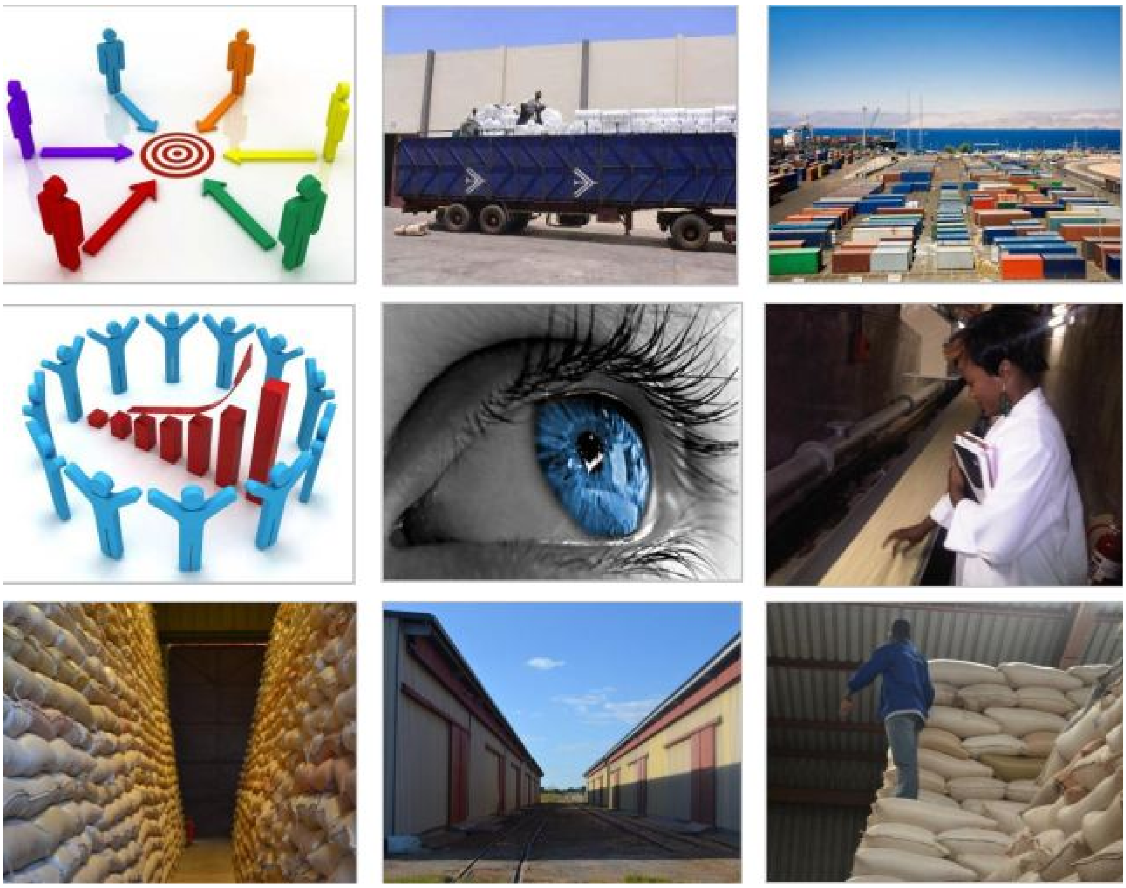
Overview of Lending Rationales, Credit Facilities and Collateral Control Services



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INTRODUCTION

The major purpose of credit analysis is to:

- **Identify risk in lending situations,**
- **Draw conclusions as to the likelihood of repayment, and**
- **Make recommendations as to the proper type and structure of the loan facility**

There are three distinct steps in the analysis of any loan proposition:

The first step is to evaluate:

- **The historical performance of the managers of the business,**
- **Determine the major risks factors, and**
- **Evaluate how well these risks could be mitigated.**

The objective of historical analysis is to identify factors in a firm's present condition and past performance that may foreshadow difficulties, or indicate the likelihood of success, in the borrower's ability to repay a bank loan at some future time. Historical analysis is of paramount importance as it is the foundation on which the second, most critical, step is built.

The second step in analysis of any loan proposition is to make:

A reasonable forecast of the probable future financial condition of the company and to conclude on the company's ability to service proposed levels of debt.

The third step:

Assess of the firm's creditworthiness and a proposal for structuring a loan facility that can be amortised given the firm's projected cash flows and that offers sufficient protection against loss and control of the lending relationship.

