project finance. For reference a list of products and services offered in the commercial lending space are:





We detail below the commercial lending products.

Primary Market Products- These products are originated at the bank's doorsteps and consist of the following products.

1.1 Term Loans

Businesses require long-term funds for various revenue generating activities. The assets acquired for these activities usually generate streams of cash flow over a long period and typically with a gap (initial years where no revenue generation takes place). Corporations therefore, require funds, which can be repaid over a period of time.

Term loan refers to loans provided by banks and institutions to the corporations that are normally repayable over a pre-agreed period. The duration of term loan varies from one year to seven years depending upon purpose of the loan.



Term Loan can be classified into two types based on the purpose and nature of the assistance:

1.1.1 Project Loan

Project loan or project finance is generally used to refer to a non-recourse or limited recourse financing structure in which debt, equity, and credit enhancement are combined for the construction and operation, or the refinancing, of a particular facility in a capital-intensive industry, in which lenders base credit appraisals on the projected revenues from the operation of the facility, rather than the general assets or the credit of the sponsor of the facility, and rely on the assets of the facility, including any revenue-producing contracts and other cash flow generated by the facility, as collateral for the debt.

In a project financing, therefore, the debt terms are not based on the sponsor's credit support or on the value of the physical assets of the project. Rather, project performance, both technical and economic, is the nucleus of project finance. It is important to understand that the term project finance does not necessarily imply that the underlying debt is non-recourse to the project sponsor. As the definition indicates, project finance debt can be non-recourse or limited recourse. Project finance transactions can be placed on a continuum, with recourse to project sponsors ranging from non-recourse to almost complete recourse. Complete recourse is a different financing technique, usually called direct lending.

A typical project finance terms are mentioned:

Project Sponsors: CMS Generation Company of Michigan and its partner, ABB Energy Ventures

Project Financers: OPIC, U.S. Export-Import Bank

Project: Jorf Lasfar Energy Company power generating project. Privatization and expansion of state-owned Jorf Lasfar power plant near Casablanca, Morocco

Facility amount: \$1.3 billion

Recourse: Limited recourse

Project benefits: Jorf Lasfar facility is not only providing Morocco with 1.32 gigawatts of electrical power, but is generating tax revenue, creating new jobs, and creating many sales opportunities for local and U.S. companies. The project is expected to use \$644 million in U.S. goods and services and create more than 1,600 American jobs. The project was awarded Project of the Year award in 1998 by Project Finance magazine.



1.1.2 Corporate Loan

Corporate Loans or Direct Lending are non-project general-purpose loans extended for the following purposes:

- Normal Capital Expenditure
- Long term working capital
- Replacement of high cost debt
- Other general purposes

Corporate Loans are generally advanced on the basis of borrowing company's balance sheet strength. The amount of loan depends upon borrowing company's credit rating, its debt servicing capacity and refinancing capability. The tenure of loan depends upon borrowing company's specific requirements and its anticipated future cash flows. The borrower's rating is tracked during the life of the loan and the financial covenants (including minimum debt service coverage ratio, interest cover, debt: equity ratio, security cover, restrictions on undertaking new projects or raising fresh borrowings) stipulated during disbursement are periodically monitored to safeguard borrowers' interests.

Lenders could also provide the borrowers with bridge loans before the borrowing corporate can secure permanent long-term finance. Bridge loans are typically short-term loans and are provided to the borrowing company to provide borrowing company with liquidity before it can obtain more capital investment through long-term debt or equity

The interest rate on term loans could be either

- Fixed, or
- Floating - with Automatic Rate revision or revision at a pre-defined period.

Fixed rate of interest

An interest rate is fixed at the time of initiating the contract. The repayment amounts will be computed based on this rate of interest and the repayment schedule. However, the interest rate applicable on a contract can be changed after the contract has been initiated. This change should come into effect as of a date called the Value Date. The interest amount will be computed based on the new rate effective from the Value Date.

Floating rate of interest

Interest rate could be linked to the prevailing market rates (usually based on an index). This application can be done in two ways:

- Every time the market rate changes, or
- Only at periodic intervals

Floating rates could use various financial parameters as an index, most common among them are LIBOR (London Interbank Offered Rate) or EURIBOR (Euro Interbank Offered Rate). The index is



marked up with a spread to arrive at the applicable interest rate. The spread applied is a function credit rating of the borrowing corporate, prevalent and anticipated interest rates, loan amount and loan tenor.

Floating rate could be applied in the following ways:

- “As-is”: The computed floating rate (Index rate+ spread) could be directly applied used to compute interest.
- Floor: In this case, the floating rate cannot go below a predefined limit even if the index falls. Example: If the floor is defined as 3%, Index rate is 2% and Spread is 0.75%, the applicable interest rate would be 3% and *not* 2.75%
- Cap: In this case, the floating rate cannot go above a predefined limit even if the index rises. Example: If the floor is defined as 8%, current Index rate is 7% and Spread is 1.75%, the applicable interest rate would be 8% and *not* 8.75%
- Collar: In this type, both cap and floor are defined and the floating rate can fluctuate within the defined limits.

1.2 Working Capital

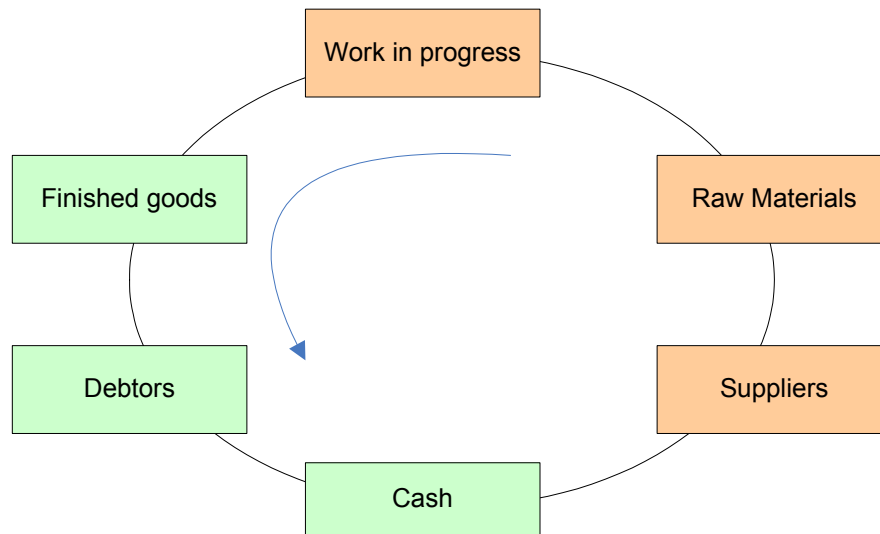
These are loans extended by banks to corporates for meeting their working capital needs and for bridging their temporary cash flow mismatches. Such working capital facilities typically take the form of cash credit and are revolving in nature-with the bank recalibrating the working capital needs of the corporate on an annual basis.

Capital or funds required for the 'day to day' operations of an organization is called the 'Working Capital'. Working capital may be viewed as comprising of two components:

- **Permanent working capital:** These represent the current assets required on a continuing basis over the entire year. It represents the amount of cash, receivables and inventory maintained, to carry on operations at any time.
- **Variable working capital:** These funds represent additional assets required at different times during the operating year. Added inventory maybe required to be maintained to support peak selling periods. Extra cash may be required to pay for increased supplies preceding high activity. Similarly, receivables increase following periods of high sales and must be financed.

The time that elapses between the company's outlay for raw materials, wages and other expenditures and the inflow of cash from sale of goods is referred to as the Operating Cycle or 'Cash Conversion Cycle'. Longer the operating cycle, the more working capital the borrower requires. A typical operating cycle in a manufacturing organization involves use of cash for purchase of raw materials to conversion of receivables into cash. The diagram below depicts the Operating Cycle:





The assets and liabilities created as companies go through the operating cycle are termed 'current assets' and 'current liabilities'. The excess of current assets over current liabilities is termed *Net Working Capital (NWC)*.

1.3 Corporate Bonds

Corporate bonds are used for the same purpose as term loans, but are transferable/marketable instruments and are backed by a guaranty from the corporate as per specified conditions. Banks sell corporate bonds to other investors who then receive the right to get payments from the corporate. Corporations generally issue three types of bonds: *Secured Bonds*, *Unsecured Bonds* (Debentures), and *Subordinated Debentures*.

All corporate bonds are backed by the full faith and credit of the issuer, but a secured bond is further backed by specific assets that act as collateral for the bond. In contrast, unsecured bonds are backed by the general assets of the corporation only. There are three basic types of Secured Bonds:

- **Mortgage Bonds** are secured by real estate owned by the issuer
- **Equipment Trust Certificates** are secured by equipment owned and used in the issuers business
- **Collateral Trust Bonds** are secured by a portfolio of non-issuer securities. (Usually U.S. Government securities)

Secured Bonds are considered to be Senior Debt Securities, and have a senior creditor status; they are the first to be paid principal or interest and are thus the safest of an issuer's securities.



Unsecured Bonds include debentures and subordinated debentures. Debentures have a general creditor status and will be paid only after all secured creditors have been satisfied. Subordinated debentures have a subordinate creditor status and will be paid after all senior and general creditors have first been satisfied.

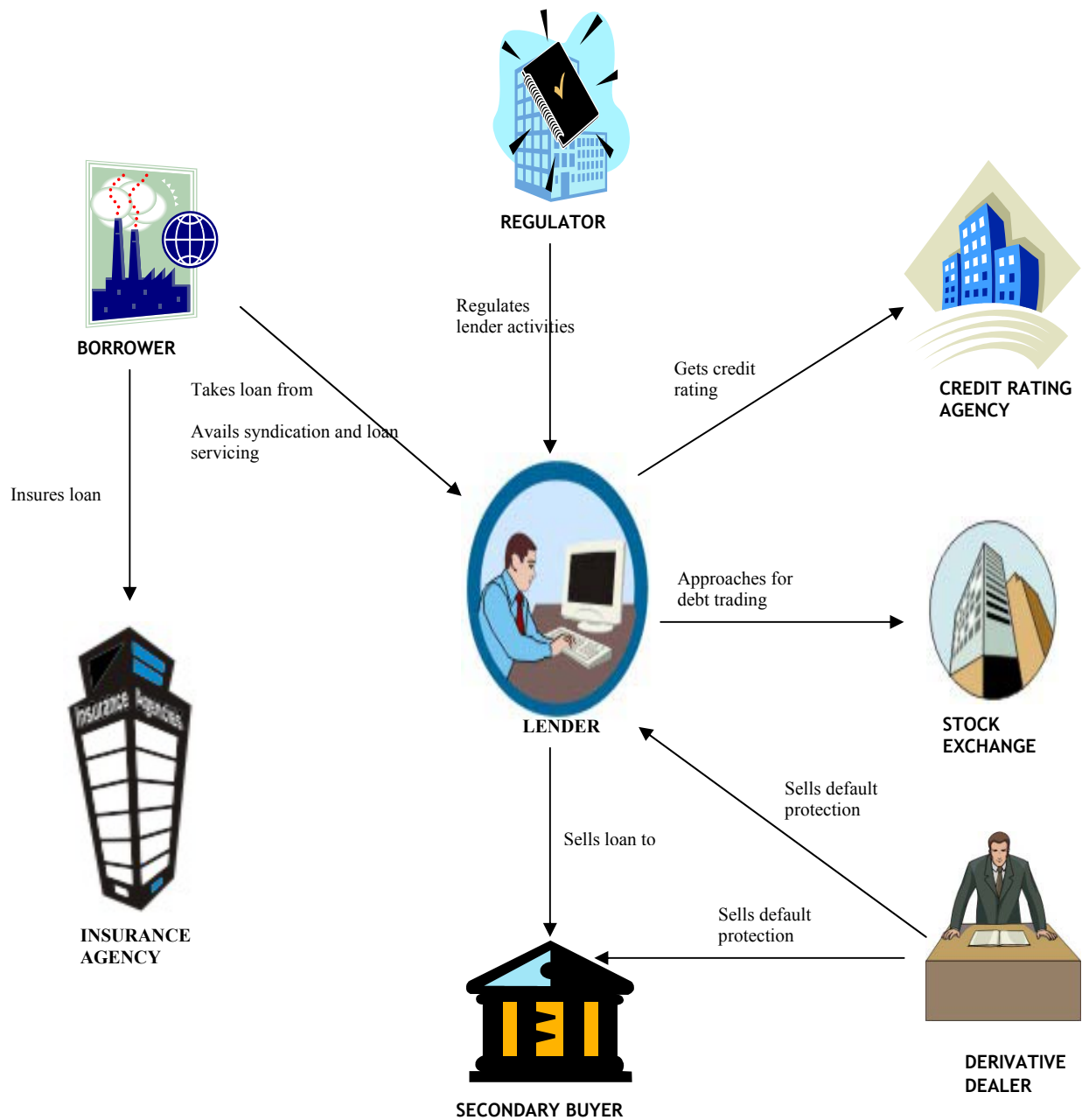
The factors that influence the bond's initial coupon rate are

- Prevailing economic conditions (e.g., market interest rates)
- The issuer's credit rating (the higher the credit rating, the lower the coupon)
- Duration of the bond (usually higher the duration, higher the coupon)
- Nature of bond – secured/unsecured

A certain class of bonds called junk bonds is issued by corporates with very low credit ratings and typically carries high rates of interest.



2.0 Commercial Lending - Major Business Entities



These entities are described in detail in the following sections.

2.1 Lender/Originators

These are entities that typically are involved in originating the commercial loans and comprise primarily of

- Commercial Banks
- Non Banking Financial Companies
- Credit Unions

Commercial Banks

Commercial Banks are the principal source of Commercial Lending. The leading Commercial Banks in US according to their assets are listed below

As of March 2004 (\$ billion)

Sr no	Company Name	Total Assets	Total Deposits
1	Citigroup, Inc.	1,318	499
2	J.P. Morgan Chase & Co.	1,121	503
3	Bank of America Corporation	1,016	573
4	Wachovia Corporation	411	232
5	Wells Fargo & Company	397	248
6	U.S. Bancorp	193	119
7	SunTrust Banks, Inc.	149	97
8	National City Corporation	128	77
9	ABN AMRO North America Holding Company	127	53
10	HSBC North America Inc.	126	86

Non-Bank Finance Companies

Finance companies offer a growing alternative for financing needs of small business. The major difference between banks and finance companies is the level of risk the institutions are willing to assume. Finance companies usually assume higher risk and therefore charge higher interest rates than commercial banks. Some of the major NBFCs are listed:

1. Bank of American Commercial Finance
2. BB&T



3. The Commercial Finance Group
4. GMAC Commercial Credit

Credit Unions

A credit union is a member-owned, non-profit institution formed to encourage saving and offer low-interest loans to members. The members are usually people working for the same employer, belonging to the same association, or living in the same community.

2.2 Secondary buyers

These are entities that are secondary buyers of commercial loans and comprise of

- Commercial Banks
- Financial Institutions like Mutual Funds, Pension Funds

The selling and purchase of the commercial loans involves suitable packaging of the same and the deal itself may be consummated through the capital markets or through negotiated deals. Commercial Banks given their position as the largest originators are also the largest sellers of commercial loans.

2.3 Derivative Dealers

These are entities that buy and sell derivative products, which provide default protection to the holders of these commercial loans and comprise of

- Commercial banks
- Financial Institutions like insurance companies and pension funds

As a class, commercial banks are the largest class of entities present on both sides of the derivative deal-as both the buyers and sellers of credit derivatives.

