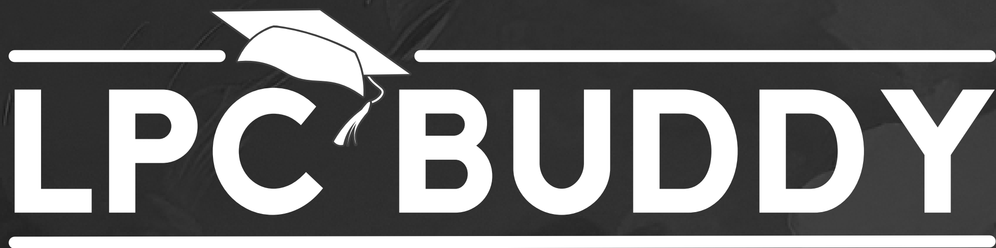

Banking & Debt Finance

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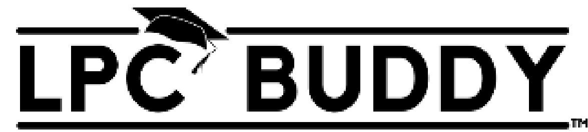

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Banking & Debt Finance

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Colour Coding Guide	❖ Blue Text – Reference to statutes and case law. ❖ Green Text – Reference to textbook[1] paragraphs, workshop tasks[2] and other notes in this guide. ❖ Orange Text – CPR references and forms.

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[1] Textbook references are to the CLP Legal Practice Guides by CLP Publishing.

[2] References to Workshop tasks are to University of Law workshop tasks (which may be adopted by other LPC institutions). The content and structure of Workshops is subject to change at short notice and so task references should be treated as a general guide only.

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Overview of Methods by Which a Company May Raise Finance

❖ *Banking & Capital Markets, 1.2*[1]

Overview	❖ The LPC Banking & Debt Finance module considers the law as it relates to companies **raising funds through "debt"**, i.e., by borrowing, by either: ➢ Entering into loan facilities[2]; or ➢ Issuing debt securities (i.e., bonds)[3]. ❖ For context, these methods are briefly compared against other means that a company may raise finance, below:

Method	Explanation	Pros	Cons
Share capital (equity).	❖ Companies can **issue shares** (instruments which, when purchased, grant the investor a share of ownership of the company, in return for capital invested).	❖ A means of raising finance **without the company taking on debt**. ❖ Can attract a **large amount of capital from a wide range of investors** if the company is public, and shares are listed.	❖ New share issues will "dilute" existing shareholders (i.e., the company's profits are spread more thinly amongst an increased number of shareholders). ❖ Shares can be **volatile;** their value will fluctuate with market forces and trends. ❖ **Limited ability for private companies to utilise** this method. ❖ Shareholders will normally expect a **return on investment in the form of a dividend.** ❖ Not necessarily suitable for **short term, small funding** requirements.
Loan facilities	❖ A company may **borrow money from a lender in the form of a loan**, which can provide a flexible and reliable source of funds.	❖ **Flexible**; different types of loan are available, such as overdrafts or term loans, with interest that may be fixed or variable, and capital that may be repayable in stages or in a lump	❖ The loan will attract interest, which can be expensive. ❖ A **level of control over the company will be given up** to the lender through the form of undertakings, security, etc. ❖ Commonly **secured**.

[1] *Chapter 1* of *Banking & Capital Markets* provides largely background/contextual information, so we have provided relatively brief notes on this.

[2] Considered in Workshop 1 – 6 at the University of Law.

