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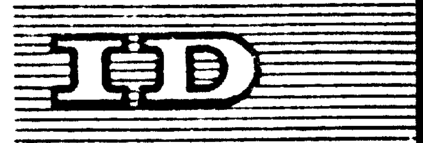

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Security Against Term Loans[1]

[1] This material has been prepared as a background paper for the Workshop by UNIDO Consultant, Dr. B. Prasad, of the Industrial Development Bank of India. The aim is to present factual information regarding Security Against Term Loans as a basis for discussion of the subject by participants. The views and opinions expressed in this paper are based on the Consultant's original study and do not necessarily reflect the views of the Secretariat of UNIDO. This document has been reproduced without formal editing.

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SECURITY AGAINST TERM LOANS

The problem of security against term loans calls for consideration of the following points:

1. Introduction,
2. Security level requirements of XYZ Development Bank[1/]
3. Whether the security requirements of XYZ Development Bank are adequate,
4. The types of securities, and
5. Valuation of securities.

1. Introduction

Security considerations, which assume prime importance for short-term lending operations, weigh also with development banks in granting term loans. This is so for various reasons: (i) there has to be adequate protection in the form of availability of security (sufficient fixed assets) to provide against loss from miscalculation in appraisal of the loan, (ii) a lending institution may have to consider a proposal which relates to a project in an industrially backward area or an industrial concern may propose to enter into a new line of production which is important from the point fo view of development of the economy but the soundness of which is unknown, and (iii) security consideration are of special significance in less developed countries where information on the character, integrity and creditworthiness of the borrowers is not readily available. Thus a prudent development bank has to secure its loan by adequate collateral and, where necessary, guarantees and, to safeguard its interest and to ensure that the ability of the borrower to discharge the loan out of future earnings is not impaired, also embody in the loan agreement, suitable protective and restrictive convenants such as maintenance of certain minimum financial

1/ The security level requirements discussed in this paper relate to the actual security requirements of a particular Development Bank.

standards, supplying to the lender adequate financial information, earlier repayment of loans under certain conditions, restriction on the payment of dividend, etc. Taking of adequate security also has the effect of infusing the necessary responsibility in the borrower.

A development bank often depends more on the collateral for the repayment of the loan rather than on the integrity and ability of the management and the borrowing concern's past and prospective earnings. This is due to the belief on the development bank's part to associate repayment of the loan with the sale of security. In these cases it is forgotten that the assets given as security such as specialised machinery, etc., cannot easily be disposed of as they do not ordinarily have a ready and regular market. Therefore, the net worth of these assets which is estimated on the basis of a "going concern" depends greatly on the earning potential of a project, as a whole. The greater reliance on security may also sometimes be due to inadequate financial appraisal which in its turn may be due to non-availability of the necessary data. However, since financial assessment is the very keystone of a project appraisal, the security cover of the loan should not be regarded as a substitute for such an assessment. Nevertheless, considerations of security form an important basis of lending and are thus a necessary adjunct to financial appraisal. The Development bank should therefore examine loan proposals from the point of view of both commercial profitability and the nature of security offered.

2. Security Requirements of XYZ Development Bank

Security requirements of XYZ Development Bank are presently governed by the provisions contained in Section 12 - 14 of its Bye Laws. Section 12 provides that the Bank shall require appropriate security for any loans or guarantees granted/issued by it. According to Section 13 the usual securities will be: (a) a first mortgage on duly registered immovable

property, including all sites, buildings, fixed plant and fixed machinery, and (b) chattel mortgage in respect of movable assets, and (c) in the Bank's own discretion, a guarantee or counter-guarantee by third persons. Section 14 provides that the Bank shall make valuation of any security required and presented and that valuation shall be final.

In persuance of the above provisions in the Bye-Laws, the Bank ordinarily requires its sanctioned loans to be secured for an amount, equivalent to a minimum of 120 percent of the amount of the loan, by a first mortgage on the borrower's fixed assets such as land and buildings and on his moveable assets therein installed or used for the purpose of the project, such as machinery, equipment, vehicles or, if the borrower has no fixed assets and is operating his plant in rented premises, by transfer into the Bank's name of the ownership rights in such moveable properties.

The 120 percent security requirement for the loan can be a combination of the following:

(a) Real estate or any other identifiable, marketable and mortgageable property of the borrower,

(b) Guarantee by another bank,

(c) Guarantee by a third party acceptable to the bank,

(d) Life insurance policies determinable by the bank, and

(e) Personal guarantee from the borrower.