2.4 Borrowers

In Commercial Lending, the borrowers are Corporate and Institutional entities-including Large Corporate clients, Medium Enterprise clients, Government Bodies and Other Financial Institutions. Banks classify and segment these borrowers based on size, industry sectors, geography, funding needs etc and create differentiated offerings for them.



2.5 Regulators

Regulators like the Federal Reserve set interest rate benchmarks that directly affect the profitability of commercial loan lenders. They also regulate the exposure norms-to companies/groups/industries and capital adequacy norms-which in turn guides the risk levels that banks can assume.

2.6 Rating Agencies

Rating agencies like S&P, Moody's, Fitch ICBA, Duff & Phelps provide ratings for the debt instruments of a corporate which gives a measure of the likelihood of timely debt repayment. These ratings and their subsequent downgrades and upgrades affects the quantum holdings of such instruments by the banks and other institutions.

2.7 Stock Exchanges

Stock exchanges like NASDAQ, NYSE and online trading platforms like Debt Exchange(DebtX), where the debt instruments are traded. Such trading has immensely helped in the development of a secondary market for commercial loans-especially in the increased ability of banks in offloading distressed loans.

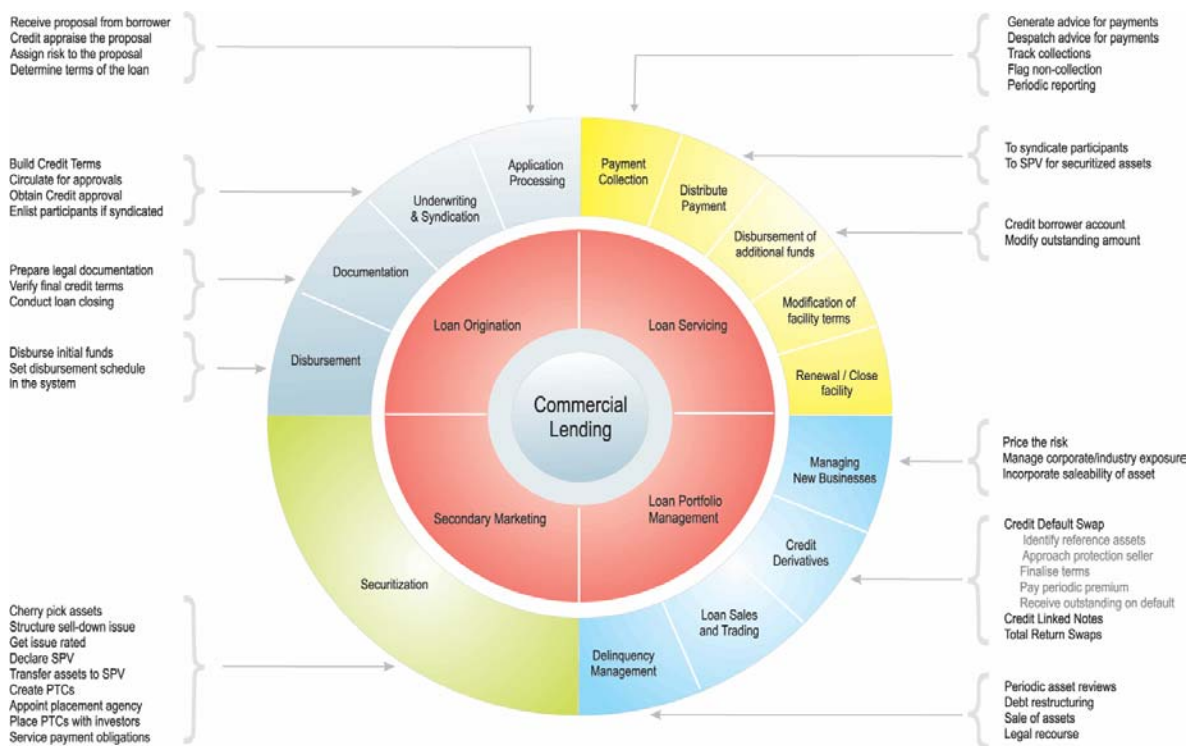
2.8 Collateral Insurers

These consist of the insurance companies which insure the physical securities provided as collateral by the corporate to the banks for their loans-in order to ensure that there is no diminution in their value to due to fire, transit, accidents etc.



3.0 Commercial Lending - High Level Processes

The high level processes in commercial lending flow out of the four broad categories of activities- origination of primary products, marketing of secondary products, management of the loan portfolio and servicing of loans. The high level processes in commercial lending are also woven around these four activity segments, as detailed below.



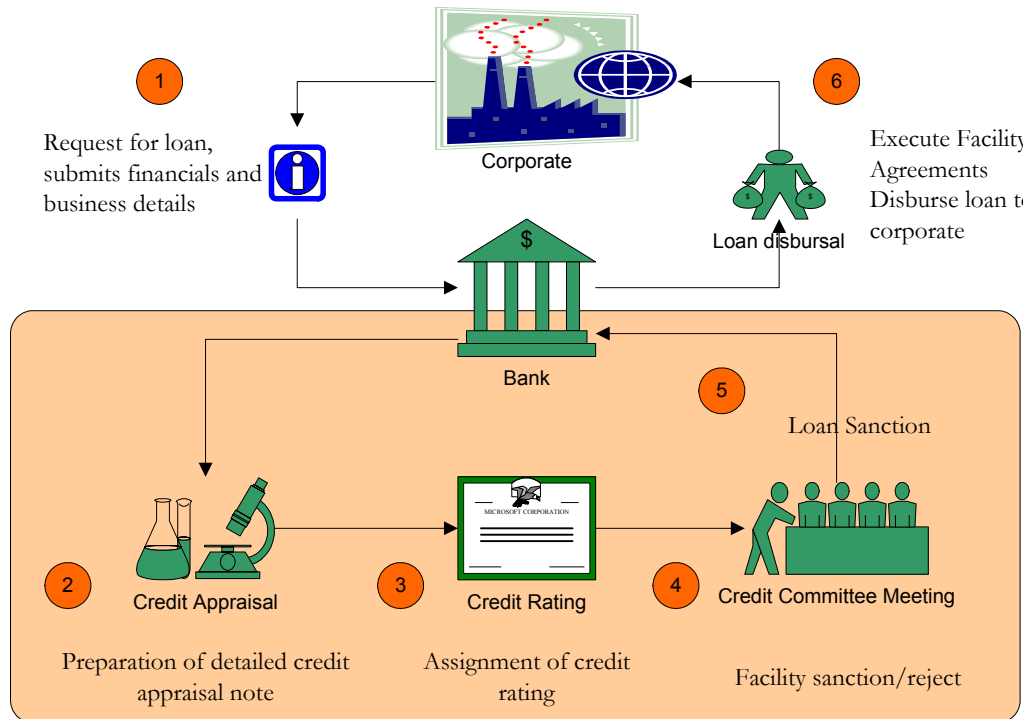
The above captures the high level processes-within which we have portrayed the major sub-processes. For example, in credit derivatives, we have mentioned the three products-Credit default swaps, credit linked notes and total return swaps and then illustrated the sub-processes for Credit Default Swaps- the derivative commonly used by banks to avail of protection from default.

In the following sections, we shall detail the four areas of activities, with relevant examples.



3.1 Loan Origination

The following are the typical high-level processes involved in originating a commercial loan-in a scenario involving a single bank-and where the loan is not split amongst a syndicate of banks.



Application Processing:

1. Corporate approaches the relationship manager of the bank with a request for a loan, with audited financial statements, details of the loan requirement, cash flow projections, security details etc.
2. The bank prepares a detailed analysis of the corporate financial statements, its products, market segment, competitors etc to ascertain the strength of the corporate's business.
3. The bank then assigns a rating to the corporate to capture factors like strength of business, financial state of the corporate, ability to repay the loan based on cash flow projections, promoter background etc.

Underwriting & Syndication

4. A committee of the bank evaluates the loan proposal and decides to sanction/reject the same.



- Once sanctioned, the bank provides a sanction letter to the corporate providing details of the loan terms and conditions.

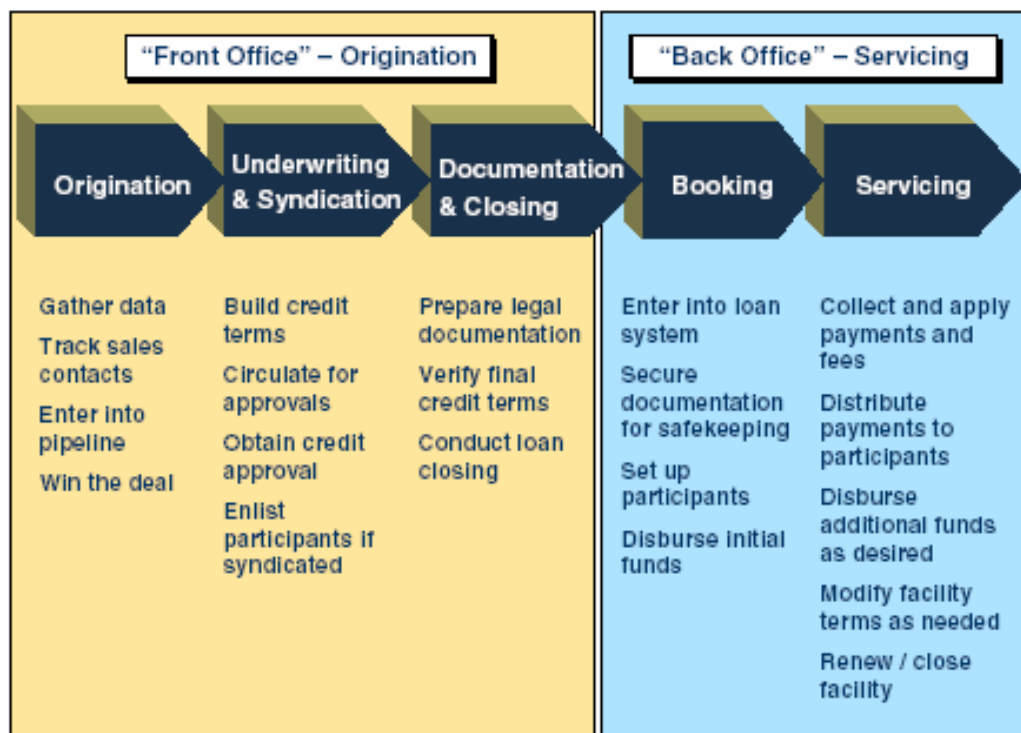
Documentation

- After the corporate accepts the same, a loan agreement is signed between the bank and the corporate. The loan agreement captures various conditions of the loan like repayment mode, repayment period, interest payable, security provided, other conditions etc. The loan becomes 'committed' at this stage.

Disbursement

- The loan terms are captured in the system and the bank disburses the loan to the corporate's account-held with the bank or with its other bankers.

While the above processes captures the processes for originating a commercial loan, the following diagram recaptures the same with more detail on the front-office origination activities and back-office servicing functions which go into the creation of the entire Commercial Lending Value Chain.



Source: TowerGroup

The above diagram provides a broad template for a bank for automating the processes in commercial lending. For example, in origination, entering the data submitted by the company,

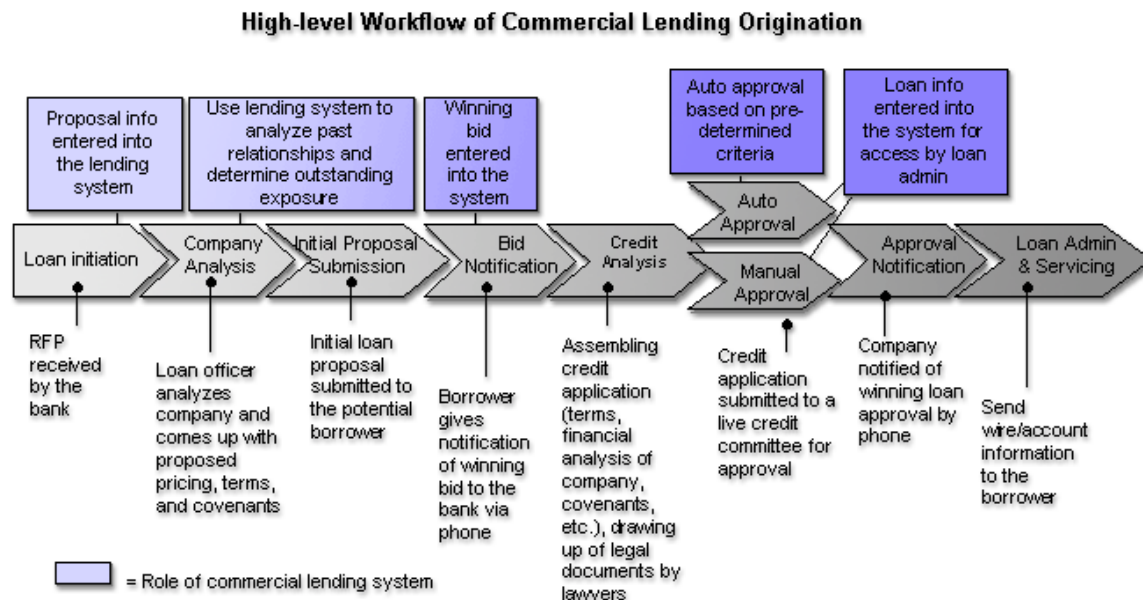


looking up the past relationships and exposures of the company are sub-processes that can be automated. Similarly, while the actual sanction may be a manual process (and would continue to remain so), the terms of the sanction and conducting loan closing-including the loan agreement templates, using workflow automation for finalizing the loan documents are steps that can be easily automated.

Loan servicing is an area, which has typically been a leader in the area of loan process automation. Thus, the following sub-processes lend themselves automation

- ☐ Scanning and storing the final loan agreements
- ☐ Generating and advising interest and principal payments
- ☐ Distributing them to the syndicate bankers
- ☐ Customer correspondences
- ☐ Modification of the sanction terms

Commercial lending processes are supported mainly through products-ACBS being a leading example of such a product. The following diagram captures the typical role of commercial lending systems in commercial loan origination.



Source: Celent

3.2 Securitization/Sell-down



Commercial lending traditionally involves the extension of credit by a bank or financial institution to a borrower, whereby the originating bank holds the loan asset generated until maturity. Loan sales allow banks to transfer loans in part or in their entirety from their own books to those of another institution. Loan sales and reselling has now become an industry within the commercial lending sector-with banks undertaking the same for generating fees and also to aid them in better management of their loan portfolio. Under the traditional policy of originate loan and hold to maturity, the portfolio manager is severely constrained in his task of constructing a diversified portfolio. This has led to a change in approach towards credit risk portfolio management – the “Asset for sale” concept. While debt, especially in the form of loans, is still not a fully liquid and tradable asset, it can still be sold and purchased. In this approach, a centralized group of portfolio managers assumes responsibility for making “buy/sell/hedge” decisions about the composition of the portfolio and tries to optimize the risk/return performance of credit assets. This can be done in two ways:

- **Assets route** – through sale and purchase / assignment of assets, securitization, purchase of equitable interest in assets etc. This involves an inflow and outflow of funds fully towards the consideration for the transactions, and may involve stamp duties / regulatory compliances etc.
- **Exposure component** – through the sale and purchase of credit derivatives like guarantees, credit default swaps, credit-related options etc. This involves only a release / infusion of the economic capital required for the credit exposure and not the entire funds itself. This also reduces requirements of stamp duty and regulatory compliance as the underlying assets remain on the books of original lender. The need for this kind of approach was born partly out of necessity, and partly out of a desire to remain profitable in an increasingly competitive landscape. Again, this approach has been facilitated by certain developments.