[3] Considered in Workshop 7 – 9 at the University of Law.

		sum at the end of the loan. ❖ Loans **do not dilute company profits** in the same way as shares. ❖ Can be used to fund **specific projects or address short-term cash flow needs.**	❖ The borrower will have to give extensive **financial undertakings, representations, and warranties**. ❖ May impact **other dealings** (e.g., through cross-default clauses, limitations on certain activities (e.g., change of business clause).
Retained profit.	❖ A company's profits that are **kept within the company to fund future operations and other funding needs**.	❖ Does not require the company to take on **any risk in the form of additional debt** or give up equity. ❖ **Stable source of funding** if there is reliable cashflow.	❖ **Limited by the amount of profit** the company generates. ❖ May **not be sufficient for larger** funding needs. ❖ **No ability to leverage** a third party's funds, so may slow growth.
Capital markets instruments.	❖ Large companies can **borrow capital from investors through "the capital markets"** by issuing debt securities, the most common form of which are bonds. ❖ A bond is essentially an IOU; the investor (the lender) purchases the bond, and the company (issuer / borrower), undertakes to repay the **borrowed capital on a specified date and pay interest in the meantime**.	❖ Can provide a **large amount of funding due to a large investor base.** ❖ Terms and conditions are generally **less onerous** than with a loan. ❖ Interest rates **tend to be cheaper** than a loan. ❖ Not normally any need for **security**.	❖ **Can be expensive to arrange.** ❖ Only generally suitable for **large borrowings** (£100m+). ❖ Relatively **inflexible** (normally the full amount is payable in one instalment on maturity). ❖ Issuers normally need to be **established companies with good credit ratings.**

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Loans vs Debt Securities (Bonds)

- *Banking & Capital Markets, 17.2.2*
- *Practical Law: Methods of Raising Debt Finance*[1]

Overview	❖ There are two principal ways that a business can **raise capital through "debt finance"** (i.e., borrowing money): ➢ **Loans:** Where the borrower borrows funds from a lender (or group of lenders, known as a "syndicate"), which must be repaid with interest. ➢ **Debt Securities:** i.e., where the borrower issues a **financial instrument** which a lender (or group of lenders) purchases, such as a **bond**. The lender, by purchasing the instrument, will be entitled to repayment of the capital sum on "maturity", and interest for the lifetime of the security (operating in a similar way to an IOU). ❖ These two forms of raising capital are the central focus of this module, and as such, a common exam question may ask you to advise a client on **which of these methods is more appropriate for them.**

Loans vs Bonds[2]

	Loan	**Bond (Debt Security)**
Investor Base	❖ Relatively **narrow**; only certain banks are authorised to lend money.	❖ **Broad**; the borrower will potentially be able to secure a much greater number of investors. ❖ For lenders, this **spreads the risk if the issuer defaults.**
Funds Available	❖ Because the investor base is smaller, funds available to be borrowed are generally **smaller than on a bond issue**, as the risk is spread between fewer lenders. ❖ As a rule of thumb, syndicated loans of £500m+ are **likely to be difficult to obtain.** ❖ *Apply to the facts: how much does your client need?*	❖ As the number of investors is far greater, the amount of **funds available is generally larger** and **interest rates lower** than a syndicated loan.
Certainty of Amount that can be Raised	❖ The borrower is likely to have **greater certainty at an earlier stage that the money they need can be raised** (subject to due diligence etc.).	❖ The amount that can be raised will depend on the issuer's lead manager's ability to drum up sufficient investor interest.

[1] https://uk.practicallaw.thomsonreuters.com/9-201-8490; see also https://uk.practicallaw.thomsonreuters.com/2-501-0352 (US jurisdiction, but many of the key features are applicable in England & Wales).
[2] Workshop 1, Prep Task