Banks have identified three generic lending situations, or rationales, Protection on:

- **The purpose of the loan,**
- **The source of repayment,**
- **The risk inherent in the situation, and**
- **The structure of the loan.**

These lending rationales are:

- **Asset conversion**
- **Cash flow**
- **Asset Protection Lending**

SECTION 1: OVERVIEW OF LENDING RATIONALES

Each of the lending rationales identified by Banks implies:

A different source of cash used to repay a bank loan. The specific source of repayment is dependent on the purpose of the loan, or the use to which the proceeds of the loan are applied.

The specific financing need implies the nature of the risk to the lenders, who must be certain to evaluate carefully the factors that will mitigate that risk and protect them against loss.

The repayment source, loan purpose, and risks dictate the form of protection, monitoring and control employed by the bank.

ACE primary purpose in distinguishing these three lending rationales is to provide the Bank analyst with support for determining those areas or issues that might be of primary concern when evaluating a particular credit and to provide an approach to analysis. It is essential to recognise that lending rationales are used to characterise a type of loan proposition or credit facility and not a type of borrower.

Thus, a company is not a "cash flow company" or an "asset Protection Lending Company". The same company may have several different loans with the bank; each made on the basis of a different lending rationale.

1- ASSET CONVERSION LENDING (SHORT TERM SELF-LIQUIDATING LENDING)

As commercial enterprises conduct their business, rarely does the flow of funds from the completion of sales transactions or the rendering of services parallel the outflows associated with the purchasing of raw materials, wage and salary payments, and other expenses involved in conducting the business.

In many cases, this unevenness of the flow of funds is not of sufficient magnitude to create a need for outside financing, as the firm's normal cash position is large enough to absorb these short-term fluctuations.

In other cases, particularly in seasonal companies, a company temporarily builds up first its inventory and then its accounts receivable above normal levels, there is a significant difference between the inflows and outflows of funds for short periods of time, necessitating the use of short-term, temporary funds from outside sources.

Such short-term, temporary financing, provided by the bank under the asset conversion rationale, derives payback from the cash collected when the receivables arising from the sale of inventory are liquidated at the completion of the asset conversion cycle. Asset conversion lending is the traditional form of bank lending to business.

Asset conversion loans are short-term, self-liquidating loans and are made to finance a temporary build-up of current assets - inventory and accounts receivable - above the permanent level the firm normally keeps on hand.

Asset conversion loans are generally unsecured, and the primary protection against loss is:

1) The bank's confidence in management's ability to complete the asset conversion cycle and
2) The liquidity of the assets being financed.
3) The nature and the tenor of the life-cycle of the lending

The defining characteristics of asset conversion lending are summarised below:

2- CREDIT ANALYSIS FEATURES

Loan Purpose:

To finance short-term lending that will be typically repaid by liquidating an asset, usually inventory or receivables (from operating cash flow) that the repayment is formed to match up with the receipt of the proceeds in form of receivable (income).

In other words, to finance seasonal working investment build up, i.e. the difference between working Investment at low point (the permanent level) and working investment at high point (the seasonal peak). For that reason, Asset-conversion loans are most commonly used by companies with highly seasonal businesses.

Primary Source of Repayment:

Cash received from the successful completion of the asset conversion cycle, i.e. the recovery of costs at the end of a major selling season.

Risks:

Inability to complete the asset conversion cycle successfully due to risks in the supply, production, sales, or collection segment of the asset conversion cycle.

Protection:

The quality (liquidity) of the working assets in the asset conversion cycle and the ability of management to mitigate the risks inherent in cycle.

Loan Structure and Control:

Use of a line of credit, with partial (if possible) borrowings on demand or short-term notes, which allows the lender to review the financial condition of the company frequently during the cycle before renewing the notes or adding new borrowings.

The tenor of the borrowings (loans) should correspond to the length of the asset conversion cycle, that is, the expected time needed to convert the assets to cash and repay the loan (self-liquidation period).

3- CASH FLOW LENDING

Cash flow lending is lending to finance a firm's permanent, i.e. long-term needs. Apart from seasonal needs, permanent needs are associated with:

- **Permanent level of working investment**
- **Capital expenditures**
- **Investment activities**

Cash flow lending by a bank is usually medium-term, with loan terms starting from one or two up to seven or eight years in most cases (It is customary to refer to any loan with a maturity of more than one year as long-term debt).

