Quadrant II – Transcript and Related Materials

Paper Code: COG111

Module Name: Types of lending facilities, Agency and miscellaneous services

Module No: 18

Notes

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3. **Project Finance/Term Loans**
   Term loans are granted for acquisition of fixed assets (land, building, machinery and equipments) to set up a new industrial unit, or for financing the modernization, expansion or diversification of an existing unit.
   The typical features of term loans are as follows:
   • The project is appraised on the basis of a detailed analysis of the borrower's projected balance sheets, profit and loss and cash flow/funds flow statements (for the period of the loan) to determine the financial viability of the project and its debt servicing capacity. The technical, commercial and managerial viability of the project is also critically examined by the banker before sanctioning a term loan.
   • Term loan is secured by mortgaging the specific fixed assets financed or the entire block of fixed assets of the borrower unit.
   • Term loan is granted for medium term (generally 3 to 5 years) or long term (over 5 years) and is repaid by the borrower from its cash accruals (net profits and depreciation etc.) in instalments spread over the period of the loan.
   • Equated monthly or quarterly instalments (principal and interest) are fixed depending on the projected cash accruals over the loan tenure.
   • Apart from the mortgage of the fixed assets of the unit and guarantee of the promoters, covenants or conditions are also stipulated by the bank for ensuring adherence to the desired financial discipline by the borrowing unit.
   • In case of large sized projects (e.g. infrastructure projects) requiring a large amount of loan for long tenures (10 to 20 years), term loans are granted by a group (consortium) of banks/financial institutions. This also diversifies the credit risk of the lenders.

4. **Loan Syndication**
   A syndicated credit is an agreement between two of more lending institutions to provide a borrower a credit facility using common loan documentation. The features of a loan syndication facility are:
   The borrower intending to raise resources awards the mandate to raise funds to a lead bank that acts a 'Lead Manager' to arrange credit on his behalf.

The lead bank prepares an Information Memorandum about the borrower and his requirement details in consultation with the latter and distributes the same amongst the prospective lenders soliciting their participation in the credit to be extended to the borrower.
The Information Memorandum provides the complete information to the lending banks so that they make an independent economic and financial evaluation of the borrower.
Thereafter, the interested lenders and the mandated bank discuss the syndication strategy relating to coordination, communication and control within the syndication process, finalizing the details like time lines for payment, charges towards management expenses and cost of credit, share of each participating bank in the credit, etc.
The loan agreement is signed by all the participating banks. The borrower is required to give prior notice to the 'Lead Manager' or his agent for drawing the loan amount to enable the latter to tie up disbursements with the other lending banks.
Thus in Syndication, the participating banks make an independent decision to part fund the project even through a lead bank coordinating the tie up between the borrower and the many lenders to make up for the credit amount based on requirement.

5. **Bridge Loan**
Bridge Loans are interim loans given essentially for short term to fill a short term gap between lack of funds and availability of funds. Large companies may need to meet their urgent and essential needs during the period when formalities for availing the term loans sanctioned by financial institutions are being fulfilled or necessary steps are being taken to raise funds from the capital market. These loans are granted by banks or financial institutions themselves and are automatically repaid out of the amount of the term loan or the funds raised in the capital market.

II] SECONDARY FUNCTIONS

1. **AGENCY SERVICES**
2. **GENERAL UTILITY SERVICES**

1. **AGENCY SERVICES**

As a part of ancillary services, banks act as agents of other institutions/customers who authorize the banks to do specific jobs on their behalf. An 'agent is a person, who is employed by another (principal) to do any act for him(principal), or to represent him (principal) while dealing with a third party, in terms of section 182 of the Indian Contract Act, 1872. Section 211 of the same Act lays down that an agent is bound to conduct the business of his principal as per the directions given by the principal, and in the absence of any directions according to the prevalent custom for doing business of the same kind at the place where the agent conducts such business.
The banks, therefore, perform the agency services on behalf of their clients as per their specific agreements/authorizations or customary practices and they exercise reasonable care in discharging these services. Banks charge commission for these services and it adds to their income.
Following are some of the main agency services of banks.
(Each kind of agency service is governed by written agreements between the banks and the other institutions as regards the range of services, accounting methods and settlement at periodic intervals, rate of commission/fees receivable by the banks, etc.):

(i) **Government Business**: Central and state governments have designated some commercial banks to receive certain taxes from the tax payers at specified branches and also to make payments of cheques issued by their designated departments for refund of tax, etc. Designated branches also sell Government of India's Relief Bonds and open/maintain accounts under its Public Provident Fund Scheme.

(ii) **Currency Chest**: SBI and some other banks maintain currency chests at specific branches on behalf of the RBI for issue and collection of RBI currency notes. RBI inspectors conduct surprise visits to these branches to verify accuracy of chest contents and accounting records.