Forces driving active credit portfolio management through loan trading

(a) Increasing liquidity in secondary loan markets

In the last few years, there has been a trend towards rising volumes in loan sales, syndications and trading of loans in the secondary debt market, particularly for high quality corporate debt. This allows portfolio managers of banks to rebalance their credit portfolios through sales and purchases of loans, commercial paper, and other credit instruments. At the same time, the take off of credit derivatives is creating possibilities of risk transformation through innovative structures. New derivative structures may involve the indexing or reinsuring of illiquid middle market and commercial real estate loans, as well as the creation of short positions in credit risk.

(b) Convergence of fixed income trading and large corporate lending

Universal banks with roots in both commercial lending and bond underwriting are viewing loans and bonds as substitute products in the same asset class. Loans, bonds and derivative exposures to the same names are being managed as a single portfolio. Traders and loan originators are recognizing that these instruments are all different means for transforming credit risk.



(c) Need for improved portfolio diversification

Banks are becoming aware of the limitations of a fixed origination infrastructure. Many banks are significantly undiversified relative to the market. Yet, one bank's risk concentrations can become another bank's risk diversification.

(d) Potential for regulatory and tax arbitrage

Moving loan assets off bank balance sheets into the hands of mutual funds, pension funds, hedge funds and other pass through vehicles eliminates regulatory capital requirements. On the demand side, non-bank investors are becoming increasingly willing to hold credit assets, leading to a growing source of off-balance sheet investment.

(e) Advances in credit risk analytics

In the past few years, there has been a revolution in the science of credit risk measurement, with the widespread adoption of risk rating, expected loss, and economic capital methodologies, and more recently, the development of sophisticated credit portfolio models.

(f) Regulatory developments

The new Basel accord is likely to favour banks with a strong internal rating system in terms of a reduction of regulatory capital requirement. This is an incentive for banks to set up strong monitoring and controls, which can be also be used for active credit portfolio management.

3.3 Loan Portfolio Management

As banks move away from providing credit to managing portfolio of loan assets, loan portfolio management becomes a crucial activity for banks in commercial lending. The main components of portfolio management are detailed below.

Managing new business and renewals

While, managing new businesses and renewals, banks need to adopt a credit portfolio model in making decisions. This model would help the bank in putting the complete price on a loan asset-including the bank's existing exposure, the sale-ability of the loan in secondary market, the hedge available etc. Typically, the loan's base pricing in many instances may tend to be attractive (on a stand-alone basis)-but the model would be able to provide the complete picture. While such models need not become the decision maker, it would help banks and their underwriters and the portfolio managers to be consistent in their evaluation and also provide a framework for discussing the merits of a transaction.

Credit Derivatives

Through credit derivatives, holders of credit assets are able to purchase protection on an increasing list of names, without the permission or knowledge of the obligor. Also, credit



derivatives provide a low-transaction-cost method of taking on those exposures that provide diversification. The most common kinds of credit derivatives are credit default swaps, credit linked notes and total return swaps. Increasingly, apart from their stand-alone use, credit derivatives are also being used in securitization. Credit default swaps are a valuable tool for higher credit quality obligors for whom they are available and for those institutions that have the necessary infrastructure and expertise to participate.

Loan Sales and Trading

One key element of the increased efficacy of bank's portfolio management has been their ability to create an active secondary market-especially for the distressed loans. The processes involve identification of suitable loans, packaging, structuring and selling-similar to those described in securitization. As mentioned, reselling of loans has become an industry within the commercial lending sector-both as a fee generating activity for the banks and as an aid in their portfolio management.

Delinquency Management

Non Performing Loans (NPLs) are a concern for the profits of a bank and banks adopt different strategies to manage such delinquencies, some of which are detailed below.

Periodic Asset Reviews - Early identification of assets that have a high possibility of default often results in deriving a higher value for the asset.

Debt restructuring – If the borrower is unable to meet its payment obligations, banks might provide for –

- ❑ Loan rescheduling - for borrowers facing temporary distortions but otherwise financially healthy. Loan repayments are rescheduled and principal payment is deferred in case it is a long-term loan. In case of a short-term loan, it is converted into a long-term.
- ❑ One time settlement – for borrowers unlikely to meet their payment obligations in the long term but with immediate short time liquidity, a one-time settlement of dues, usually with a hair cut, could be negotiated between the borrower and lender

Sale of assets – NPLs are usually sold to Asset Management Companies (AMCs) usually at a steep discount.

Legal recourse – If the lender believes that the borrower is a willful defaulter, he may resort to legal methods to recover the moneys owed to him by the borrower.

3.4 Loan Servicing

This consists of all the servicing aspects of loan, as detailed below.

- Payment Collection- Generating the demand for interest and principal, collecting the interest and principal repayment, MIS Reporting etc.



- Distribute payment- Where applicable, to the other lenders and syndicate members and investors in securitized loans.
- Disbursement of additional funds
- Modification/Resetting of facility terms
- Renewal/liquidation of the facility



4.0 Commercial Lending - Business Segments

Commercial lending is a fairly mature business and segmentation of borrowers is broadly done by banks on the following categories.

- ❑ Based on the size-large caps and medium/emerging corporate
- ❑ Based on the geographical footprint of the corporate-an MNC may get to have a relationship that is handled/controlled at a global basis, which a local corporate wouldn't.
- ❑ Based on industry sector- for example, many banks have cluster arrangements for dealing with the whole class of companies in an industry sector-say pharma or IT.
- ❑ Based on the corporate's access to capital markets-those with direct and easy access to capital markets and institutions have relationships with banks that is inclined more towards non-funded products-like loan syndication, cash management etc., while companies with less access to capital markets depend upon banks for their funding needs.

Depending upon the size and location of the bank, they choose one or more of the above categories to segment their customers and create differentiated offerings to them.



5.0 Commercial Lending – Products & Services

The products under commercial lending have already been elaborated. In this section, we will detail the services-those activities that are woven around the products and from which banks earn significant amount of revenues-which could be a stable and steady source of revenue.

5.1 Syndication Services

With an active secondary market for commercial loans and strict capital norms for holding assets, banks and institutions have evolved their syndication and participation services where they undertake these services based on their relationship strengths-but without any lending commitments from their side-and earn fees out of these activities. Usually large value terms loans and corporate bonds issuance are syndicated where two or more banks jointly agree to make a loan to a borrower. Every syndicate member has a separate claim on the debtor, although there is a single loan agreement contract. The creditors can be divided into two groups. The first group consists of senior syndicate members and is led by one or several lenders, typically acting as mandated arrangers, arrangers, lead managers or agents. These senior banks are appointed by the borrower to bring together the syndicate of banks prepared to lend money at the terms specified by the loan. The syndicate is formed around the arrangers – often the borrower's relationship banks – who retain a portion of the loan and look for junior participants. The junior banks, typically bearing manager or participant titles, form the second group of creditors. Their number and identity may vary according to the size, complexity and pricing of the loan as well as the willingness of the borrower to increase the range of its banking relationships.

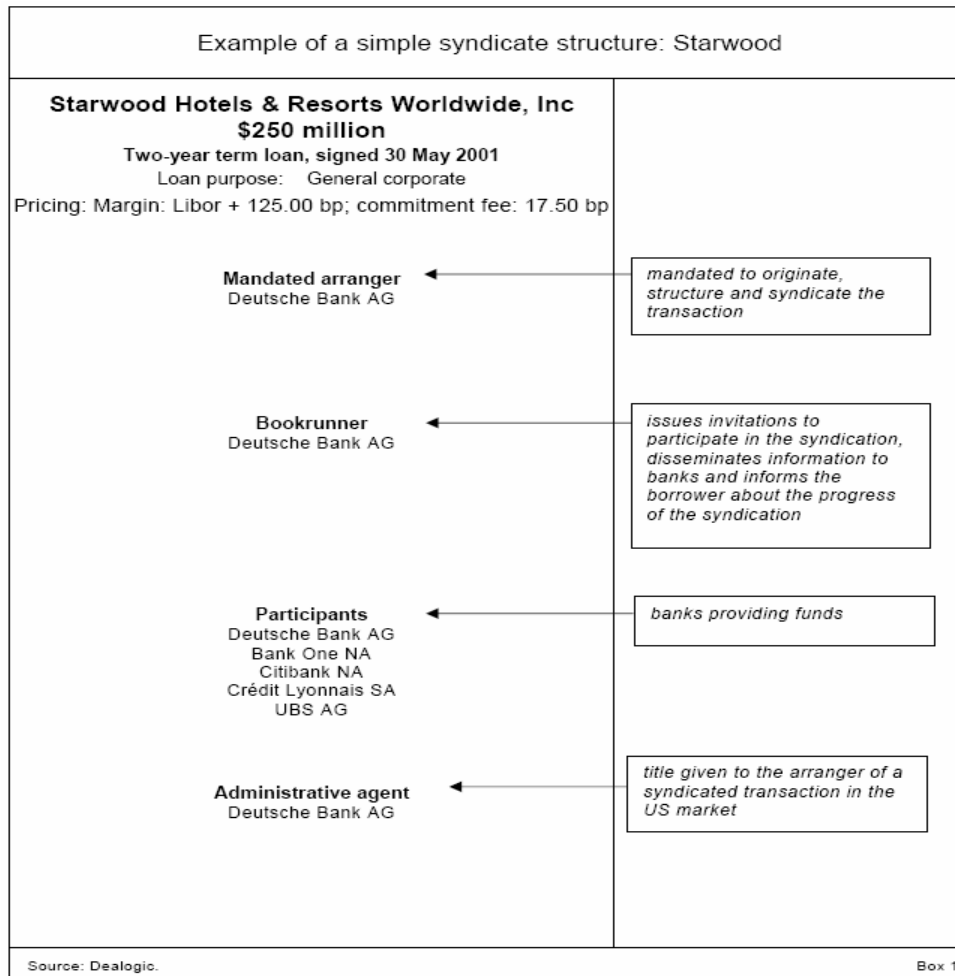
The lead bank that manages the placement of term loan or bonds undertakes this activity on either a firm commitment basis or best-efforts basis:

Underwritten commitment: The lead arranger guarantees placement of loan or bond to the extent of his underwritten commitment. The arranger covers any shortfall in placement by investing in bonds or participating in loan.

Best – efforts: There is no commitment from the arranger on the amount of bonds/loan placed. The best efforts arranger is not at risk, and any unsold bonds remain with the issuer. The arranger fee for best-efforts basis thus is less than fee for underwritten commitment.

Syndicated credits lie somewhere between relationship loans and dis-intermediated debt –the diagram below shows, in decreasing order of seniority, the banks that participated in a simple syndicate structure to grant a loan to Starwood Hotels & Resorts Worldwide, Inc in 2001.





Senior banks may have several reasons for arranging syndication. It can be a means of avoiding excessive single-name exposure, in compliance with regulatory limits on risk concentration, while maintaining a relationship with the borrower. Or it can be a means to earn fees, which helps diversify their income. In essence, arranging a syndicated loan allows them to meet borrowers' demand for loan commitments without having to bear the market and credit risk alone.

For junior banks, participating in a syndicated loan may be advantageous for several reasons. These banks may be motivated by a lack of origination capability in certain types of transactions, geographical areas or industrial sectors, or indeed a desire to cut down on origination costs. While junior participating banks typically earn just a margin and no fees, they may also hope that in return for their involvement, the client will reward them later with more profitable business, such as treasury management, corporate finance or advisory work.

Arrangers and banks in the syndicate receive various fees. The arranger and other members of the lead management team generally earn some form of upfront fee in exchange for putting the deal together. This is often called a *praecipium* or *arrangement fee*. The underwriters similarly earn an *underwriting fee* for guaranteeing the availability of funds. Other participants receive a *participation fee* for agreeing to join the facility, with the actual size of the fee generally varying



with the size of the commitment. The most junior syndicate members typically only earn the spread over the reference yield. Once the credit is established and as long as it is not drawn, the syndicate members often receive an annual commitment or facility fee proportional to their commitment (largely to compensate for the cost of regulatory capital that needs to be set aside against the commitment). As soon as the facility is drawn, the borrower may have to pay a per annum utilization fee on the drawn portion. The agent bank typically earns an agency fee, usually payable annually, to cover the costs of administering the loan. Loans sometimes incorporate a penalty clause, whereby the borrower agrees to pay a prepayment fee or otherwise compensate the lenders in the event that it reimburses any drawn amounts prior to the specified term.

The structure of fees in a syndicated loan is given in the table below:

Fee	Type	Remarks
Arrangement fee	Front-end	Also called praecipium. Received and retained by the lead arrangers in return for putting the deal together
Legal fee	Front-end	Remuneration of the legal advisor
Underwriting fee	Front-end	Price of the commitment to obtain financing during the first level of syndication
Participation fee	Front-end	Received by the senior participants
Facility fee	Per annum	Received by the senior participants
Commitment fee	Per annum, charged on undrawn part	Paid as long as the facility is not used, to compensate the lender for tying up the capital corresponding to the commitment
Utilization fee	Per annum, charged on undrawn part	Boosts the lender's yield; enables the borrower to announce a lower spread to the market than is actually being paid
Agency fee	Per annum	Remuneration of the agent bank's service
Conduit fee	Front-end	Remuneration of the conduit bank
Prepayment fee	One-off if prepayment	Penalty for prepayment

5.2 Loan Servicing

These services embrace all those activities from loan disbursement upto the repayment of the loan. With the deepening of the secondary market for commercial loans, servicing of these loans comprise a significant chunk of services performed by banks and institutions.

From a business process perspective, commercial loan processing may be broadly categorized into three parts: Front Office, Middle Office and Back Office.

The Front Office is responsible for:

- Customer prospecting and relationship management



- Loan terms negotiation and booking
- Customer credit evaluation
- Liaison with Middle Office

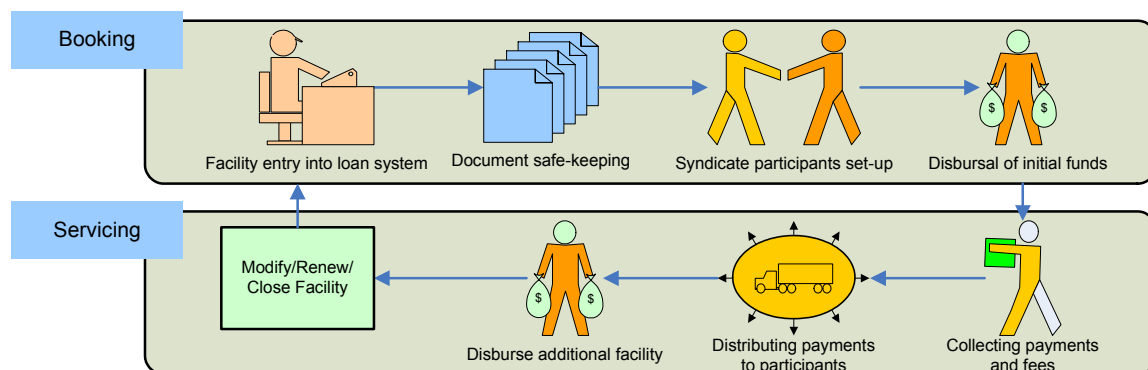
The Middle Office (MO) is responsible for:

- Completion of all documentation required throughout the life of the loan.
- Sending booking instructions to the back office for transaction entry into the loan booking system.
- Management of customer queries and loan information
- Liaison with Back office or operations

The back office or operations is responsible for loan processing and supporting the activities of the Front Office and MO. Back Office personnel enter all “hard-copy” transactions created by MO into loan booking system and any updates thereof through the life of the loan. They also generate standard and MIS reports from the system to address operations management, MIS and customer query requirements. This consists of all the servicing aspects of loan, as detailed below.