The "support" assets such as plant and equipment that are being financed are expected to produce other, "working", assets which, when converted to cash through the successful completion of successive asset conversion cycles, will generate sufficient cash to repay the loan. In the case of permanent levels of working investment, an increase in sales volume will usually require an increase in the permanent level of working investment. It is expected that the increased level of sales will result in additional cash flows that will repay the term loan.

For example, a loan to finance the purchase of equipment necessary to manufacture a new product line is usually made on a long-term, cash flow basis. The fixed asset being financed is not itself expected to be converted to cash to repay the loan; rather, profits generated from the sale of the products produced by the new equipment provide the source of cash used to repay the loan. The generation of sufficient profits to repay the amount of the loan is expected to take place over the long-term and not on a short - term basis. **For that reason, taking into consideration of the tenors and also the effect of the new investment on the income generation for the company, in some cases, the repayment of the loan can be started after several years (i.g. first two years without payment).**

Cash flow lending, then, is essentially lending to repeated asset conversion cycles, and payback is dependent on the firm's ability to generate (and retain in the business) sufficient cash over a number of years of profitable operations to make required interest and principal payments on the loan.

It should be also borne in mind and consideration that, the equipments that are financed under this type of lending gives extra asset power on the balance sheet of the company.

Assessing a firm's creditworthiness for a term loan to be repaid out of cash flow requires making reasonable projections of the firm's future sales prospects and cash flow and determining the amount of cash that will probably be available to service debt in the future the debt capacity. Long-term loans present greater risk to the lender than short-term loans since the longer into the future that payback is scheduled, the greater the chance of unforeseen events intervening and jeopardising the safety of the loan.

The primary justification for a cash flow loan in such nature is not primarily based the historical financial performance of the company but rather the expectation of the firm's future ability to generate sufficient cash flow,

Therefore, Covenants in the loan agreement are often included to signal to the lender a deteriorating situation so that corrective action may be taken.

4- CREDIT ANALYSIS FEATURES

Loan Purpose:

To provide external financing for investments / permanent needs, which will support or enhance the generation of net cash inflows from profitable operations based upon the assets created.

Primary Source of Repayment:

Cash flow (primarily from additional profits) within the period of the loan repayment.

Risks:

Delay in asset construction period, non-conformance to the required specification of the products, Inability to generate and/or retain sufficient cash from operations to amortise debt (i.e. not reach the expected sales / profit levels due to the insufficient market conditions, selling problems arising from competition, product failure or obsolescence, etc., or inability of management to efficiently and prudently manage the sources and uses of cash).

Protection:

Primary protection against loss is the stability of profit generation and preservation of the strength of the firm's financial position. Covenants in the loan agreement establish conditions necessary to preserve cash flow and financial strength and serve to signal deterioration in these areas that may threaten payback.

Cash flow lending by a commercial bank is medium-term, starting from 1 up to 7 or 10 years; long-term loans of up to 40 years are made by insurance companies, pension funds, governments, and the public (through bond offerings). Lenders are often willing to refinance the individual debt issues, depending on the perceived ability of the firm to service the debt and, thus, a serviceable level of medium - and long-term debt can be a "permanent" source of capital. Usually term loans will call for amortisation of a portion of the loan annually or quarterly and each long-term debt issue will have a series of notes corresponding to the timing in the amortisation schedule.

<u>Form of Control</u>:

Covenants in the term loan agreement set parameters within which the borrower must work to assure strength in the overall financial condition.

Therefore, the term sheets of these loans always bear “regular checks of the covenant” by the banks with regular term, for example quarterly or every 6 months in order to follow-up closely the financial shape of the company.

5- Asset Protection Lending

Asset Protection lending is a method of financing a relatively permanent need with a short-term vehicle. The permanent need normally consists of a stable, but revolving, level of current assets. The asset Protection loan thus combines features of the asset conversion loan (a short-term vehicle) and the cash flow, or term, loan (a permanent financing need), but is quite distinct from these forms of lending.

Asset Protection lending differs from asset conversion lending, in which the financing need is temporary and payback is expected in full at the completion of the asset conversion cycle. The need financed by the asset protection loan is, by contrast, a permanent level of current assets, and the bank is essentially financing an ongoing stream of asset conversion cycles.