		❖ There is a **higher risk that the money will not be raised** (after incurring costs of issuance).
Status of the Borrower	❖ **Private or public companies** can enter into a loan agreement.	❖ s755 of the Companies Act 2006 **prohibits private companies** from issuing securities to the public, which would include bonds.
Interest Rate (Cost of Borrowing)	❖ Generally **higher for a syndicated loan** as fewer lenders take on more risk.	❖ Generally **lower for a bond** (but weighed against higher cost of issuance i.e., upfront costs). ❖ This is because banks will generally seek higher rates of return than investors, and the costs of borrowing on capital markets tend to be lower.
Regulatory Capital Costs	❖ Most providers of commercial loan facilities incur **costs associated with meeting regulatory funding requirements**. ❖ For instance, non-interest bearing deposits must be placed with the Bank of England, which the lender cannot therefore invest, and periodic fees are payable to the FCA and PRA. ❖ These are known as "regulatory capital costs" and invariably these are **passed on to borrowers in their interest rate**, increasing the cost of borrowing.	❖ Regulatory capital **costs do not generally apply to investors on capital markets**, helping reduce the cost of raising money.
Upfront Financing Costs	❖ The **costs of arranging a syndicated loan are generally cheaper for the borrower**; there is no need, for example, to incur fees in preparing a prospectus, or to a trustee, etc. ❖ *Apply to the facts: does your client have sufficient cash available for a bond issue to be a realistic option?* ❖ *If they have the choice, the client should be advised that the upfront transaction costs of a bond may well be outweighed by a cheaper rate of interest vs a syndicated loan.*	❖ The **costs of arranging a bond issue will generally be higher**. ❖ This is, however, weighed against a **cheaper rate of interest on a bond.** ❖ As the cost of interest scales with how much is borrowed, as a rule of thumb the tipping point where a bond will be **cheaper for a borrower is where they seek to borrow £100m or more**.
Transaction Speed	❖ If a syndicated loan is fully underwritten (i.e., where a few initial lenders fund the loan with the intent of	❖ Tends to be slower than obtaining a loan; the normal timetable between an issuer first instructing the arranger and

	selling this to other lenders either before or after the initial funding), it ***could* take less time to negotiate and close the loan than a transaction involving debt securities.** ❖ *Apply to the facts: Does the client need funds urgently? Depending on the facts, they may be better off seeking to arrange a loan rather than going through the regulatory processes required to issue a bond.*	them receiving the money is at least **5-6 weeks** but might be longer if the borrower has not previously issued a security.
Ability to Trade	❖ A loan can technically be sold by the lender to a third party; however, this **tends to have a limited market.** ❖ There is **little secondary trading except in the "distressed" debt market** (i.e., where the target company is insolvent; this has a high level of risk but potentially very high level of return).	❖ A debt security is a transferable instrument, meaning it can be **sold on to a third party** on the international capital markets relatively **quickly and easily.** ❖ This is an advantage for investors (lenders), who can **sell the bond prior to maturity** if they need to realise their investment.
Covenants	❖ Will usually impose **much more stringent covenants than a bond.** ❖ E.g., information covenants, or covenants not to make substantial changes to the borrower's business. ❖ This is an **advantage for a lender**, giving them more control over the borrower's dealings and maximising the prospects of repayment, but is a disadvantage for a borrower who will prefer to have as few restrictions as possible. ❖ *Apply to the facts: borrowers, as a rule of thumb will not want their business to be interfered with. How bothersome is this for your specific client?*	❖ The terms and conditions will generally contain **fewer covenants than a syndicated loan**.
Interest Rates	❖ Generally inflexible; most syndicated loans require a **floating rate of interest**.	❖ **More options for how interest is paid**; bonds may be issued with fixed rate interest, floating rate interest, or "zero coupon" (i.e., no interest).
Security	❖ Generally **secured**.	❖ Frequently **unsecured**.