- Payment Collection- Generating the demand for interest and principal, collecting the interest and principal repayment, MIS Reporting etc.
- Distribute payment- Where applicable, to the other lenders and syndicate members and investors in securitized loans.
- Disbursement of additional funds
- Modification/Resetting of facility terms
- Renewal/liquidation of the facility

The loan servicing functions are depicted in the workflow diagram below:



6.0 Structured Finance

Structured Finance is a financial technique whereby a deal, contract, or product is designed, customized, or engineered to meet the customers' specific financial or investment objectives and the banks' / financial institutions' risk taking ability.

It involves isolation of specific risks, evaluation of the same, allocating the risks to various participants in the transaction based on who is best equipped to mitigate the respective risks, mitigating the risks through credit enhancement structures and pricing the residual risk borne by the bank/financial institution. This involves evaluating the transaction from the legal, regulatory, taxation and accounting implications from the perspective of various participants.

Modern structured finance uses financial engineering techniques to transform the risk-return characteristics of a financial asset to suit the needs of the parties to the financing. The technique involves construction of more complex products from basic financial components

Genesis of Structured Finance

The evolution of Structured Finance has been driven by the following factors:

1. Setting up of large projects by companies / promoters with relatively low financial strength. This necessitated financing of the projects on a non-recourse or limited recourse basis. This has led to evolution of structured finance in project financing, more aptly described as structured project finance.
2. More sophisticated investors with a deeper understanding of efficient risk allocation.
3. Increasing dis-intermediation and intense competition among financial institutions leading to a move towards offering customized solutions to clients.

Motivation for Structured Finance

A "structured" product is designed to meet any of the following client objectives:

Reduction of funding costs, through segregation of better quality assets.

Non-recourse funding and/ or off balance sheet funding.

Balance sheet management through identifying and unlocking hidden value & exiting unrelated investments.

Improvement in firm value by management of risks such as credit risk, market risk and interest rate risk in a more efficient manner.

Simultaneously, the funding institution providing the structured products also derives the following benefits:

In an increasingly competitive financial services sector, structured products help the funding institution to differentiate itself from the competition and to consolidate its position with existing clients by meeting specific needs through customized products.

The institution can build new client relationships and thereby help expanding business of the institution in a competitive environment, since structured products help setting up funding mechanisms for customers who are otherwise of lower credit quality.

Using the mechanism of credit enhancement the institution can offer better pricing to customers.

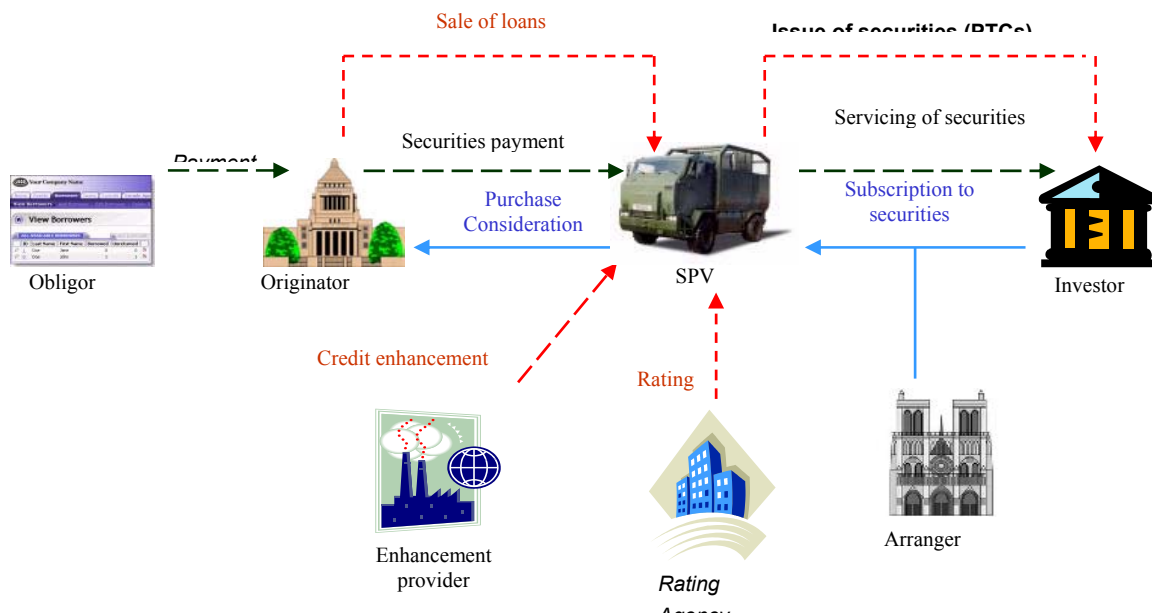


Given the high quality of underlying asset in a structured product, the risk quality of the overall portfolio can be improved. Thus structured finance, if used effectively, can lead to de-risking of the asset portfolio of the funding institution.

The document discusses two classes of structured finance – Securitization and Credit Derivatives

6.1 Securitization

Securitization is a process through which homogenous illiquid financial assets are pooled and repackaged into marketable securities. It is a method of funding receivables such as mortgage debts, leases, loans, or credit card balances through creating freely tradable securities backed by these assets



The following are the typical high-level processes in a securitization activity.

1. The Lender identifies assets that can be sold down, based on its portfolio requirements. Loans can be securitized individually, or multiple homogeneous loans could be clubbed together.
2. A Structuring Agency may be appointed to work out the terms and structure of the Securitization issue. In the case of large banks and financial institutions, the Structuring Agency may be a group within the organization.
3. The Lender (Originator) creates a Special Purpose Vehicle (SPV), which is collateralized with securities, through which the receivables from the underlying asset are passed on to the Investor.



4. Further credit enhancement of the issue could be achieved by providing additional security by the Originator or some other agency such as a Credit Enhancement Provider.
5. The SPV takes ownership of the asset receivables and creates either Pay-Through-Certificates or Pass-Through-Certificates, by which the subscriber of the certificates (PTC) will be passed on all receivables arising from the asset.
6. The PTCs are rated by an external Credit Rating Agency.
7. The Originator appoints a Placement Agency to place the PTCs with potential Investor(s).
8. The Investor(s) subscribes in the PTCs through the SPV.
9. The Lender (or an appointed servicing agency) collects payment (principal/interest) due on the loan(s) and pass them on, along with related MIS to the SPV.
10. The SPV arranges for the funds so collected to be passed on to the Investor(s).
11. If there is any credit event the Credit Enhancement Provider / Insurer, if any, would be obligated to meet any shortfall. If necessary, the securities/ cash/ assets given as collateral are used to meet any shortfall.

6.2 Credit Derivatives

Credit derivatives are financial contracts that permit one party to transfer credit risk of a reference asset that it owns, to another party without actually selling the asset. A bank, which has given a loan to a corporation, can hedge its exposure by buying protection in the credit derivatives market. Likewise, another bank may be willing to take on that credit risk by selling protection and thus enhance the expected return on its portfolio.

Credit Derivatives may be broadly classified into

- Credit Default Swaps
- Total Return Swaps
- Credit Linked Notes

In a credit default swap (CDS), the protection buyer continues to pay a certain premium to the protection seller, with the option to put the credit to the protection seller should there be a credit event (which would be defined between the two entities). Unless there is a credit event, there is no exchange of the actual asset or the cash flows arising out of the actual asset. A credit event may defined as one or more of the following: Bankruptcy, insolvency, failure to pay, repudiation and restructuring, delinquency, price decline, rating downgrade and so on. It may be noted that the protection buyer is exposed to counter-party risk from bankruptcy of the protection seller.

In a total return swap (TRS), the parties agree to exchange the actual cash flows from the reference asset, including the appreciation and depreciation in its market value, periodically, with returns referenced to a certain reference rate. If the reference rate is LIBOR, the protection buyer will get LIBOR + spread, and pay over to protection seller all earnings, including appreciation in value, from the reference assets. Thus, the returns from the reference asset is replaced by a

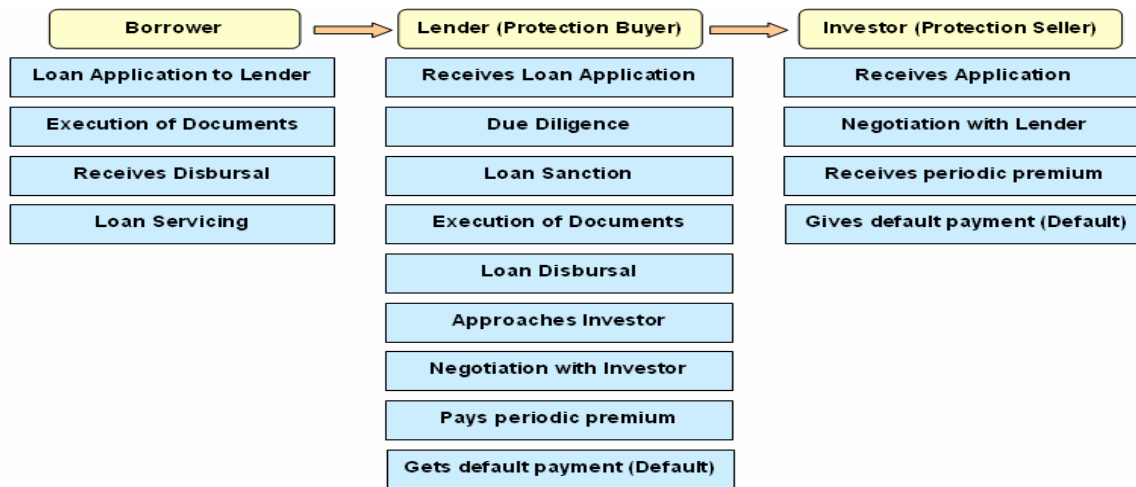


return calculated on a reference rate, thereby transferring both the credit risk as well as the price risk of the reference asset. If there is any depreciation in the value of the reference asset, the protection seller pays the depreciation amount to the protection buyer at the end of the transaction period. A TRS is primarily an off balance sheet financing vehicle.

Credit linked notes (CLN) package a credit default swap into a tradable instrument - a note or a bond. The credit-linked notes may be issued either by the protection buyer himself or by a special purpose vehicle. Unlike CDS or TRS, a CLN is an on-balance sheet investment vehicle.

Credit Default Swap: High level Process

The high-level process flow of a Credit Default Swap transaction is given below



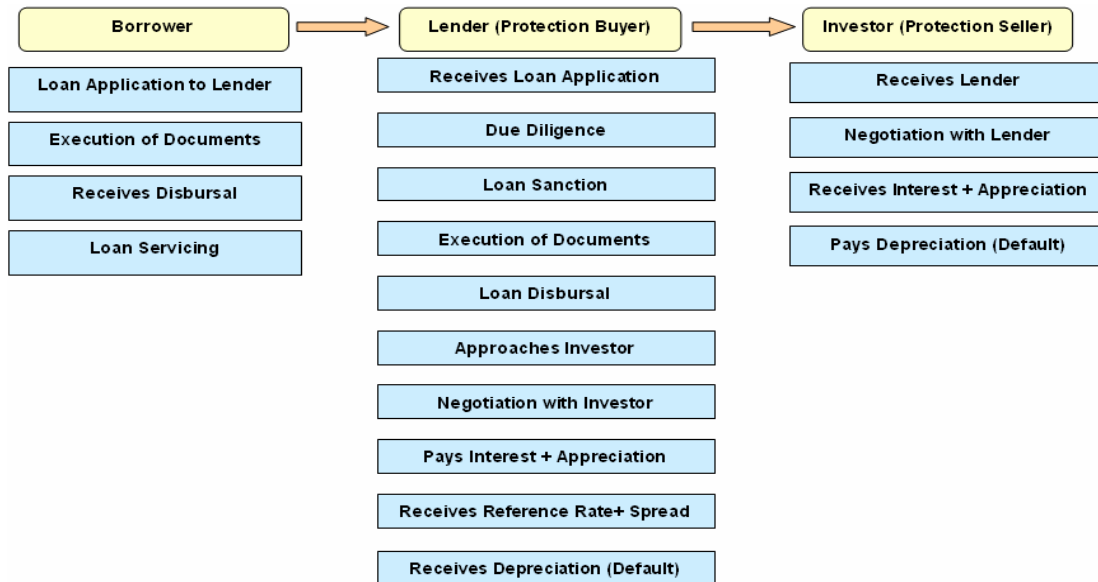
The general procedure for the creation and sale of a credit default swap is as follows:

1. The borrower applies for commercial loan with the Lending bank.
2. The Lending Bank (Lender) conducts due diligence.
3. The Lender sanctions the loan.
4. The Lender and Borrower execute documentation and other formalities relating to the loan are completed.
5. Disbursement of the loan takes place.
6. The Borrower services the interest/ principal payments of the loan (reference asset) as per the repayment schedule
7. The Lender approaches the Investing Bank (Protection Seller) with the intention of buying protection for the reference asset created above
8. The Protection Seller conducts negotiations on term and Conditions with the Lender (Protection Buyer)
9. On completion of the deal, the Protection buyer pays a periodic premium to the Protection Seller in return for a Put option on the reference asset in case of a credit default event.



10. If there is any credit event (as negotiated between the two parties in step 8), the Protection Buyer exercises the Put Option and the Protection Seller must purchase the reference asset.

Total Return Swap: High level Process



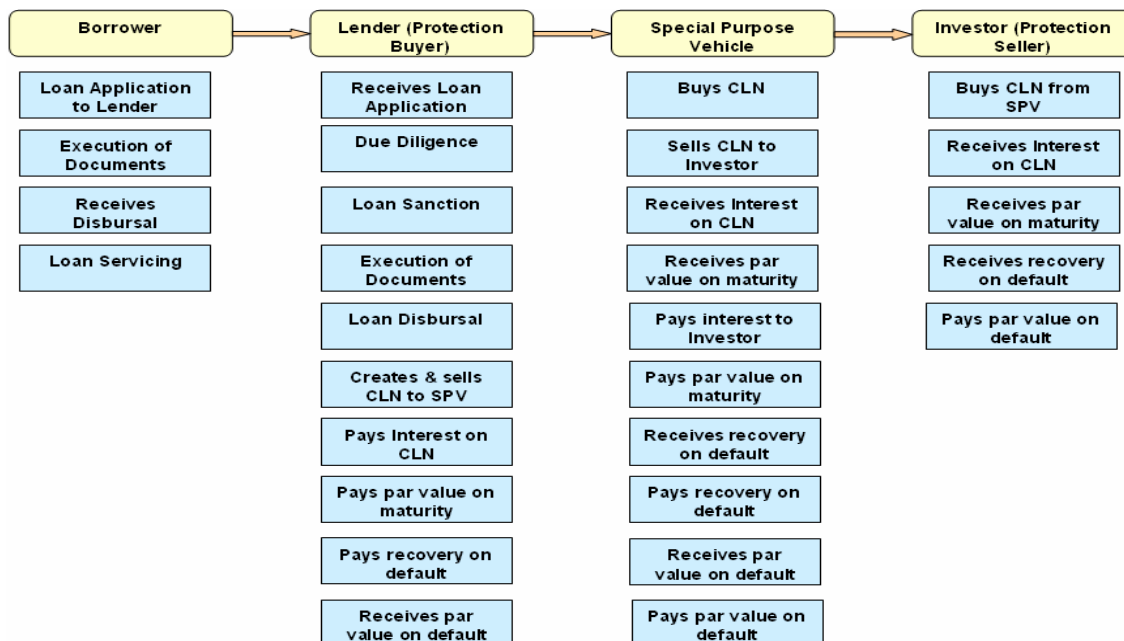
The general procedure for a TRS transaction is as follows:

1. The borrower applies for commercial loan with the Lending bank.
2. The Lending Bank (Lender) conducts due diligence.
3. The Lender sanctions the loan.
4. The Lender and Borrower execute documentation and other formalities relating to the loan are completed.
5. Disbursement of the loan takes place.
6. The Borrower services the interest/ principal payments of the loan (reference asset) as per the repayment schedule
7. The Lender approaches the Investing Bank (Protection Seller) with the intention of buying protection for the reference asset created above
8. The Protection Seller conducts negotiations on term and Conditions with the Lender (Protection Buyer)
9. On completion of the deals, the Protection Buyer pays to the Protection Seller, the interest flows received from the reference asset and any appreciation in the value of the underlying
10. The Protection Seller pays to the Protection Buyer, a reference rate (usually LIBOR) + spread, which represents the funding cost of the latter.
11. If there is any credit event or any depreciation in the value of the reference asset, the Protection Seller makes a net payment of the difference between the price of the reference asset at the beginning of the transaction and the price of the reference security at the time of default. Alternatively, the Investor may agree to take delivery of the



defaulted reference asset and pay the initial price of the reference asset to the total rate of return payer.