The implication of this situation is that the asset-Protection loan is an "evergreen" loan, that is, continuously rolled over. The loan could not be paid back in full without reducing the normal level of the firm's current assets and thus seriously disrupting the firm's operations.

The fundamental paradox of Asset Protection Lending is that the repayment of a permanent level or principal is not expected as long as the business is a going concern, although individual transactions or promissory notes within that level are expected to be self-liquidating.

Asset Protection lending also differs from cash flow lending. Although both finance a permanent need, in an Asset Based situation, the company does not generate sufficient cash flow to amortise a substantial term loan.

The bank, however, has confidence in the ability of the firm to repay the loan, if necessary, from the liquidation of the assets being financed, and, therefore, makes funds available through a short-term vehicle in order to exert greater control, similar to that inherent in asset conversion loans.

Of critical importance in assessing the creditworthiness of a firm for an Asset Protection loan is the competence and integrity of the firm's management. The bank will lend only when it is assured of the firm's ability to successfully complete rapidly successive asset conversion cycles and to continue in the future as a viable concern. Asset Protection lending also requires that the bank be assured about the net realisable value (in a forced sale or liquidation) of the assets being financed is sufficient to fully satisfy the amount of the loan, given sufficient senior creditor status. This requirement of Asset Protection loans is designed to protect the bank against loss in the event of bankruptcy or liquidation.

Depending on the strength of the borrower, the quality of the assets being financed, and the nature of the transaction cycle, Asset Protection loans may be secured or unsecured.

There are several situations in which asset protection lending is appropriate:

1. The most common use of the Asset Protection loan is to finance the permanent level of current assets i.e., where the business acts as an intermediary between buyer and seller, supplier and manufacturer, saver and investor, etc.

In these businesses there is little value added during the asset conversion process and there is, therefore, low profit per transaction and low retained earnings and equity, with profits generated primarily by high volume. The high financial leverage that is characteristic of these businesses implies high risk to the lender.

The bank, however, will lend under the Asset Protection rationale if it is assured of the viability of the business as a going concern and if the quality of the assets is such that, if liquidated, the net realisable value would be sufficient to repay senior claims.

2. There are also situations in which the Asset Protection rationale provides secondary justification for a loan to be paid back primarily out of cash flow. Indeed, there may be a significant degree of uncertainty regarding a firm's ability to generate sufficient cash flow to amortise a term loan or, where the level of borrowing is so high that there is an unstable financial condition in the near term.

Therefore the bank will take security in assets with a liquidation value adequate to repay the loan, if necessary. The most obvious example of this type of lending is a personal mortgage, which is amortised primarily by the borrower's earnings but is also supported by the liquidation value of the home and property being financed, other forms of asset-Protection financing, such as leasing, would also fit this broad category.

This type of financing, as mentioned above, is also appropriate when the bank has reason to doubt the firm's cash flow potential. An example would be a start-up manufacturer, for which the bank might finance plant, equipment, or permanent working investment with a secured term loan, expecting sufficient profits over time to pay back the debt, but due to the uncertainty of the new enterprise, takes security in the company's assets to assure payback should the firm prove unprofitable.

Another example might be a firm that had recently experienced cash flow problems that injected new uncertainty into its prospects for future profitability to an extent that disqualified if for consideration for an unsecured term loan.

The characteristics of Asset Protection Lending as the primary lending rationale are summarised below:

6- Credit Analysis Features

Loan Purpose:

To finance permanent level of current or readily marketable working assets.

Source of Repayment:

On a going-concern basis, the successful completion of individual transactions in an amount equal to the stated value of the working assets (in a going concern, the loan is a continuous one, in which payback in full of the principal is never really expected). In a distress situation, the liquidation of the assets being financed is the source of repayment.

Risks:

Risks of shrinking - due to price fluctuations or other factors - the value of the assets shrinks below the net realisable value necessary to pay out the bank.

Protection:

Value and liquidity of the assets financed. (This must be assumed in both secured and unsecured lending situations).

Loan Structure and Control:

Short -term secured or unsecured notes with tenors dictated by the expected length of the financing need in the asset conversion cycle itself or in a specifically financed transaction. Control becomes extremely important in secured asset protection lending, the mechanics of which will be presented in the unit on Asset Protection Lending.