Examination of the loan agreements of the XYZ Development Bank has revealed that it is generally the period of loan, medium or long, that determines the quantum of security. In practice, the Bank has taken security from the borrowers anywhere between 120 percent and 150 percent (though in most cases security taken is about 135 percent), depending upon the type of asset offered as security and the period for which the loan was required. In most cases it has taken a first mortgage on land,

buildings and machinery installed. It has also accepted houses in residential areas or life insurance policies as collateral. It has not so far accepted any guarantee from another bank or any other third party.

3. Whether the Security Requirements of XYZ Development Bank are Adequate

It has been observed that the normal security requirements of XYZ Development Bank are 120 percent of the loan granted, though very often this limit has been exceeded. Security requirements of 120 percent means that if the amount of the sanctioned loan is US$100, the security offered to the Bank must be of the value of US$120.

Security Requirements of XYZ Development Bank in Terms of Margin for the Loan: Development banks all over follow a special technique, called margin requirements, for granting loans. Margin denotes the portion of fixed assets which is in excess of debt. Translating this definition into equation we get the formulae:

$$\text{Margin} = \frac{NF - \text{Debt}}{NF}$$ where NF is the net fixed assets

Availability of margin is generally expressed in terms of percentage. Thus, on 120 percent security requirements, in terms of "Percentage Margin" for the Bank loans, the available margin on a loan of US$100 will be:

$$\text{Margin} = \left(\frac{120 - 100}{120}\right) \times 100 = 16.6 \text{ percent.}$$

The above would mean that on a loan of US$100 sanctioned by the Bank, where the borrower offers 120 percent fixed assets as security, the available margin to the Bank would be 16.6 percent.

Margin Requirements of Development Banks in Other Countries: Development banks associated with the World Bank Group in most countries require that the book value of the mortgaged assets should at least be double the loan proposed to be advanced by them and that the assets to be mortgaged should have a resale value. However, exceptions are always

possible. Whenever normal margin limit is relaxed, loans are always guaranteed to a suitable extent by the partners/directors including the managing partner/managing director of the borrowing firm. In other cases of insufficiency of margin, loan may be guaranteed by a bank or other securities taken as collateral. It may be noted that fixed assets offered as security equal to double the amount of the loan will provide 50 percent margin only. On the basis of the formula for determining margin, this can be worked out as under:

$$\text{Margin} = \left(\frac{NF - \text{Debt}}{NF}\right) \times 100$$

$$= \left(\frac{200 - 100}{200}\right) \times 100$$

$$= 50 \text{ percent.}$$

Need for Revision in Margin Requirements of XYZ Development Bank Loans: Judged from the practice followed by other development banks, it would appear that the normal requirements of only 16.6 percent margin on XYZ Development Bank loans is too low. It may be noted that fixed assets like buildings, plant and machinery when sold do not fetch a price which is equal to their book value due to their depreciated nature, rapid rate of obsolescence in the industry and absence of ready and organised market for such assets. Also, although the security on a loan may appear considerable, it might prove difficult to realise it in the event of liquidation; or it might be difficult to exercise mortgage rights due to customs or title difficulties; or a combination of circumstances might make it more costly to try to realise the security on a loan than to write it off. Granting of loans by the XYZ Development Bank on a 16.6 percent margin can be a risky business and if a closure is forced the assets may realise much less than the amount of the loan. There is therefore need for increasing the margin to 50 percent in normal cases though this limit can be relaxed (40 to 35 percent) in suitable cases.

When this is done sufficient guarantees should be taken from the partners/directors, commercial bank or other third parties acceptable to the Bank.

It may be pointed out that the XYZ Development Bank has not yet felt the impact of security requirements since most of its business has been confined to medium terms loans, 2 to 6 years, where stipulation of low margin of 16.6 percent or a little higher has generally sufficed for its needs. However, if the XYZ Development Bank is to expand its business and take up granting of more and more long term loans, 6 to 15 years, it is bound to realise that with the existing rate of depreciation its security requirements of 16.6 percent are too low and there is need for increase in the level of security.

4. Types of Securities

It is important that the assets (Security) to be mortgaged should have a resale value. This could be discussed under the following headings:

(i) Intangible assets as security,
(ii) Tangible assets as security, and
(iii) Personal guarantees of Partners/Directors.

i) Intangible Assets as Security: Intangible assets like promotional expenses, technical know-how fees, capital issue expenses, trade marks, goodwill, patents, etc., should not be included in calculating margin if they do not have resale value. Sometimes, intangible assets just referred to have a resale value if the unit can be sold as a going concern. This is so because the unit as an organised entity has a value over and above the worth of its tangible assets due to vast clientele, technical and organisational advantage, specialised acumen acquired in manufacture and distribution of products, reputation built up over a period of time, etc.