Credit Linked Notes: High level Process



The general procedure for a CLN is as follows:

1. The borrower applies for commercial loan with the Lending bank.
2. The Lending Bank (Lender) conducts due diligence.
3. The Lender sanctions the loan.
4. The Lender and Borrower execute documentation and other formalities relating to the loan are completed.
5. Disbursement of the loan takes place.
6. The Borrower services the interest/ principal payments of the loan (reference asset) as per the repayment schedule.
7. The Lender (Protection Buyer) creates a CLN from the reference asset through a Special Purpose Vehicle (SPV) or Trust, which is collateralized with highly rated securities. The SPV acts as a conduit for the flow of funds.
8. The Protection Seller invests in the CLN through the SPV.
9. The Protection Seller receives a fixed or floating coupon (interest) during the life of the CLN.
10. At maturity, the Protection Seller would receive the par value of the note if there is no credit event.
11. If there were a credit event, the Protection Seller would receive an amount equivalent to the recovery value of the asset.



12. If there were a credit event, the Protection Seller would pay, via the SPV, the par value of the reference asset to the Protection Buyer.



7.0 Common Processes and Enablers

The common processes and enablers applicable to commercial lending are discussed.

7.1 Credit Appraisal and Risk Assessment

Effective risk management is critical to achieving financial soundness and profitability. One of the major risks in a commercial bank's business is credit risk arising from likelihood of counter-party default. Hence identification, measurement and monitoring of risk form an important aspect of risk management. A commercial bank assigns a rating to the company after carefully going through the rating process discussed later in detail. The rating assigned represents an opinion on the credit quality of a company and/or the credit instrument, and therefore serves as an important indicator of credit quality.

Risk refers to any factor, which could result in variability in cash flows of a company. The companies are rated based on a scoring system of the various risk parameters, which in turn, comprise of the risk factors.

- Risks of the company are broken down into risk categories
- Risk categories are broken into risk parameters
- Risk parameters are broken down into risk factors

An analysis of the company based on below mentioned factors indicates the risks associated with lending to the company. Weights are assigned to each risk factor within the parameters, and the sum is used to arrive at the rating score for the company as a whole. The rating of the company is crucial as the pricing structure depends upon it. Also considered are rating from the external credit rating agencies like Moody's and S&P.

Business Risk

Assessed by the company's market position vis-à-vis its competitors. This is further broken up into product-related position, price related position, location advantage, and promotion related position. Also, the company's operating efficiency is assessed based on parameters like capacity utilization, operating costs, availability of infrastructure, working capital management, etc.

Industry Risk

Assessed through the following parameters:

- Industry characteristics (viz. importance to the economy/industry size, growth outlook/demand and supply, cyclicity, and government policies)



- Industry competitiveness (i.e. domestic competition, import threat/substitutes, technology risk, entry barriers, bargaining power of buyers/suppliers, international competitiveness)
- Industry financials (viz. return on capital employed and operating margins (to be taken at 3 year industry average), earning stability)

Management Risk

Assessed by studying the promoter's track record (i.e. experience in the industry, quality of management personnel, past successful strategic initiatives, labour relations), its financial conservatism, attitude to risk, payment record to lenders, group support, management succession, corporate governance, and market reputation.

Project Risk

Assessment involves project implementation risk (i.e. construction/stabilization risk, and funding risk), and the post-implementation project risk (i.e. industry risk, business risk, financial and management risks).

Financial Risk

Assessed by looking at operating margins, interest cover, ROCE, debt equity ratio, and current ratio for the current and previous years. In addition, corporates financial flexibility, cash flow adequacy and the quality of its financial statements are also assessed.

Cash flow analysis

Evaluating cash flow is the single most important element in determining whether a business has the ability to repay debt. Two principal methods of calculating the cash flow available in business to service debt are presented in this subsection. The results of these methods should be used to determine the adequacy of cash flow in each credit evaluated at an institution. The accrual conversion method is the preferred method because it is the most reliable. The second and less reliable method is the supplemental or traditional cash-flow analysis; however, the information needed for this analysis is usually more obtainable and easier to calculate. The traditional method can be used when circumstances warrant, for example, when the borrower's financial statements are not sufficiently detailed for the information requested in the accrual conversion analysis or when historical information is inadequate.

Components of the Accrual Conversion Method of Cash Flow:

Category	Basis for Amount
Sales:	Dollar amount of sales in period
+/-change in A/R, INV., A/P	Represents the absolute difference of the current period from the corresponding period of the previous year in accounts receivable, inventory, and accounts payable.
Formula:	a) An increase in any current asset is a use of cash and is subtracted from the calculation. Conversely, a decrease in any current asset is a source of cash and is added to the calculation.



	b) An increase in any current liability is a source of cash and is added to the calculation. Conversely, a decrease in any current liability is a use of cash and is subtracted from the calculation.
SGA:	Subtract selling, general, and administrative expenses.
Interest Expense:	Add interest expense to the calculation if SGA “expense” includes interest expense.
Excess (Deficit) Cash Flow:	Represents cash available before debt service.

Calculation of Supplemental/Traditional Cash Flow

Category	Basis for Amount
Net Income:	Amount of net income reported on most recent annual income statement before taxes.
Interest Expense:	Add the total amount of interest expense for the period.
Depreciation/ Amortization:	Add all non-cash depreciation and principal amortization on outstanding debt.
Cash Flow before Debt Service:	Indicates net Earnings Before Interest, Taxes, Depreciation, and Amortization (EBITDA). Amortization should include both principal and interest payments required on debt.
Debt Service:	Subtract scheduled principal and interest payments.
Capital Expenditures:	Subtract all capital expenditures for the period.
EQUALS—	
Excess (Deficit) Cash Flow:	Total amount of excess or deficit cash flow for the period after debt service.
Coverage Ratio:	Cash flow before debt service divided by debt service (principal and interest).

Limitations of Cash Flow Analysis—

Cash-flow analysis uses the income statement and balance sheet to determine a borrower's operational cash flow. Careful analysis of all investment and financing (borrowing) activities must be made for an accurate assessment of cash flow. Credit appraisers should be careful of conclusions reached using the traditional cash-flow analysis, without consideration of balance-sheet changes or other activities that affect cash flow. The traditional cash-flow analysis does not recognize growth in accounts receivable or inventory, a slow-down in accounts payable, capital expenditures, or additional borrowings. One critical issue to remember is that deficit cash flow does not always mean that the borrower is encountering serious financial difficulties. In some cases, a business experiencing significant growth causes deficit cash flow, and there is a pronounced need for external financing to accommodate this growth and eliminate the deficit cash-flow position. In this case, an adequate working-capital facility may not be in place to



accommodate the need for additional inventory. A comprehensive analysis of changes in the balance sheet from period to period should be made before the loan proposal is rejected.

Ratio analysis

Ratio analysis is the oldest and most widely used method to analyze the financial performance of a firm. Ratios do not convey any meaning as absolute figures till they are compared with similar figures of earlier years, or with those of other industries. The trends revealed in the financial reports are carefully analyzed and variances and aberrations are must be discussed with the company before a view is taken.

Liquidity ratios: Financial ratios in this category measure the company's capacity to pay its liabilities as they come due.

Ratios	Definition and analysis
Current Ratio	<p>The ratio between all current assets and all current liabilities; another way of expressing liquidity.</p> <p><u>Current Assets</u> Current Liabilities</p> <ul style="list-style-type: none"> 1:1 current ratio means; the company has \$1.00 in current assets to cover each \$1.00 in current liabilities. Problem with the current ratio is that it ignores timing of cash received and paid out.
Quick Ratio	<p>The ratio between all assets quickly convertible into cash and all current liabilities. Specifically excludes inventory.</p> <p><u>Cash + Accounts Receivable</u> Current Liabilities</p> <ul style="list-style-type: none"> Indicates the extent to which one could pay current liabilities without relying on the sale of inventory Although a little better than the Current ratio, the Quick ratio still ignores timing of receipts and payments.

Safety ratios: Indicator of the businesses' vulnerability to risk. Creditors often use these ratios to determine the ability of the business to repay loans.

Ratios	Definition and analysis
--------	-------------------------



Debt to Equity	<p>Shows the ratio between capital invested by the owners and the funds provided by lenders.</p> <p><u>Debt</u> Equity</p> <ul style="list-style-type: none"> ▪ The higher the ratio, the greater the risk to a present or future creditor. ▪ Too much debt can put a business at risk. Too little debt may mean the business is not realizing the full potential, and may actually hurt the overall profitability
Debt coverage ratio	<p>Indicates how well cash flow covers debt and the capacity of the business to take on additional debt.</p> <p><u>Net Profit + Non-cash expenses</u> Debt</p> <ul style="list-style-type: none"> ▪ Shows how much of cash profits are available to repay debt. ▪ Lenders look at this ratio to determine if there is adequate cash to make loan payments.

Profitability ratios: These ratios indicate the ability of a business to make profits.

Ratios	Definition and analysis
COGS to Sales	<p>Percentage of sales used to pay for expenses, which vary directly with sales.</p> <p><u>Cost of Goods Sold</u> Sales</p> <ul style="list-style-type: none"> ▪ A stable ratio indicates that the company is in control of its gross margins
Gross Profit Margin	<p>Indicator of how much profit is earned on products without consideration of selling and administration costs.</p> <p><u>Gross Profit</u> Total Sales</p> <p>where Gross Profit = Sales less Cost of Goods Sold</p> <ul style="list-style-type: none"> ▪ Compared to other businesses in the same industry to see if business is operating as profitably as it should be. ▪ Indicates if there is enough gross profit in the business to cover operating costs ▪ Indicates if there is a positive gross margin on all products
Return on Equity	<p>Determines the rate of return on investment in the business. As an owner or shareholder this is one of the most important ratios as it shows the hard fact about the business – is it making enough profit to compensate the owner for the risk of being in business?</p> <p><u>Net Profit</u> Equity</p> <ul style="list-style-type: none"> • Compare the return on equity to other investment alternatives, such as a savings account, stock or bond. • Compare ratio to other businesses in the same or similar industry.



Efficiency ratios: Also called Asset Management ratios. Indicator of how efficiently the company manages its assets.

Ratios	Definition and analysis
Days in Receivables	<p>This calculation shows the average number of days it takes to collect accounts receivable (number of days of sales in receivables).</p> $\frac{\text{Average Accounts Receivable} \times 360 \text{ days}}{\text{Sales}}$ <ul style="list-style-type: none"> ▪ Creditor looks for trends that indicate a change in customers' payment habits. ▪ Compares the calculated days in receivables to stated terms. ▪ Reviews an Aging of Receivables watches for trends that might indicate a problem.
Accounts Receivable Turnover	<p>Number of times that trade receivables turnover during the year</p> $\frac{\text{Net Sales}}{\text{Average Accounts Receivable}}$ <ul style="list-style-type: none"> ▪ The higher the turnover, the shorter the time between sales and collecting cash.
Sales to Total Assets	<p>Indicates how efficiently business generates sales on each dollar of assets.</p> $\frac{\text{Sales}}{\text{Total Assets}}$ <ul style="list-style-type: none"> ▪ A volume indicator that can be used to measure efficiency of business from year to year.

7.2 Security Creation and Collateral Management

Security considerations assume prime importance for term loans. It is essential that there should be adequate asset protection behind a term loan to provide against loss resulting from errors of judgment in appraising the loan. There may also be occasions where security considerations assume greater importance. A facility is termed secured if it is backed by an asset that can be repossessed by the lender if the borrower defaults. The asset is termed a collateral.

The value of pledged collateral is critical to a secured lender, loan conditions and covenants, such as insurance coverage, are always required of a borrower. A lender typically minimizes its risk by conservatively valuing the collateral and by loaning only a percentage of its appraised value. The maximum loan amount, compared to the value of the collateral, is known as the loan-to-value ratio. A lender might be willing to loan only 75 percent of the value of new commercial equipment. If the equipment was valued at \$100,000, it could serve as collateral for a loan of approximately \$75,000.

A charge could be created on various types of assets – movable or immovable, tangible or intangible. The various charge types are:



- **Hypothecation** - Hypothecation does not transfer title, but it does provide the right to sell the hypothecated property in the event of default. The term is used for movable properties like a vehicle, stock-in-trade, etc.
- **Mortgage** – Charge is created on an immovable property or fixed assets like land, building, etc.

Seniority of charge - Seniority refers to the order of repayment in the event of bankruptcy. Senior debt must be repaid before subordinated debt is repaid. The charge is classified as first or second. First charge holders have seniority over the second charge holders and get first right over the collateral to reclaim their dues in the case of a default. *Pari passu* refers to secured loans or bonds having equal rights of payment, i.e. have the same level of seniority.

Term loans are normally secured by a first *pari-passu* charge over the fixed assets of the company. It is also normally secured by a charge over the movable assets of the company subject to the prior charges in respect of raw materials, semi finished goods, consumable stores and book debts created in favour of the Banker's for the working capital assistance. Working capital loans are usually secured by a first *pari passu* charge over the accounts receivable and inventory. However, in some cases the fixed assets may not be sufficient, or additional comfort may be required.

In the majority of cases lenders, as an act of prudence, also take personal guarantees of the directors/managing agents/promoters. As the future of the concern is largely dependent on the standard of the management, joint and several personal guarantees obtained from the promoters ensures the entire commitment of the promoters. Depending upon case-to-case basis, security package could also include corporate guarantee from some other company, pledge of shares, escrow of some cash flows or charge over intangible assets.

Other sources of comfort are:

- Personal Guaranty of Promoters – guaranty provided by the promoters or sponsors
- Corporate Guaranty – guaranty provided by a concern other than the borrowing company – usually of a higher credit rating
- Pledge of shares – shares owned by the borrowing company are kept as security, usually with an agreement to top-up if the market value of shares declines below a certain pre-determined level
- Escrow of Cash Flows – identified cash flows are routed to an escrow account, the lender usually has a lien on the escrow account
- Intangible Assets – brands, goodwill and other intangible assets are used as collateral

7.3 Documentation



A number of documents are executed between the borrower and lender to effect the credit facility. Some of these documents are:

Promissory note - A promissory note is a contract. When the borrower signs a promissory note, it promises to repay to the lender a certain amount of money, at a certain time, and according to certain terms and conditions. A promissory note may be unsecured or secured.