7- LENDING RATIONALE

PURPOSE	SOURCE OF PAYMENT	BANKS	PROTECTION	CONTROL	
Asset Conversion	Financing short-term. Seasonal build-ups of working assets. Financing other temporary, transactional build-ups of current assets.	Cash received from the successful completion of the asset conversion cycle	Inability to recover costs through successful completion of the asset conversion cycle	Asset liquidity. Management's ability to complete cycle. Short time factor.	Short-term notes. Frequent opportunity to review situation before renewal.
Cash Flow	Financing of long-term assets or permanent working investment and support assets	Cash from profits generated and retained in the business over time	Inability to generate a stable level of profits over several years	Management's ability to generate profits. Adequate equity cushion & Unused debt capacity.	Covenants in the term-loan agreement to preserve or enhance the financial condition
Asset Protection Lending	Evergreen financing of a permanent level of working assets. Financing other assets under temporary condition of increased risk, as a secondary lending rationale	If asset protection is primary rationale, no payback on an ongoing basis is expected. If it is the secondary rationale, payback is expected from asset conversion or cash flow. In both cases, liquidation of assets being financed will pay back the loan in a distress situation	Inability to recover costs by successful completion of asset conversion cycle; inability to generate profits fast enough to maintain a sound financial condition. Decline in the value of the assets below amount necessary to pay out senior creditors	Management's ability to complete each transaction and to generate a satisfactory level of profits over a number of years. Asset liquidity and low shrinkage in a forced sale	Demand or short – term notes. Security and proper documentation. Debt limitations and covenants where applicable.

SECTION 2: OVERVIEW OF CREDIT FACILITIES

There are four major types of credit facilities

Short -Term Credits (maturities less than one year)

______**1.** Offering Basis short-term Notes

______**2.** Lines of Credit

Term Credits (Maturities in excess of one year)

______**3.** Terms Loans

______**4.** Revolving Credits

Loan funds from short-term credits are generally used for short-term purposes, and repayment of such loans comes from sources that can generate cash quickly. Conversion to cash of liquid or current assets thus provides the usual repayment source for short-term credits.

Term credits, on the other hand, are commercial loans with maturities in excess of one year. The borrowed funds are usually used for purposes with long-lasting benefits to the company, such as the supplementing of permanent working investment, the acquisition of fixed assets, the financing of long-term investments, or the retiring or refinancing of long-term debt. Term credits are characteristically repaid from cash flows over a period of years.

1- SHORT-TERM CREDITS

1. Offering Basis

A loan made on an offering basis is an arrangement under which the bank grants a loan in a specific amount, for a particular purpose for a stated period of time, usually, less than one year. The note is written for not more than 90 days, even when repayment is not expected within this length of time. This facilitates management of the loan, since it must be reviewed every 90 days.

An offering basis loan is appropriate for specific transaction financing, where the borrower has a one-time or occasional need for funds or where the lender is not familiar enough with the borrower's condition or abilities to justify a line of credit. Offering basis loans are made without any indication to the borrower of the bank's willingness to make additional loans. Each loan decision is for a single transaction when the opportunity to lend is offered by the prospective borrower.

At the maturity date, the loan's payback is expected with the interest accrued for this period starting from disbursement of loan till the date of repayment.

2. Line of Credit

A line of credit is an arrangement whereby the bank agrees to lend up to a certain amount on a short-term basis, with the company borrowing all or a portion of the total amount as needed to meet its needs. The company may borrow, repay, and re-borrow at the bank's discretion during the life of the accommodation. The line of credit is a formal agreement between the bank and its customer with respect to the maximum amount of credit that the bank will permit the company to owe it at any one time within the completion of the needed requisites by the borrower (i.e. documentation etc).

In form, the Preliminary Term Sheet is a letter stating that the bank stands ready to grant up to a specific amount of loan with up to a maximum limit during the coming year subject to certain condition precedents

Legally, it is a declaration of intent and not a legal commitment and thus may be cancelled or amended by the bank in their discretion at any time. The line of credit is subject to annual review and re-approval by the lender. The annual review allows the bank to re-evaluate the company's needs and financial condition and to readjust the limit if necessary.

There are two types of lines of credit: the advised/confirmed line and the guidance line.

1. Advised/Confirmed Line of Credit:

Under the advised/confirmed line of credit, the bank agrees to make funds available to the borrower, upon request, up to a specified amount. The bank advises the customer of the maximum amount available.