As far as new units are concerned, since they are yet to acquire goodwill or reputation, etc., it is safe generally to exclude intangible

assets for calculating margin. If the new unit, however, is found to be technically superior after a thorough scrutiny by technical experts, the inclusion of assets like patents, technical know-how fees, etc., in calculating margin can be justified. That is, inclusion of intangible assets in calculating margin is justified if such assets have a resale value.

ii) Tangible Assets as Security: Generally, tangible acceptable securities to a development bank would be the existing industrial assets as well as those to be acquired from the loans to the borrowers. Quite often development banks also accept non-industrial assets (such as land and residential buildings of the directors or partners) as part of the main security in cases where industrial assets are not sufficient or as collateral. Although, in principle, industrial assets are by far the best security for industrial loans, non-industrial assets may also be accepted as supplementary security and for new ventures, as an interim measure, till sufficient industrial assets are created to cover the loans. In such cases, it is often the practice to stipulate a higher margin.

iii) Personal Guarantee of Directors/Partners: Development banks may also obtain, as a measure of abundant caution, the personal guarantees of the Directors/Partners. As the future of the concern is largely dependent on the standard of the management, joint and several guarantees obtained from persons responsible for directing the affairs may be of particular value. However, this may not be applied rigidly and the absence of such a guarantee may not be necessarily treated as a disqualification. Where relaxations are made in other terms and conditions of the loan, such as the reduction of margin requirements etc., a greater emphasis may be placed on personal guarantees.

5. Valuation of Security

It would seem that the onus of choosing the right type of security and the responsibility of valuing it and fixing a margin on it, is placed on the development bank itself. An assessment of

the sufficiency of security offered as cover for the loan implies a proper valuation of assets. The assets may be valued on the basis of (i) book value, (ii) current market value, or (iii) replacement value. In applying one or the other basis of valuation care has to be taken to maintain proper balance in valuation of assets so that a borrower gets all the advantages without at the same time impairing the interest of the lender. For example, a rigid application of the book value to an asset which has been written down considerably, though its market value is high, might not be helpful to the borrower. Also, adhering to the market value at a particular time might not be a good basis of valuation incase of a term loan ranging over a period of years during which a number of factors might affect the market value prevailing at the time the loan was sanctioned. Again, replacement value in some cases might prove an over estimate. It would, therefore, seem proper to adopt one or more of the methods of valuation, depending on the type of the asset, so that the valuation finally adopted might be equitable to the interest of the development bank as also to the borrower.

Technical evaluation of assets, as far as possible, be entrusted to specilists in the particular field of industry. The examination of title deeds, documents, etc. should be done carefully and in the light of local laws, customs, etc. For example, advances against plant and machinery installed in rented premises have to be viewed against the benkground of the prevailing law governing transfer of tenancy rights. In the event of the borrower's failure to repay the loan, the development bank might find itself in legal difficulties being unable to transfer the tenancy rights to the purchaser who would want to take over the unit as a running concern. Also, in the case of leased premises, the development bank may ensure that the period of the unexpired lease

is long enough, at least a few years longer than the period of the loan. Since the title on the land would effect the title to the structure on the land, it would be ensured that the former title is clear and marketable. The development bank should closely examine the depreciation policy adopted by the concern and see how the book values of the assets have been arrived at. In estimating the value of machinery, it is usual to include such items as freight, duties, insurance, transport charges, etc., incidental to the commissioning of the plant, along with the invoice cost of the machinery. Similarly, the capital value of assets may be taken to include installation charges, interest on borrowed funds during construction of factory and consultation and know-how fees. Valuation on the basis of the review of the assets by experts (including consultation where necessary) should be adequate and realistic and be equitable to both the lending institution and the borrower.