Security agreement - A security agreement gives the lender a "security interest" in specific property owned by the borrowing company. The agreement spells out the security enforcement details.

Loan/credit agreement - A loan agreement contains terms and conditions for the loan in addition to those contained in the promissory note, security agreement, or mortgage. Common provisions in a loan agreement include provisions regarding the lender's commitment to lend, repayment and note terms, pre-conditions to the disbursement of loan, representations and warranties, agreements by the borrower to take or not take certain actions, and events of default.

Personal guaranty - A personal guaranty is a contract between an individual and the lender. Personal guarantor agrees to *personally* repay your company's loan if the company fails to repay. Usually, the lender is not required to repossess and sell any collateral before approaching the personal guarantor for payment.

Corporate guaranty – A corporate guaranty is a contract between a company, other than the borrower, and the lender. The guaranteeing company agrees to repay the borrower's loans in the event of default.

Other documents – Some documents need to be furnished before the loan is disbursed

- Board resolution – A copy of the board resolution accepting the terms of the sanction of the credit facility
- Auditor's Certificate - a certificate from the auditors of the company certifying that the proposed borrowings of the company along with all existing borrowing falls within the limit stipulated in the board resolution
- No objection certificate (NOC) – An NOC from the existing lenders for the proposed credit facility
- Representation and warranty documents as detailed in the loan/credit facility agreement

7.4 SWIFT Messaging

SWIFT is the acronym for the Society for Worldwide Interbank Financial Telecommunications. It is a highly secured private telecommunications network set up originally for the exclusive use of



banks, financial institutions and related market infrastructures (e.g. clearing systems). As such SWIFT neither provide clearing or settlement services, nor does it transfer money. It acts as a secure link between the financial communities to exchange messages about money. In many cases the clearing and settlement systems also uses both the SWIFT network and messages standards. SWIFT is owned by its members, approximately 7,500 financial institutions, and operates in just over 200 countries. On some days it may move in excess of 10 million messages between market participants.

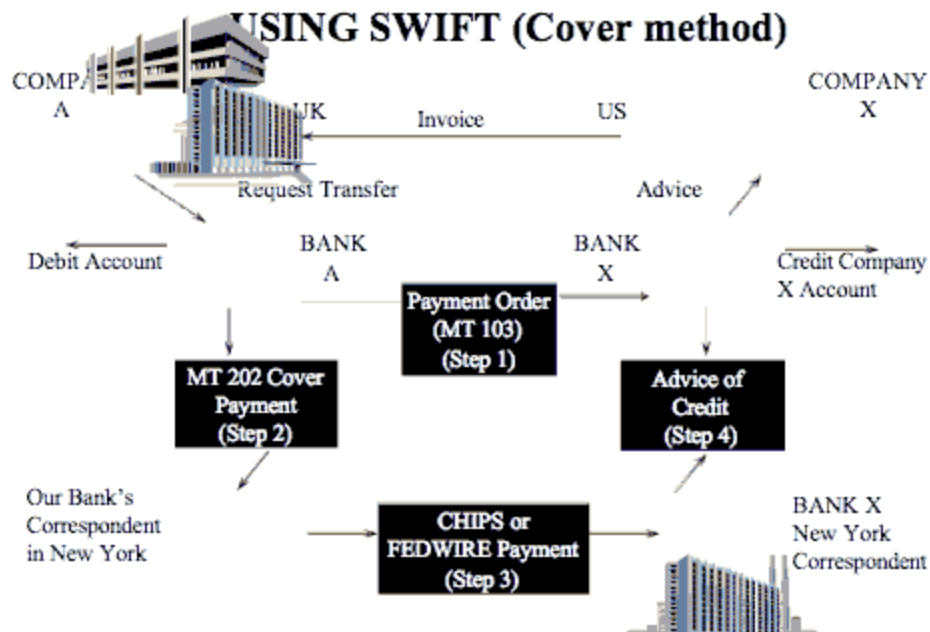
Exchanges between corporates and banks

Many of the exchanges between banks and corporates using electronic, Internet or server-to-server banking are carried out using SWIFT message standards. Most international bank-to-bank and branch-to-branch transactions relating to corporate payments and account information also use SWIFT - both the message standards and the network. The message types (MTs) are divided into various categories. The most widely used for corporate business are the 100 and 900 message series, but certain others will be used on occasions.

The 100 series was for many years dominated by the MT100, a single customer transfer. This message, sent from a remitting bank (or branch) to a receiving bank (or branch), would be used to instruct the receiving bank to debit the sending bank's nostro account (correspondent account held in a foreign country) and to remit funds through the local clearing in the receiving bank's country to a beneficiary at another bank. This message had a number of non-mandatory fields that could be used for different purposes, and as remitting banks started to use these, the incoming messages could not be processed automatically on receipt at the receiving bank. Therefore in 2003 this message was replaced by the MT103, which has been specifically designed for STP purposes.

MT101 messages are used for multi-banking, where a corporate uses one bank as its lead payments bank and takes that bank's electronic banking system, but wants to channel payment instructions through that bank to other banks that it uses. The MT101 is sent to the account holding bank through the lead bank, and having been previously authorized by the initiating customer (one-off authority) will debit the customer's account and make the payment. MT102 messages are often used for server-to-server instructions where a customer sends a file of non-urgent payment instructions to his bank. These will be processed as a batch, usually at the end of the day by the bank and may be sent via SWIFT to the paying bank or branch also as a batch. Other 100 series messages include MT104 used for direct debits and MT105 and 106 used for exchanging EDIFACT messages. The 200 series messages are generally used as bank-to-bank messages, but two will be used for corporate payments in certain cases. When a bank needs to make a payment on behalf of a company to a bank that it has no relationship with, it will need to instruct its correspondent bank to move funds to that bank. One way of doing this is to use a MT202 cover payment message.





The figure above shows how the 202 is used in conjunction with a 103, while making a US dollar payment from the UK to a smaller US bank. In this case the remitting bank and the receiving bank both use other banks. These are often called 'pay through banks'. The remitter, company A, has its account in the UK with bank A. Bank A uses its US correspondent bank to put a payment instruction into the CHIPS clearing system. The beneficiary, company X, banks with a US based local bank, bank X. This bank is a SWIFT member, but is not a member of the CHIPS clearing system. It therefore uses a correspondent bank in New York that is a CHIPS member to clear its international US dollar payments and receipts.

Also certain banks enable large corporates to use the MT210 message to advise a receiving bank that they will receive funds either for their own or a subsidiary's account. The 300 series is used for foreign exchange transactions and confirmations, the 500 series for securities messages and the 700 series for trade finance transactions.

The other widely used category of messages is the 900 series, which provides for reporting account activity. The most widely used message is the MT940, which contains a customer bank statement. This message can be sent from an account holding bank or branch to a lead bank, which will then report the detail received to its customer through its own proprietary electronic banking system. The MT940 is an end-of-day message that will be seen by the customer the next working day. The MT942 is used to provide details of transaction activity across bank accounts during the working day and the MT941 reports changes to account balances due to such movements, again same day. The latter two messages are often used by banks to provide intra-day or real-time reporting to customers through their own electronic banking systems.

SWIFTNet

SWIFTNet is the latest version of SWIFT, which operates using Internet Protocols, but still as a private network. It does not use the World Wide Web. It uses the same high level of security based on Public Key Infrastructure that was used on the older network, but now provides banks with a number of newer services, some of which are browser-based. SWIFTNet started its rollout in the third-quarter of 2003 and all banks using SWIFT converted across to the new system by the end of 2004.

Benefit of SWIFTNet to corporates



With the introduction of SWIFTNet corporate customers now have the ability to use the SWIFT network themselves by joining one or more Member Administered Closed User Groups (MA-CUGs). This enables a corporate to link to its banks using the same high security levels as bank-to-bank links and to have one standard method of connection with multiple banking partners. Traditionally, multiple banked corporates have been faced with an array of different proprietary electronic banking systems, or they have had to use one bank as the lead bank, pass payments through this bank, and use it to collect bank account information on its behalf. Both methods are often expensive and not very efficient for a multi-national treasury. Direct membership of MA-CUGs is not necessarily suitable for all companies. CUGs are designed for the larger sophisticated corporates that handle high volumes of payments and data exchanges.



8.0 Other Commercial Financing Methods

8.1 Leasing

A lease or tenancy is an interest in personal property or real property given by a lessor to another person (lessee or tenant) for a fixed duration such that the lessee has obtained certain of the Lessor's rights to possess and/or use the property and has provided to the Lessor certain consideration in exchange for such rights.

There are two types of property – (a) Real property which is Land (b) All other property either tangible or intangible, i.e. physical property like a computer, or an enforceable right like a patent or intellectual property.

Real property - An owner can contractually or by grant permit a third party to have possession and control of the property through a lease or tenancy agreement. For this purpose, the owner is called the lessor or landlord and the other person is called the lessee or tenant, and the rights to possess and control the land are exchanged for some consideration (usually a monthly rent. A lease may be:

- For a specified period of time (the "term") and, when the term expires, the lease will end; or
- It can be conditional, i.e. it lasts until some specified event occurs, e.g. the death of a specified individual will terminate the lease; or
- It is at will, i.e. it lasts only as long as the parties wish it and it can be terminated without penalty by either party.

Tangible personal property - An owner can allow another the use of a car or a computer either for a fixed period of time or at will. This can be a simple leasing transaction, or it can be a transaction intended to allow the user the right to buy the car at some future time.

There are three separate levels of rights or interests affecting both forms of property. In descending order of importance they are:

- Ownership,
- Possession or control, and
- Use

The legal documents that transfer these rights are respectively: conveyance/transfer, lease/tenancy, and bailment/pledge for tangible property, assignment for intangible, and Licenses.

Lease or Own

Whether it is better to lease or buy property will be determined by each state's legal and economic systems. In those countries where acquiring title of the property is complicated, the state imposes high taxes on owners, transaction costs are high, and finance is difficult to obtain, leasing will be the norm. But, freely available credit at low interest rates with minimal tax disadvantages and low transaction costs will encourage property ownership.

Types of leases

Leases can be classified into the following types:



Capital Lease / Finance Lease

These leases share the advantage of fixed monthly payments *but with the guaranteed option* to purchase the asset for a nominal price at the conclusion of the lease. With this type of lease there is no uncertainty about the value of the asset at the conclusion of the lease as the buyout terms are generally a part of the initial agreement.

- The lessee *is* considered the owner of the asset and maintains full control of the residual value.
- The lessee can depreciate the asset.
- Lessees record the equipment as an asset and the lease payments as liabilities on their balance sheets.

True Lease or Operating Lease

Also known as fair market value leases. The most notable feature of this type of lease is that its structure *does not* contemplate a full payout of the cost of the asset, as is the case in a "Finance" type lease. Two of the common tests are:

- The term of the lease is generally not greater than 75% of the asset's anticipated useful life.
- The present value of the lease payments should not exceed 90% of the fair market value of the asset using the lessee's incremental cost of borrowing.

A significant benefit is that the monthly payments are also less than on a finance type lease or even a bank loan. Typically the lessee either returns the equipment at the conclusion of the lease or may be granted the opportunity to purchase the equipment from the Lessor for "the fair market value." Payments under this kind of lease structure are treated (by the I.R.S.) as rental payments and therefore are 100% tax-deductible operating expenses. Also, as rental payments, neither the asset nor its corresponding liability needs to appear on the company's balance sheet. The Lessor retains the right to depreciate the equipment. End of lease features:

- The lessee may have to option to continue renting the asset
- The lessee may have the option to "re-lease" the asset

A tabular comparison of Operating and Financial Lease is given:

	Operating lease	Financial Lease
Nature of Contract	Renting out the asset	Renting out the asset
Nature of income	Rental	Rental
Ownership	Lessor	Lessee
Registration of charge (companies act)	Not required	Not required
Endorsement	Required	Required



Residual Value	Not ascertained	Ascertained for purchase by lessee
Accounting		
Books of Lessor	Asset to be treated as fixed asset	Asset to be treated as current asset
Book Depreciation (Lessor)	Claims depreciation	Cannot claim depreciation
Books of Lessee	Off balance sheet	Asset to be capitalized; liability to be recorded
Book depreciation (Lessee)	Cannot claim depreciation	Claims depreciation
Income Tax		
Lessee	Rentals tax deductible operating expense	Rentals not tax deductible operating expense

Benefits of commercial leasing

- For businesses, leasing property may have significant financial benefits:
- Leasing is less capital-intensive than purchasing, so if a business has constraints on its capital, it can grow more rapidly by leasing property than it could by purchasing the property outright.
- Capital assets may fluctuate in value. Leasing shifts risks to the lessor, but if the property market has shown steady growth over time, a business that depends on leased property is sacrificing capital gains.
- Leasing may provide more flexibility to a business which expects to grow or move in the relatively short term, because a lessee is not usually obliged to renew a lease at the end of its term.
- Depreciation of capital assets has different tax and financial reporting treatment from ordinary business expenses. Lease payments are considered expenses, which can be set off against revenue when calculating taxable profit at the end of the relevant tax accounting period.

Disadvantages

There are some significant drawbacks:

- If circumstances dictate that a business must change its operations significantly, it may be expensive or otherwise difficult to terminate a lease before the end of the term. In some cases, a business may be able to sublet property no longer required, but this may not recoup the costs of the original lease, and, in any event, usually requires the consent of the original lessor. Tactical legal considerations usually make it expedient for lessees to default on their leases. The loss of book value is small and any litigation can usually be settled on advantageous terms. This is an improvement on the position for those companies owning their own property. Although can be easier for a business to sell property if it has the time, forced sales frequently realize lower prices and can seriously affect book value.



- If the business is successful, lessors may demand higher rental payments when leases come up for renewal. If the value of the business is tied to the use of that particular property, the lessor has a significant advantage over the lessee in negotiations.

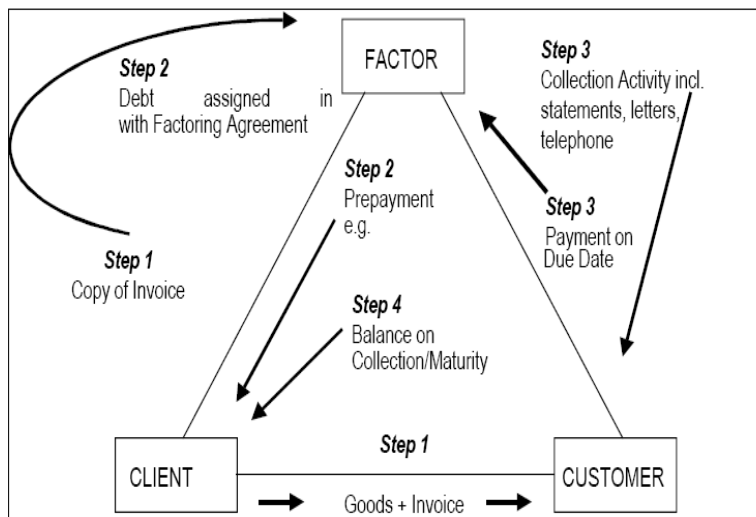
8.2 Factoring

Factoring involves the direct purchase of third-party (traditionally termed the “customer”) accounts receivable. A company sells a product to a customer who agrees to pay at some future time. The company “sells” that receivable to a Factor (a financial institution). The factor purchases the receivables at a discount, pays the company (traditionally termed the “client”) what the third party (customer) owes, and assumes all the credit risk for the purchased accounts. Factor then collects the full amount from the customer and returns it to the company minus a small percentage.