2. Guidance Line of Credit:

A guidance line of credit is a facility that combines aspects of offering basis loans and the advised/confirmed line of credit. Under the guidance line, the bank sets internal (shadow) limits in the amount it will provide the borrower under the line of credit. The borrower is not informed of the limit and usually is not even aware there is a line of credit arrangement. This is mainly for the internal use of the Banks.

The guidance line is a tool that facilitates the handling of loans to companies that do not yet warrant an advised line of credit and is most appropriately used when the borrowing need is frequent - seasonal or periodic.

The undisclosed loan limit allows the officer to exercise control over the loan; the loan officer must approve each request for an advance of funds.

Having a guidance line available enables a loan officer to make a decision on the spot if all conditions remain at least as strong as when the line was approved.

In this sense, the guidance line provides a marketing tool as it allows the officer to respond quickly and positively to a customer's request for funds.

Protection against Loss in Asset Conversion Lending

The primary protection against loss in an asset conversion loan lies, as we have seen, in the quality of the working assets, the company's financial past performance and management's ability to mitigate risks in the asset conversion cycle. When the bank lends on an asset conversion basis, it is essentially expecting that the seasonal cycle progresses smoothly and that the cash collected at its completion will be sufficient to pay back the existing outstanding loan amount. Any lending situation, however, entails some risks, and the bank must consider whether it would be protected against loss if things were to go wrong in the asset conversion cycle subject to financing.

Followings are a few possible scenarios.

a) A Ginner for example, finances the purchase of his inventory with a seasonal line of credit, expecting to repay the bank at the completion of the cotton season. Due to adverse market circumstances in Asia, purchase of lint are down and the borrower is unable to clean up the line. The bank has several options to obtain repayment. If, on the one hand, the bank demands immediate payment, the Ginner may be able to obtain the necessary cash by selling the unsold inventory in an out-of-season sale. If the Ginner is sufficiently well capitalised, he will be able to absorb any losses resulting from selling the inventory at a discount (although because of the nature of the inventory, he may be able to obtain good value from the sale and suffer only negligible losses).

Alternatively, if the bank judged the borrower to be in essentially sound financial condition and was convinced that the inventory could be sold at normal, or even appreciated, prices - then the bank may be willing to renew the note (extend the maturity) until the time that the proceeds from sales of the goods will be enough profitable to self-liquidate the existing outstanding loan. The Ginner could then avoid any losses resulting from an out-of-season sale (although he would, of course, incur additional interest costs that would reduce his profit).

b) In a more difficult case, approximating a worst case scenario, a manufacturer of highly faddish dresses, who has financed his summer line with a seasonal line of credit, has missed the season due to production delays and is consequently unable to clean up his line borrowings. The bank does not want to continue the financing because changes in consumer taste have already greatly reduced the market value of the dresses, and the bank feels that by the following summer season the market will have virtually disappeared. Therefore, the bank calls the note and demands immediate payment. To obtain cash, the manufacturer sells the inventory to a discount distributor at 60% of the actual cost, not enough to repay the note. In an attempt to make up the difference, the manufacturer starts to liquidate his remaining inventory beyond the level it normally keeps on hand. In liquidating this permanent level of inventory, however, the manufacturer is essentially putting himself out of business. In this case, the company may have to declare bankruptcy in order to meet, not only the bank's claim, but the claims of other creditors as well.

In bankruptcy all the assets of the company are liquidated under the authority of the bankruptcy court and the proceeds are distributed to the various creditors. To the extent that the liquidation proceeds are sufficient to repay all creditors, neither the bank nor other creditors will incur a loss. If, however, liquidation proceeds fall short of what is necessary to meet the claims of creditors, some, or all, the creditors will not be able to recover the outstanding principal and accrued interest. (In bankruptcy the claims of some creditors may be senior to the claims of others. If a creditor's claim, for example, is secured by the assignment of certain assets of the company, then the proceeds from the liquidation of those assets will go to that creditor until his claim is satisfied (waterfall distribution principle). If all creditors are unsecured, then they have equal claim on the pool of assets and the proceeds from their liquidation will be distributed on a pro-rata basis).

This discussion of possible loss scenarios leads us to a more direct consideration of what provides protection against loss in an asset conversion-lending situation. Simply stated, the bank is protected against loss when the liquidating value of the assets is sufficient to meet the claims of creditors. To assess the adequacy of protection, the bank looks ultimately to the relation of debt to equity in the borrower's capital structure. The greater the potential shrinkage in the value of the assets, the greater should be the firm's equity cushion to absorb this shrinkage.