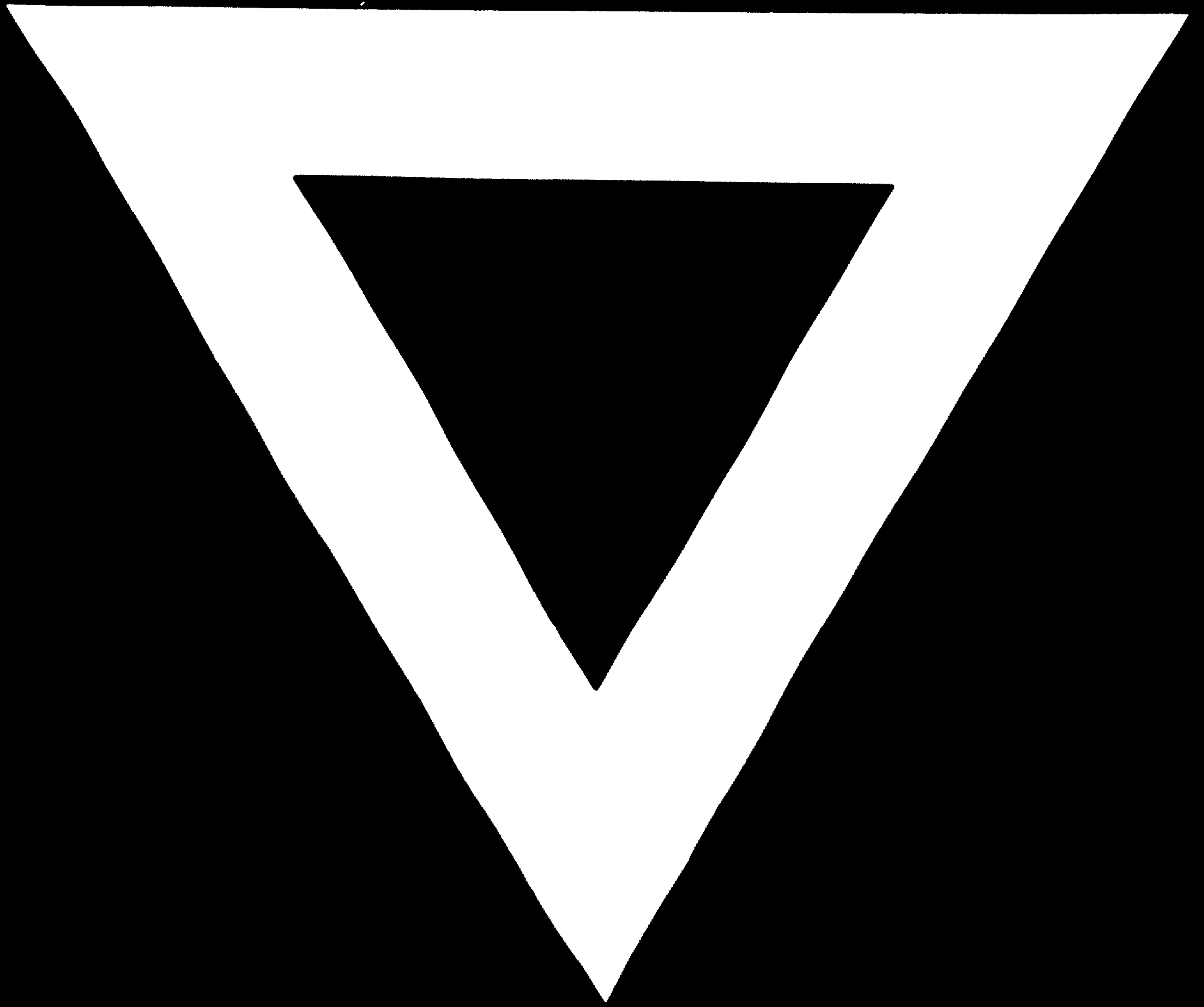
Having discussed the valuation of security, the following guide lines may be found helpful in regard to valuation of specific assets.

Land: Land is sometime valued at cost: but generally a preference is shown for assessing land at the market value. In arriving at the market value of land, it is desirable to take into account the locality, recent sales in the neighbourhood, proximity to roads, markets and other centres, possibilities of fluctuation due to development, present and anticipated future income, etc.

Buildings: The valuation of buildings is generally entrusted to architects or engineers and detailed instructions are sometimes issued by development banks in this regard. The value of the buildings may be arrived at on the basis of replacement cost less depreciation for the number of years the buildings have been in use or market value, whichever is lower. The area, the type of construction and the nature of the materials used, the age of the building, the nature of the maintenance and the condition

of the building, etc., have to be taken into consideration while assessing the value of building. In computing the replacement cost, reasonable allowance has to be made for the engineers' and architects' fees and the building contractors' profit. In practice, some development banks accept book value or the market value of the asset, whichever is lower. Book value, however, is often much lower than the market value as the value of the buildings especially in urban areas generally appreciates far in excess of their original cost. Since their value is not likely to come down, there may not be much risk in valuing them on the basis of market value.

Plant and Machinery: The value of new plant and machinery during the first year of working is generally taken at invoice value plus freight, duties, insurance, transport and erection charges. Where the machinery has been in use for more than a year, it is usually taken at book value or cost less normal depreciation. Sometimes replacement cost less depreciation for the number of years the machinery has been worked is also taken. The basis adopted depends on the circumstances of each case. For example, where the machinery has been written down in the books to a nominal value, its book value would not be sufficiently representative of its present worth. It would be desirable in such cases to have the machinery valued by engineers or by specilists in the field. It is important to take into account the condition of the machinery, its maintenance and upkeep, its efficiency in working, the period of future useful service it can give, etc. All second-hand machinery should be valued separately as also electrical equipment, whether for power or light, together with the value of transformers, etc. The value of workshop machinery and repair machinery may also be included in the main valuation. In the process of valuation, it would be necessary also to ensure that overheads allowed, viz., freight, duties, insurance, etc. are reasonable.



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