(iii) **Agency arrangements with other banks**: A new or small bank which does not have branch at certain business centres (Bank A), enters into draft drawing arrangements with a bank having branches at those centres (Bank B), for honouring demand drafts drawn by Bank A on Bank B at designated branches.
Bank A deposits all the demand drafts drawn under the arrangement in its account with the designated Focal Point branch of Bank B on a daily basis. The Focal Point branch of Bank B reimburses its other branches which have paid the demand drafts of Bank A in due course.

(iv) **Sale of products of other Institutions**: Banks have been traditionally selling through their specific branches, the securities/bonds/travellers cheques issued by other banks. In recent years, banks have also started selling of their own subsidiaries or of other banks. With the opening up of Insurance sector, the new insurance companies and also LIC have made arrangements with certain banks to sell their insurance products. The rationale of such arrangement is that it helps the insurance companies, which do not have branches at several important locations/centres, to enhance the sale of their products.
Banks engaged in these transactions earn additional income from such sales and the customers also find it convenient to purchase the products from banks which they can easily visit or with which they maintain accounts. Insurance, mutual funds and banking products are financial products and selling them needs convergence to satisfy the financial needs of customers at one financial shop. This philosophy is the rationale behind the agency arrangements entered into with banks.

(v) **Miscellaneous agency services**: Banks also provide the following agency-services: viz. executor and trustee business, portfolio management of customers, investment advisory services etc. For all these agency services, banks charge fees at agreed rates.

2. GENERAL UTILITY SERVICES

These services are those in which the bank's position is not that of an agent of his customer. They include the issue of credit instruments like letter of credit and travellers' cheques, the acceptance of bills of exchange, the safe custody of valuables and documents, the transaction of foreign exchange business,

i) Safe Deposit and Locker Facilities

Safe custody of valuables and important documents has been a traditional service rendered by banks, on a fee basis. Customers have faith in the bank about the safety, security and confidentiality of the valuables kept with them. As these requirements are rarely met elsewhere, banks have been the main repositories of customers' valuables. The duly sealed safe custody packets/boxes are kept by the bank is its 'strong room'/vault and a receipt is issued to the depositor for presenting while taking delivery. As of now, most of the vaults have been occupied and therefore many banks may have curbed this service.
Banks also provide Safe Deposit Lockers at many of its branches which have adequate space and strong room. Safe deposit lockers are built of steel and have reliable locking arrangements; these are kept in vaults of banks, to provide double safety. Customers hire lockers by paying yearly rentals. The lockers are opened by dual key system –one of which is with the authorized bank officer and the other with the customer. Since the Lockers are very much in demand, presently, many banks restrict this facility to their valuable customers or ask for certain fixed deposit to be lodged by the customer. Lockers Rentals have also increased substantially in metros and big cities.

ii) Banker's Draft and Letters of Credit

A banker's draft is an order, addressed by one office of a bank to any other of its branches or by one bank to another, to pay a specified sum to the person concerned.
A 'letter of credit' is a document issued by a banker, authorizing some other bank to whom it is addressed, to honour the cheques of a person named in the document, to the extent of the stated amount in the letter and charge the same to the account of the guarantor of the letter of credit. A letter of credit includes a promise by the issuing banker to accept all bills of exchange to the limit of credit.

iii) Guarantees

In commercial transactions, bank guarantees are required as a security for due fulfilment of a contract by the obligator, in favour of the beneficiary. The obligator's financial standing and credentials may be unknown to the beneficiary of a commercial contract and a bank's guarantee on behalf of the obligator would pacify him.
The bank issues the required guarantee on behalf of the obligator, after making a proper assessment of the financial standing and ability to fulfil his part of the contract. The bank may also demand some tangible security or cash deposit to fall back upon in the event of enforcement of the guarantee by the beneficiary.

iv) Circular Notes, Travellers Cheques, Circular Cheques

Circular notes are cheques on the issuing banker for certain round sums in his own currency. On the reverse side of the circular note is a letter addressed to the agents specifying the name of the holder and referring to a letter of indication in his hands, containing the specimen signature of the holder. The note will not be honoured unless the letter of indication is presented.
Travellers' cheques are documents similar to circular notes with the exception that they are not accompanied by any letter of indication.
Circular cheques are issued by banks in certain countries to their agents abroad. These agents sell them to intending visitors to the country of the issuing bank.

v) Foreign Exchange Dealing

- Consumers typically come into contact with currency exchange when they travel. They go to a bank or currency exchange bureau to convert one currency (typically, their "home currency") into another (i.e. the currency of the country they intend to travel to) so they can pay for the goods and services in the foreign country.
- Businesses typically have to convert currencies when they conduct business outside their home country. For example, if they export goods to another country and receive payment in the currency of that foreign country then the payment must be converted back to the home currency. Similarly, if they have to import goods and services, then businesses will often have to pay in a foreign currency, requiring them to first convert their home currency into the foreign currency.
- Investors and speculators require currency exchange whenever they trade in any foreign investment, be that equities, bonds, bank deposits or real estate. For example, a Japanese real estate investor who sells a New York property may want to convert the proceeds of the sale in U.S. Dollars to Japanese Yen.