In this section, we will present tools that can be used to determine whether a borrower is sufficiently well capitalised so that the bank may have confidence that it will be repaid, even in the event the borrower encounters difficulty in seasonal cycle. The greater the business risks inherent in the cycle, the greater the potential shrinkage in values of the current assets and the greater the protection the bank will look for in the financial structure of the company. Where the quality of the protection is weak vis-a-vis the risks involved, the bank will seek to improve its protection by, for example, lending only against specific assets that the borrower has assigned to the bank as collateral. There are other means, short of taking security.

2- LONG-TERM CREDITS

3. Term Loans

A term loan is a formal, legal commitment to lend a specific amount, for a particular purpose, for a stated period of time exceeding one year (usually ranging from 3 to 7 years). Unlike a line of credit a term loan does not usually offer the customer the flexibility to borrow and repay at will.

Advantages and Disadvantages

The advantages to the customer of a term loan arrangement as opposed to other forms of financing include the following:

1 - Unlike short-term financing, term loans represent a legal commitment of funds and assure the corporation of a credit source as long as the terms of the agreement are met.

2 - Term loans can be negotiated faster, more confidentially and at less expense than a public issue of debt securities. A term loan can be arranged in several weeks, whereas a public issue takes a good deal longer. Direct placement avoids typical public flotation expenses such as registration, issuance, transfer fees and investment banker margins. Finally, the borrower can deal confidentially with the lender and does not have to reveal certain information to the public.

3 - Term loans can be tailor-made to meet the borrower's needs and are more flexible financing vehicles. Should the firm's requirements change, the terms and conditions of the loan may be revised. It is considerably more convenient to negotiate with a single lender or a small group of lenders than with a large diverse group of public security holders, as there are with a bond issue. Publicity issued bonds usually requires the approval of two thirds of the holders to change or waive any part of the contract.

4 - Term loans are suitable financing vehicles to meet medium-term needs. The company is not locked into long-term financing at excessively high, fixed interest rates when the projected duration of need does not develop nor is it normal for call provisions to carry high prepayment penalties, as is often the case with public issues.

Term loans, however, have certain disadvantages, which include the following:

a. Term facilities are relatively more expensive than short-term borrowings because of the greater risk involved in the longer time period.

b. Many borrowers find the maturities and repayment schedules on term facilities excessively restrictive as compared to 20-25 year maturities and liberal amortisation provisions available on public bond issues.

MATURITIES AND REPAYMENT SCHEDULE

Term loans are usually repayable in periodic instalments each quarter or year, with the particular amortisation schedule determined by the anticipated potential ability of the borrower to meet payments on specific dates.

There are various types of repayment schedules these can be classified as conventional, moratorium, unequal, balloon, and bullet forms of payback:

- Conventional - payback is in equal annual instalments over the life of the loan
- Delayed payment period or grace period (Moratorium)- no payments are scheduled for the first one or two years, with payback in equal annual instalments thereafter.

- Unequal - payback is scheduled in unequal instalments predefined and agreed upon by the Lender.

- Balloon - payback is made in small equal payments over the life of the loan with a large lump-sum payment at maturity or in a specific time (can be pre-defined or undefined) during and within the lifetime of the loan.

- Bullet - repayment in full is made at maturity. Bullet repayments are usually built in to the terms of the loans

These repayment schedules are illustrated in the following chart:

$50,000 Five - Year Term Loan

Repayment Schedule

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	YR 1	YR 2	YR 3	YR 4	YR 5
Conventional	10,000	10,000	10,000	10,000	10,000
Delayed	-	12,500	12,500	12,500	12,500
Unequal	10,000	5,000	15,000	15,000	5,000
Balloon	5,000	5,000	5,000	5,000	30,000
Bullet	-	-	-	-	50,000

Disbursement: Straight and Standby Term Loans

Disbursement of the proceeds of a term loan may be made on a straight or stand-by basis. Under a straight term-loan arrangement, the entire amount is borrowed on the first day and then repaid over the life of the loan. Under a stand-by term loan arrangement, the bank specifies a period during which the company can borrow all or a portion of the total term loan amount. At the end of the stand-by period, the outstanding loan is converted to a term loan of agreed upon maturity, and the company has the option of borrowing the remaining amount available. The term loan is then amortized according to the agreed upon repayment schedule, which may be any of the schedules outlined above.