Factoring can be classified into:

- Discount factoring and Maturity factoring:** In discount factoring, the factor discounts the receivables prior to the maturity date, while in maturity factoring the factor pays the client the purchase price of the factored accounts at maturity.
- Recourse factoring and Non-recourse factoring:** In recourse factoring, a factor takes responsibility for the clients’ debt collections but retains the right to seek full recourse from the client for any bad debts. The client may buy credit insurance separately but no cover is provided by the factor. Non-recourse factoring offers the client full credit management service cover on approved debts against the eventuality of the factor being unable to secure full payment of factored invoices.

Figure: Process of Factoring



1. Client sells goods or services to the Customer on credit for \$1,000.
2. Client “sells” receivable to Factor @ discount rate of 2%, \$980.

Factor advances 85% of discounted invoice, \$833.
3. Factor sends the invoice to the customer and collects \$1,000.
4. Factor remits reserve to Company, \$147.

Factors frequently perform professional services such as:



- All accounting functions in connection with the accounts receivable
- Customer and Client Credit investigation
- Collecting payments from their customers
- Pursuing late payers
- Providing advice to clients on credit management
- Protecting the client against bad debts

Factoring is common in certain industries, particularly the textile, apparel, carpet, and home furnishings industry. Generally factors limit their activities to a few industries in which they have expertise and an established network. Although national banks can be factors, most factoring is done by non-regulated businesses. A third-party “customer” does not have the same allegiance to the factor that it had to the seller of goods. Even when financially pressed, this party will pay a key supplier to ensure availability of critical goods. Nevertheless, a factor has some leverage and third parties are careful to cultivate the factor’s support to protect their reputation and access to credit. The factor has the right to reject receivables from individual customers, and when this happens, the manufacturer is likely to reduce or halt sales to that customer.

Factors focus most of their due diligence on the third-party customer rather than the manufacturing “client”. Typically, the factor establishes an overall limit for the client and sub-limits for each third-party customer’s receivables based on payment status, total exposure, and credit strength. Factors investigate client manufacturers to make sure that they have sufficient capacity to handle charge backs and disputed accounts.

Factoring foreign receivables is more complex than factoring domestic ones because of the extensive trade documentation on foreign sales. The basic process is fundamentally the same: the factor purchases the receivables and assumes the position of the client, collecting the receivables as per the trade documents. Since the factor owns the drafts and documents, the collection process is undertaken for its account when documents are routed through a commercial bank. Occasionally, a factor will use its own credit line with a commercial bank to “carry” receivables purchased from the exporter until payment is received from the ultimate buyer. The factor may also act as an intermediary between its customer (the importer) and the bank by substituting its own credit for that of the importer. With the added support of the factor’s guaranty, a bank may provide a letter of credit for a customer who may otherwise not meet the bank’s credit standards.

Benefits of Factoring

- For the Client, factoring offers advantages like improved cash flow. For example, a company with an average accounts receivable balance of \$100,000 and annual sales of \$1 million has Days’ Sales Outstanding (DSO) of 36.5 [$\$100,000/(\$1,000,000/365)$]. If it were to factor all of its accounts receivables with an advance rate of 85% made in three days, the DSO would be reduced to eight days, nearly an 80% improvement in cash flow
- The underwriting and management of risk associated with collection is effectively outsourced to the factor, reducing the company’s credit risk and creating an opportunity to reduce credit and collections department expenses such as wages, benefits, and infrastructure costs
- With a large, professional factor, the dilution rate (uncollectible accounts rate) may actually improve as a result of the factor’s management services and network. Example: A company earning 10% pre-tax return on annual sales of \$1 million with a 5% uncollectible accounts rate and average A/R balance of \$100,000. If by factoring their receivables (at a 1% front-end



discount fee) the uncollectible accounts rate is reduced to 3% of sales, the additional collections net of the front-end factoring fees improve pre-tax return on sales to 11%.

- Factoring offers a significant advantage with respect to balance sheet reporting. Instead of creating an obligation, it converts accounts receivable to cash. Standard measures of liquidity such as current ratio and quick ratio are relatively unaffected. In addition, since factoring can speed up the cash cycle, it can help maintain appropriate balance sheet elements such as minimum cash balances required by loan covenants. Thus, for a company with current and quick ratios greater than or equal to 1.0, these types of loans immediately reduce the ratios.

Costs of Factoring

Annual sales volume, average invoice size, longevity of factor-company relationship, accounts receivable turnover, historical dilution rate, and concentration all impact the terms of factoring. These costs need to be assessed relative to opportunity cost savings as well as to the cost of alternative sources of financing.

In general, greater annual sales volume and larger average invoice size enjoy better terms while the total volume of invoices is inversely related to the cost of factoring. Clearly, risk assessment, receivables management, and collection of a large number of smaller invoices will consume more resources on the part of the factor, and this will be reflected in its fees.

The longevity of the factor-company relationship affects both the cost of factoring as well as the advance rates. As the partnership matures, the company will likely see front-end discount fees decline and advance rates increase. This reflects a natural progression of the relationship, as the factor better understands the company and its operations. Also, the company needs to evaluate the factor and assess its ability to provide needed services.

Accounts receivable turnover, the velocity at which receivables are collected, is also directly related to the cost of factoring. In general, faster turnover lowers the discount rate charged by the factor. The factor, by remitting funds in advance of collections, must consider its own cost of funds and include this in the discount rate. The historical dilution rate (uncollectible accounts as a percent of sales) and concentration (% value of receivables associated with one or a few customers relative to the total value of receivables) will impact advance rates. Higher uncollectible accounts will translate into relatively lower advance rates. A company with demonstrable uncollectible accounts of 1% of sales will enjoy better terms than a firm with a historical dilution rate of 5% of sales. Similarly, a factor will hold higher reserves (advance a lesser percentage) for highly concentrated receivables. Although not directly related to the cost of factoring, these issues clearly affect the amount and timing of cash available and are a reflection of higher risk for the factor.

8.3 Forfaiting

Forfaiting is the purchase of a series of credit instruments such as drafts drawn under time letters of credit, bills of exchange, promissory notes, or other freely negotiable instruments on a "non-recourse" basis. The Forfeiter deducts interest (in the form of a discount), at an agreed rate for the full credit period covered by the notes. The debt instruments are drawn by the exporter



(seller), accepted by the importer (buyer), and will bear an aval, or unconditional guarantee. The guarantee, normally issued by the importer's bank, can be accepted without a bank guarantee for some strong corporate.

In exchange for the payment, the Forfeiter takes over responsibility for claiming the debt from the importer. The Forfeiter either holds the notes until full maturity (as an investment), or sells them to another investor on a non-recourse basis. The holder of the notes then presents each receivable to the bank at which they are payable, as they fall due.

Forfaiting is used for international trade transactions. Normally, a Forfaiting house handles transactions worth more than \$100,000. Traditionally, Forfaiting is fixed rate, medium term (one to five years) finance, but Forfeitors are becoming flexible about the terms. Some houses accept paper with tenors up to ten years; and in other cases for shorter periods, down to 180 days. The market for paper generally ranges between one and ten years, depending upon the country /importer financed and the guarantor.

Payments are normally made semi-annually in arrears, but most Forfeitors accommodate quarterly, semi-annually, annually, or bullet payments. These can include capital and interest repayment holidays. There is no need to have a ready-made transaction to sell the Forfeiter. Many houses structure deals on their own, and advise on credit terms, which debt instruments to ask for, and help price the deal.

The Forfeiter needs to know the identity and nationality of the buyer; what goods are being sold; detail of the value and currency of the contract; and the date and duration of the contract, including the credit period and number and timing of payments (including any interest rate already agreed with the buyer). They also need to know what evidence of debt will be used (promissory notes/ bills of exchange/ letters of credit), and the identity of the guarantor of payment (or avalor).

Forfeiter usually require the following documents:

- a) Copy of supply contract, or of its payment terms
- b) Copy of signed commercial invoice
- c) Copy of shipping documents including certificates of receipt, railway bill, airway bill, bill of lading or equivalent documents
- d) Letter of assignment and notification to the guarantor
- e) Letter of guarantee, or aval. The aval is the Forfeitors' preferred form of security of payment of a bill or note. For an aval to be acceptable, the avalizing bank must be internationally recognized and credit worthy.

The aval may be placed on the face of the note. Sometimes a guarantee is issued instead of an aval, particularly in some countries that may not recognize the aval as legally binding. Usually it is provided in a separate letter. Alternatively, the Forfeiter may be happy to accept a blank endorsement by a guarantor. Standby letters of credit may also be used.

The most important point to remember is that any guarantee should be irrevocable, unconditional, divisible, and assignable.

Once the Forfeiter has all this information, indications or quotations can be given immediately by phone or fax. A commitment can be given prior to contract or delivery, and options can be given to assist the exporter in the final negotiation of the contract.

Commonly used debt instruments

Many U.S. exporters prefer to have the importer's bank open a letter of credit to cover their debt under a supplier's credit. The bank issues a deferred payment letter of credit that specifies a series of one or more time drafts which the bank will accept (guarantee) upon presentation of the



usual documents required by an LIC. The letter of credit does not have to be transferable, or confirmed by the advising bank in the exporter's country; but it must be subject to the Uniform Customs and Practice for Documentary Credits (UCPDC) of the International Chamber of Commerce, Paris (UCP 500).

Promissory notes or bills of exchange (or drafts) are actually the most commonly Forfaited debt instruments. Under a Forfaiting agreement, a promissory note or bill of exchange/draft is issued for each installment of the supplier's credit thus documenting the existence of a claim of the exporter on the importer that is totally abstract: that is, it is unconditional irrevocable, and divorced from the underlying trade transaction.

Costs of Forfaiting

As far as possible, Forfaiters will ensure that the buyer, not the seller, incurs charges involved in a Forfait transaction. Sometimes this will involve changes to the structure of deals concluded, but Forfaiters stress their flexibility in tailoring deals to suit the exporter's needs. When faced with competition for the contract, exporters may choose to absorb some of the fees or financing cost to make the transaction more attractive to their buyer.

Charges depend on the level of interest rates relevant to the currency of the underlying contract at the time of the Forfeiter's commitment, and on the Forfeiter's assessment of the credit risks related to the importing country and to the avalizing (or guaranteeing) bank

Briefly, the interest cost is made up of:

- A charge for the money received by the seller, which covers the Forfeiter's interest rate risk. In effect, this covers the Forfeiter's refinancing costs and is invariably based on the cost of funds in the Euromarket. Forfaiters calculate this charge on the LIBOR (LIBOR is the London Interbank Offer Rate) rate applicable to the average life of the transaction. On a five-year deal, for example, repayable by ten semiannual installments, the average life of the transaction is 2-3/4 years. The LIBOR rate for this period would be used.
- A charge for covering the political, commercial, and transfer risks attached to the guarantor. This is referred to as the margin, and it varies from country to country, and guarantor to guarantor.
- Additional costs (which are also included in the Forfeiter's calculations) include a "days of grace" charge; and when necessary, a commitment fee. Days of grace are an additional number of days interest charged by the Forfeiter which reflect the number of day's delay normally experienced with payments made from the debtor country. These range from none to, say, 10 days on some countries.

Mechanics of Forfaiting

Steps involved in a typical Forfait transaction are as follows:

1. The exporter approaches a Forfeiter who confirms that he is willing to quote on a prospective deal, covering the export in X months' time bearing the aval of XYZ Bank. If the transaction is worth \$1M, the Forfeiter will calculate the amount of the bills/notes, so that after discounting the exporter will receive \$1M, and will quote a discount rate of 'n' per cent.
2. The Forfeiter will also charge for 'x' days grace and a fee for committing himself to the deal, worth 'y' per cent per annum computed only on the actual number of days between commitment and discounting. The Forfeiter will stipulate an expiry date for this commitment (that is, when the paper should be in his hands).



3. This period will allow the exporter to ship goods and get bills/notes avalized and to present them for discounting. The exporter gets immediate cash on presentation of relevant documents, and the importer is then liable for the cost of the contract and receives credit for 'z' years at 'n' per cent interest.

Many exporters prefer to work with Forfait brokers who, because they deal with a large number of Forfait houses, can assure the exporter of competitive rates on a timely and cost effective basis. Such brokers typically charge a nominal 1% fee to arrange the commitment. This is a onetime fee on the principal amount and frequently is added to the selling price by the exporter. The broker frequently consults with the exporter to structure the transaction to fit the Forfait market.

Comparing Forfaiting with Government supported export credits

An interesting comparison may be made between Forfaiting and official supported credits, (through the country's EXIM bank). It should be remembered, that Forfaiting is a complementary method of finance to officially supported export credits. Nevertheless, Forfaiting does offer exporters some real advantages over EXIM.

Forfaiting allows the exporter greater flexibility in structuring a deal, particularly where goods are being supplied from a country where EXIM requirements on local and foreign content cannot be met under existing regulations.

Further, if a buyer insists on 100 per cent financing (only 85 per cent finance is available under EXIM rules), then Forfaiting could supply the remaining 15 per cent. Typically, unless it is a very large or complex deal, a Forfaiter will be able to indicate within a couple of days whether financing is available or not. It may take longer for EXIM to come through with a commitment.

In addition, Forfaiting is 100 per cent without recourse. Once the Forfaiter has bought the paper, the exporter can collect the cash and even forget the entire transaction. Finance can also be obtained for countries that are off cover from official export credit insurance (and there are no insurance premiums to pay).

Advantages of Forfaiting

- Forfaiting provides a flexible, creative alternative to traditional international trade financing methods, and is particularly useful for transactions with buyers in developing nations.
- Corporations get cash in hand without recourse instead of a receivable.
- Forfaiting eliminates:
 - Country / political risk
 - Currency / transfer risk
 - Financial / commercial risk

8.4 Revolving Lines of Credit

Most commercial businesses require differing amounts of cash each month to meet their actual operating commitments for that month; they wish to pay only interest justified by the actual usage of borrowed cash (without penalties); and pay nothing at all when revenues are entirely sufficient to pay the month's expenses. This requires a special kind of loan that can provide long-range flexibility (allowing the principal of the loan to vary from month to month); that can temporarily cancel the loan without penalty in a month where borrowing is not required; and that can provide



an almost automatic approval from the lender for each new loan amount (to a maximum overdraft). While some of this might be achieved by a Bank Overdraft Scheme, the more commonly accepted way is to use a revolving line of credit.

A line of credit, also referred to as a loan commitment or revolving credit facility, allows the corporate to draw up to a maximum figure agreed to by the commercial lender, usually a bank or financing company. This can be viewed as a sanctioned credit facility which be availed by the business whenever it needs.

The difference between a loan and the line of credit is that the loan disbursement happens as per a defined schedule while line of credit can be availed by the corporate at its discretion any time and as many times till the overall limit is reached, and resembles bank overdraft facility. This up and down, fluctuating nature of the loan amount (account balance) is why it has come to be called a "revolving line of credit." There is no scheduled repayment of principal because there is no set principal amount of the loan.

Lines of credit are usually secured by the account receivables, inventory or assets of the corporate or could be unsecured.

For example, Lexent Inc., a broadband technology company, details their line of credit in their FY 2000 10-K filing as follows:

At December 31, 2000, the Company had notes payable to banks aggregating \$2.0 million under a \$50 million collateralized revolving credit facility, which expires in November 2003. Borrowings bear interest at the prime rate or at a rate based on LIBOR, at the option of the Company. This credit facility is to be used for general corporate purposes including working capital. As of December 31, 2000, the prime rate was 9.5%. The line of credit is secured by substantially all of the Company's assets, including its membership interests and stock in its subsidiaries, and is senior to \$5.1 million of subordinated indebtedness to a principal common stockholder.