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	❖ *Apply to the facts: does the borrower have an asset that could be secured if possible? Consider the nature of the client's assets, whether security is feasible (and the nature of it e.g., fixed charge vs floating charge), as well as any pre-existing security.*	
Use of Capital	❖ Loan agreements **often seek to control the borrower's use of capital**. For instance, an RCF may be subject to a "clean down" provision where the provision requires any money borrowed to be used for working capital and not long-term capital expenditure.	❖ The borrower will usually **have a lot more flexibility** as to the uses they put the borrowed capital towards.
Disclosure	❖ Each individual investor takes on more risk so will normally require **much more extensive disclosure through the due diligence process.**	❖ Information about the borrower (issuer) that is disclosed to the lender is **generally limited to that which is already publicly available**: ➢ Most issuers are large companies with very good credit histories that are perceived as less risky than an unknown borrower. ➢ The amount being lent by each investor is usually less (because there are more of them), meaning there is less risk.
Flexibility of Amount Borrowed	❖ Syndicated loans **allow for more flexible facilities than bonds.** The loan may be structured as a term loan, or a revolving credit facility, there may be flexibility as to how much is drawn down, or not even be a requirement to draw down at all. ❖ **Reborrowing** may be possible. ❖ *Apply to the facts: how certain is the client that the money will be required? For example, if needed for an acquisition, how likely is it that that will go through successfully?*	❖ **Less flexible**; the issuer will normally receive the **full amount** investors pay for the bonds **on the issue date**. This can lead to more expensive interest payments if the issuer ends up not requiring the full amount at once.
Repayment Options	❖ Much **more flexible than a bond issue**; e.g., if the loan is a revolving credit facility, the borrower can repay and redraw money as required.	❖ **Less flexible**; debt securities normally provide for a "bullet repayment", which is a single payment on maturity, and regular interest payments.

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	❖ *Apply to the facts: will the client have the ability to meet a potentially significant bullet repayment on a bond?*	
Currency	❖ Syndicated loans may contain multi-currency options where the borrower can **switch currencies between interest periods.** ❖ *Apply to the facts: is this relevant to the client? If they do business in multiple currencies then this may be attractive as it could save on exchange fees, transaction fees, etc.*	❖ The issuer will usually **borrow in the currency that is specified when the debt securities are issued.**
Publicity	❖ Loan agreements are private transactions, which can be kept **confidential between the parties**. ❖ *Apply to the facts: does your client have a need to keep the reasons for raising finance confidential (e.g., a planned acquisition)?*	❖ Bond issues are commonly listed, which generally requires **publicity**.
Renegotiation of Terms	❖ The harsher terms of a loan are balanced against the fact that it may be **possible to negotiate with the lenders** if the borrower finds itself in financial difficulties, particularly if the borrower has a strong pre-existing relationship with the arranger. ❖ *Apply to the facts: how important is this to the client? Certain clients will be more willing to dispense with this for the sake of securing a lower interest rate. If the client is in a good financial position this may not be a high priority.*	❖ Renegotiation is much more difficult; there are normally **too many investors to be able to attempt to renegotiate.** The borrower may not know their identity.
Size of borrower	❖ Generally, loans are **more available to smaller companies** with worse creditworthiness than might be required to issue a bond. ❖ *Apply to the facts: does the client have any factors such as a small size or poor credit history that may mean a bond is unlikely to be feasible?*	❖ **Issuers generally need to be established companies** with a good credit rating. ❖ Investors will be **more willing to invest in a company with a good credit history and reputation.**
Term	❖ The term for a general-purpose syndicated loan will typically be shorter (3-7 years), whereas bond issues are generally longer term.	❖ Generally longer term (8 years+).

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Importance of Credit Rating	❖ The borrower will not be ascribed a credit rating for the loan itself, but the borrower's credit rating in respect of other debt may be accounted for in due diligence, which may give rise to a higher rate of interest.	❖ Issuers of bonds on the international capital markets will be assigned a credit rating by an independent rating agency. ❖ As investors will be the public, and normally have no prior relationship with the borrower, they may place more weight on the issuer's credit rating than a lending syndicate. ❖ If the issuer has a **lower rating, they will have to do more to attract investors (principally, by offering a higher interest rate).**