The nature of the stand-by term loan makes it ideal for financing needs where the amount is known but the timing of the need during the earlier stages is uncertain. Typical uses of stand-by loans include: 1) acquisitions where the seller desires a good faith deposit as proof of intention and additional instalments during the negotiation and transfer period; and 2) plant or building purchases requiring progress payments during the period of construction. The obvious advantage of a stand-by over a normal term loan lies in minimising unnecessary interest expense during the initial financing period.

Pricing

Term loans are priced at increments over a floating prime (e.g., p + 1/4%) or a certain percentage of prime (. e.g. 110% of prime). There is also a balance requirement, usually 20% of usage (or a fee equivalent).

A commitment fee is usually charged on a stand-by term loan and is assessed on the unused portion of the commitment, usually at a minimum of 1/2 of 1% per annum.

A facility fee computed on the face amount of the commitment can also be charged. The amount is negotiable, but usually 1/4 of 1% per annum. Whether or not a facility fee is charged is dependent on market conditions and the strength of the borrower.

There are several pricing methods used in medium-term lending:

1. **Linear pricing** - a constant blended rate over time (e.g., p + 3/4% over the life of the loan).
2. **Step-up pricing** - an increasing rate which is "stepped up" each year (e.g., p + 1/2% from inception for the amounts maturing in years 1 and 2; p + 3/4% from inception for the amount maturing in years 3 and 4 and p + 1% from inception for amounts maturing in years 5 and 6).
3. **Incentive pricing** - decreasing pricing provided the company meets certain criteria agreed upon.

Currently, linear pricing is used in most cases, unless market pressures force the use of step-up.

Documentation

1. **Loan Agreement**: This is the legal document that defines the relationship between the customer and the bank. Understanding this document is critical to understanding the relationship.

2. **Promissory Notes**: A note is signed evidencing the liability of he customer to the bank. Grid notes may be used in stand-by arrangements; in these notes, the full amount of the loan is stated on the front, and actual borrowings are noted on the back.

Uses of the Term Loan

The nature of the term loan, which requires the initial sum to be drawdown on the first day, along with the lack of flexibility to borrow and repay at will, usually limits the term loan to financing needs where both the amount and the timing of the need are known.

Term loan facilities are suitable for cash flow lending situations in which the loan proceeds are used for long-term needs, such as to finance equipment acquisitions, permanent working investment, stock repurchases, and the refunding of existing maturities of short-term debt as they come due.

Revolving Credits

A revolving credit is a formal, legal agreement in which the bank agrees to lend up to a certain amount for a specific purpose over a specified period of time, usually 2-4 years. The borrower has complete flexibility in borrowing all or a portion of the total amount as necessary and repaying any amount at any time during the life of the commitment. In other words, revolving credit arrangements do not have set repayment schedules. The amount repaid any time during the period of the commitment is at the discretion of the borrower. However, the amount outstanding at the end of the revolving credit is due and payable on that date or, if stipulated might be converted into a term loan whose term and repayment schedule is stipulated in the original agreement.

Pricing

Pricing for a revolving credit is essentially the same as for a term loan. A commitment fee is usually required on the unused portion of the loan, usually 1/2% p.a., as in the case with stand-by term loans.

Documentation

This is essentially the same as for a term loan. There is a loan agreement whether or not there is a term loan option, since the revolving credit is, by definition, a legal commitment.

Uses of the Revolving Credit

The nature of the revolving credit makes it the most flexible financing provided by the bank. It has the features of both a short-term borrowing arrangement and a term loan, for the company can borrow a fixed amount for the entire duration of the commitment. This facility is used when both the amount and the timing of the need are uncertain.

Though the revolving credit can be used in a wide variety of situations, two typical uses include the following:

1. Financing semi-permanent, fluctuating growth in working assets that accompanies an extended period of growth in sales volume. In this case, the amount and timing is not known and/or the company may have a seasonal, as well as a growth need. At the maturity of the revolving credit, that portion of increased working investment that is identifiable as the new permanent level is converted to a term loan to be repaid from future profits. If continued growth is expected, a new revolving credit may be negotiated and the process repeated.

2. "Bridge" financing of fixed asset projects that will be refinanced with long-term money at the completion of the project or when market conditions are more favourable. (Such refinancing must be clearly specified and available).