This states that Lexent Inc. can, for its working capital needs, withdraw up to 50 million from the Line of credit and as of 31st December 2000 has withdrawn only 2 million. The used portion of the line of credit (USD 2 million) is a debt obligation, whereas the unused portion of the line of credit (USD 48 million) remains off the balance sheet.

Interest on the withdrawn amount either computed daily and payable monthly or may be applied on the highest amount withdrawn during a month. Lexent Inc. may payback the 2 million and the accrued interest or may just pay the accrued interest and "revolve" the principal (2 million). On paying back the 2 million, Lexent Inc available credit limit would be 50 million instead of current 48 million.

Lexent Inc pays a commitment fee on the unused portion of the line of credit that is a percentage of the unused portion, and a pre-determined interest rate on any drawn amounts. Commitment fee is much smaller than the interest rate.

Lines of credit may contain a variety of covenants that fall broadly into four categories:

1. Covenants that require the borrower to maintain certain financial ratios,
2. Covenants that require prepayment of the debt obligation if the firm sells assets, issues equity, or issues new debt ("sweeps covenants")
3. Covenants that restrict dividend payments or other uses of cash



4. Covenants that restricts the total amount of the line of credit to a “borrowing base” of some liquid asset of the firm (cash, accounts receivable, etc.).



9.0 COTS Products for Commercial Lending

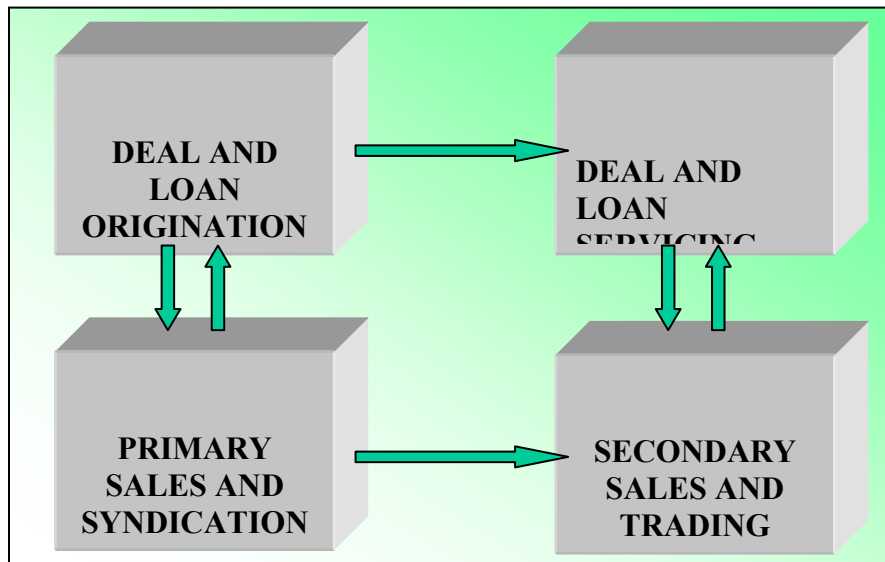
9.1 ACBS

Advanced Commercial Banking System (ACBS) is comprehensive commercial lending and trading system of Fidelity. They acquired it from ALLTEL in 2003. The system embodies a “once-and-done” workflow and information management process that integrates front-office origination, syndication, deal structuring, documentation, credit approval, portfolio monitoring and trading with back-office servicing and accounting processes.

Some of the functionalities provided by the system are:

- Loan Origination & Servicing
- Loan Authorization.
- Automated Structuring and Syndication of the loan
- Monitoring compliance of corporate borrowers
- Monitoring credit-worthiness of borrowers
- Loan-trading
- Investor Profiling

ACBS product Suite:



Deal and Loan Originating - This module is responsible for deal and loan booking of a client. This module supports the front and middle office work of a bank. The process starts with the potential borrower applying for the loan. Deal and Loan origination is the process of gathering necessary client data from internal and external sources and analyzing the data for deal / loan



approval. Approval process comprises of the credit officer going through the various data gathered, evaluating the feasibility of the loan and conforming the status of the loan whether booked, held or rejected. Once the loan is booked, information is transferred to the DLS for loan servicing.

Deal and Loan Servicing - This DLS module supports the back office work for loan servicing for the entire life-cycle of the loan. Once the booked loan is transferred to the DLS, all activities related to servicing the loan like customer enquiries on existing loans, including setting up and maintaining loan account records, managing cash flows, compliance monitoring, document management, collateral management, generation of invoices, reversal of transactions, rollovers, restructuring of loans, customer service, collections activities, general ledger reconciliation, production and ad-hoc reporting etc. are handled.

Primary Sales And Syndication - The PSS modules handle prospecting, structuring, marketing, and managing the syndication and distribution of newly originated assets in the commercial / corporate primary market. The syndication process would include deal and contact management as well as investor profiling and matching. It empowers front office users to deploy capabilities and efficiencies at the start of the lending process, long before the asset is booked. It provides real-time, up-to-the-minute access to information that enables syndicators and other support staff to make informed decisions on deal structuring and investor offerings.

Secondary Sales and Trading - Secondary Sales & Trading involve loan trading system, designed to accommodate the most sophisticated trading transactions for those involved in the business of trading commercial/corporate loan assets in the secondary market, from initial trade commitments to final accounting. All processing associated with loan trading, including trade entry and settlement are automated

9.2 LoanIQ

LoanIQ used to be a product offering by IQ Financials, the US banking software developer, in the comprehensive commercial lending space. Misys acquired IQ Financial Systems from Deutsche Bank for £24m (12-Jan-2004). Acquired from IQ Financials in 2004 Misys Loan IQ is a comprehensive tool that covers the entire life cycle of a loan - from origination and deal tracking to administration and record maintenance. Some of the world's largest enterprises are intimately familiar with its power to transform a cumbersome chain of events into a streamlined, controlled process. The result helps them achieve greater upside and improved client service

Features:

- Global leader in high-end solutions for lending operations
- Providing a sub-ledger, audit trails, a P&L system and fully automated loan administration
- Supports global functionality such as multi-language, multi-currency as well as new technology enhancements (AFS does not)



- Is a high-cost transaction processing engine compared to AFS although much more sophisticated than the AFS
- Loan IQ is not designed (at least as of now) to process thousands and thousands of transactions in the middle market, still very much the vast majority of commercial loans today
- Top banking and lending institutions run Loan IQ and ACBS primarily for the syndicate lending business
- Three-tiered architecture delivers unparalleled scalability, flexibility and reliability in a wide range of operating environments
- Client workstations and application servers run on Windows NT, 2000 or XP, and the application server layer's full scalability accommodates comprehensive configuration and requirement parameters
- The database server is a completely open and documented relational database that runs either Oracle or IBM's DB2 UDB on all supported platforms, including Windows, UNIX and IBM OS/390
- Modular design lets one customize one's functionality according to operational and budgetary requirements
- All of the system's modules are fully integrated on a single database, making additions completely seamless
- An open architecture allows for easy integration with money transfer systems, email and faxing software and other well-established enterprise systems, and an object-oriented development platform facilitates rapid deployment
- RSA Security for Misys Loan IQ utilizing the RSA BSAFE encryption software. This optional, enhanced encryption and security solution is an industry standard, proven solution that ensures critical information is secure within Misys Loan IQ

9.3 AFSVision

AFS Vision is a fully integrated lending system for all types of loans - consumer, commercial, specialized assets, and investment banking. It uses straight-through processing from origination through decisioning, closing, booking, servicing, recovery, reporting, and securitization.

AFS also has a browser based ASP model, called AFS Commerce.

Other products of AFS are AFS Treasury Management, AFS Deposit Analysis Service (database management and analytic) and AFS Xpress (Loan origination).

Product Metrics

- Loans worth \$1.5 trillion have been processed through the ASP model since its inception 4 years back
- The ASP model has more than 11000 licenses
- The ASP model is the 6th largest US loan processor, with a growth rate of 35% pa
- AFS has 13 orders (in 2005) for conversions from other systems to AFS (\$32 billion in client loan portfolios)



- Over \$150 billion in assets have been shifted from other systems to AFS since 2000
- AFS Loan Origination service was used to generate and evaluate 300,000 new loans in 2004
- 67% of existing clients became repeat customers in 2004
- AFS clients gained \$88 million in incremental revenue and cost reductions in 2004 due to AFS products
- 7 out of top 10 US Lead Arrangers are AFS Syndication users

The strength of AFS is the fully integrated nature of its lending automation system., and its ASP model. The weakness of AFS is the lack of global functionality (Multicurrency, multilingual system). The opportunities for AFS lie with lower-tier financial institutions, typically having assets below \$50 billion. The threats for AFS come from competitors like ACBS and Loan IQ, which offer multicurrency, multilingual systems, and which have better offerings for high-end syndication.



Appendix1: Glossary of terms:

Acceleration clause	A provision in a loan document stating that the entire amount of unpaid indebtedness owed to the lender may become immediately due and payable if the borrower defaults.
Accounts payable	A category of liabilities that represents funds due to creditors. Usually, accounts payable is due to trade creditors who have supplied goods or services without requiring immediate payment. Accounts payable is sometimes simply called payables. Accounts payable to trade creditors are sometimes called accounts payable trade, due to trade, or trade payables.
Accounts receivable	An asset account that reflects amounts due from private persons or organizations for goods and services furnished.
Acid test ratio	Another name for the quick ratio.
Aging	A report or schedule of all outstanding accounts payable or accounts receivable that lists all account debtors or creditors by name, shows the total amount due to each debtor, and shows how much of the amount due to each debtor is due within specific time periods.
American depository receipt (ADR)	Trust receipts equal to a specific number of shares of corporate stock issued in a foreign country. ADRs are sold and traded in the United States.
APR	See annual percentage rate.
Asset-backed security (ABS)	A debt security collateralized by assets. Created from the securitization of any loans other than mortgage loans. (Securitized mortgage loans are called mortgage-backed securities or collateralized mortgage obligations.) Typically, asset backed securities are created from consumer installment or credit card loans.
Automated clearing house (ACH)	The ACH network is a nationwide electronic funds transfer system for participating depository financial institutions. The American Clearing House Association, Electronic Payments Network, Federal Reserve and Visa act as ACH Operators, central clearing facilities through which financial institutions transmit or receive ACH debits and credits.



Aval	A guaranty.
Cash flow	A finance and accounting term used to describe the net amount of cash generated by a firm's operations. In traditional and over-simplified usage, cash flow is defined as the sum of net income after tax plus all noncash expenses such as depreciation. More modern and sophisticated usage defines cash flow to include the net difference between all cash outflows and cash inflows
Cash flow gap	The difference between cash inflows and cash outflows in a defined time period. Also called liquidity gap.
Collateral	Property that a debtor has pledged, mortgaged, or assigned to a creditor.
Contingent liability	A debt or obligation that becomes a liability only when something else happens. For example, a guarantor becomes liable for his guarantee only if the debt that is guaranteed does not get paid by the debtor
Cost of goods sold	Amount shown on a firm's income statement representing the direct expenses that the firm incurred for sales. Cost of goods sold is always a debit balance and is shown as either a deduction or a negative number
Counterparty risk	The risk that a counterparty will default (fail to perform) on its obligation under a contract. Counterparty risk is not limited to credit risk (the risk that the counterparty cannot fulfill its contractual obligations) but may also result from other problems associated with a counterparty unwilling to honor the contract.
Credit derivative	Contractual arrangements that allow one party to transfer credit risk of a reference asset, which it may or may not own, to one or more counterparties. The first party may be called the "protection buyer", the "beneficiary" or the "originator". The counterparty or counterparties may be called the "protection seller" or the "guarantor". Credit derivatives are contracts for transferring risk - just like foreign exchange, commodity and interest rate risk derivatives. The only difference is the type of risk transferred.
Credit enhancement	A measure that alters the structure of a security in a way that reduces its credit risk. Credit enhancement may take the form of a letter of credit issued to back securities. For mortgage-backed and asset-backed securities, credit enhancement may take the form of arrangements to over-collateralize the security
Credit event	A term used in credit swap and some other credit related contracts. The specified credit event in each contract is defined by the parties to suit their particular needs. Typical specified credit events are bankruptcy, insolvency, credit rating downgrade or failure to make a required scheduled payment. Note that for a credit swap transaction, these events do not refer to occurrences or change impacting one of the contract counter parties. Instead they refer to events applicable to the



	underlying reference asset. The defined events must be well-defined and unambiguous.
Credit risk	The risk to earnings or capital from the potential that a borrower or counterparty will fail to perform on an obligation.
Current assets	The group of assets considered the most liquid. Usually comprised of cash, accounts receivable, inventory, and a few minor items. The subgrouping of assets into current and long-term categories is common for all financial statements except for firms in the financial industry.
Current liabilities	The group of liabilities considered to be of the shortest term. Usually comprises accounts payable, short-term bank debt, bank overdrafts, other short-term accounts or notes payable, current portion of long-term debt, and a few minor items. The subgrouping of liabilities into current and long-term categories is common for all financial statements except for firms in the financial industry
Debt service coverage ratio	A simple comparison of the cash available to make principal and interest payments to the bank or to bond holders with the amount of those required principal and interest payments. Debt service coverage is expressed as a ratio with the annual net income divided by the annual debt service requirement
Depreciation	The amount by which a fixed asset's accounting or book value is periodically reduced to reflect the fact that the economic value of the asset is steadily reduced by a combination of wear and tear from use, age, and/or obsolescence. The offsetting entry is depreciation expense
Derivatives	Financial instruments whose value depends upon the values of underlying assets, interest rates, currency exchange rates, or indexes. Options, futures, swaps, and swaptions are common derivatives used for hedging purposes.
Event of default	An event described in a promissory note, security agreement, or loan agreement that triggers rights of the lender to take remedies set forth in the documents. The most common event of default is the debtor's failure to make required interest and/or principal payments to the bank when they are due. Often, the remedy permitted to the bank when an event of default occurs is the right to declare the debt to be due and payable in its entirety. Formal loan agreements frequently include numerous events of default
Factoring	Providing working capital to businesses by buying their receivables (usually at a discount) rather than lending against them. Factoring is not lending; it is an outright purchase of the receivable assets, usually on a nonrecourse basis.
Guaranty	An agreement by a person, partnership, or corporation (other than the borrower) to repay a bank loan if the borrower does not pay.
Junk bonds	An informal name for high-yield securities with quality ratings below investment grade
Liquidity	Both the capacity and the perceived capacity to meet all obligations



	whenever due and to take advantage of business opportunities important to the future of the enterprise.
Permanent working capital	An informal phrase used to describe the amount of short-term liabilities needed to offset a continuous or nearly continuous working capital shortfall. Also used as a name for a borrower's need for year-round working capital financing. This type of financing is usually needed by rapidly growing and/or undercapitalized firms and is usually provided by asset-based lenders
SWIFT	Society for Worldwide Interbank Financial Telecommunication. A privately owned electronic payments system used for funds transfers between member banks
Underwriter	The investment bank, commercial bank, or brokerage firm that works with an issuer to sell a new issue. Issuers may select underwriters by obtaining bids or on a negotiated basis. Potential underwriters may form groups called underwriting syndicates to bid collectively
Underwriting	The name used to describe the process of analyzing and structuring a proposed loan. Good underwriting is the most important aspect of secured lending.
With recourse	A lending expression that means the loans or leases that have been acquired from an original lender or lessor are guaranteed by the originator
Without recourse	A lending expression that means loans or leases that have been acquired from an original lender with no guaranty from the originator