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Due Diligence

- *Banking & Capital Markets, Chapter 2*

Overview	❖ Prior to agreeing a loan facility, the lender will conduct due diligence i.e., they will **investigate a prospective borrower** to acquire as much information as possible in order to determine its level of credit risk, and decide whether or not it **wishes to risk its capital by lending, and if so, on what terms.**

Process

- *Banking & Capital Markets, 2.2*

No standardised process.	❖ There is **no standardised process of due diligence**. ❖ The process accordingly varies according to factors such as the size and type of the loan, its purpose, and whether the borrower is known to the bank. ❖ However, a *typical* process may play-out as follows:

Step 1 – The borrower is assigned an "account officer".	❖ This is an individual within the bank who has responsibility for evaluating the loan application. ❖ They provide a **consistent point of contact with the borrower**, and will, based on their knowledge of the borrower, **put together basic proposed terms** for the loan covering: ➢ The amount and term. ➢ Repayment dates. ➢ Principal financial covenants.
Step 2 – The account officer conducts a "credit analysis".	❖ The account officer undertakes credit analysis, i.e., a **thorough review of the borrower's financial information,** in order to determine its creditworthiness. ❖ The account officer will commonly review the borrower's: ➢ **Most recently published accounts**, reviewing, in particular, the borrower's income and assets, cashflow and liabilities; ➢ **Credit history;** ➢ **Business operations**, including key personnel, market conditions, and competitors, etc.; and ➢ For smaller borrowers, the lender may require **more current information** such as **management accounts** (i.e., internal accounting information).
Step 3 – The completed credit analysis is sent for "credit clearance".	❖ The completed credit analysis report will be sent for **review and approval by the bank's credit department**, known as "credit clearance". ❖ The credit department will see all credit requests and therefore will have a view of overall lending of the bank. They will seek to confirm whether any decision to lend **complies with internal limits and policies, as well as any external restraints.** ❖ If the credit department approves the loan, they may do so **subject to revised terms** being agreed (e.g., smaller loan, stricter undertakings, or a shorter term).

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Step 4 – Prepare the draft term sheet.	❖ When clearance is given, the account officer will **finalise a draft "term sheet".** ➢ This is a document which outlines the basic terms and conditions in the loan facility. ➢ It is not usually intended to be legally binding, but is an "agreement to agree", and serves as a basis for the final loan agreement; see notes on *Term Sheets and Commitment Letters*.
Step 4 – Subsequent Investigation	❖ Once the term sheet is agreed, the bank will conduct further investigation, normally with professional advisers, including: ➢ Instructing solicitors to **prepare a draft facility agreement**. ➢ Instructing accountants to **compile a report on the borrower**. ❖ The draft facility agreement will set down conditions precedent which the borrower must meet in order for the borrower to draw down on the facility; these will generally **require the borrower to deliver up various information to the lender such as:** ➢ Constitutional documents; ➢ Insurance policies; ➢ Certificates of title for any properties; ➢ Executed security documents, together with any documents of title (e.g., share certificates); ➢ Related documents e.g., fee letters, hedging agreements; ➢ Management accounts; and ➢ Any consents or licences necessary.
Step 5 – Ongoing Information	❖ The bank will **conduct ongoing monitoring** of the borrower throughout the lifetime of the loan, to ensure it has the best chance of getting its loan repaid and is aware of any potential issues as soon as possible. ❖ The bank will conduct this, in part, by requiring the borrower, at the start of each interest period**, to repeat representations and warranties that are made in the initial loan agreement, in order to verify their ongoing truthfulness.** ❖ These representations cover matters such as, for instance, confirming that the borrower has **not undergone an event of default** under any of its commercial lending agreements. If the representation is untrue, this may lead to an event of default which may allow the bank to demand immediate repayment (as well as liability for breach of contract and misrepresentation). ❖ Warranties in the loan agreement will generally be drafted to provide that they are true and accurate ***EXCEPT as provided by relevant disclosure*** by the borrower. This wording encourages the borrower to make as full disclosure of information about their business as possible, to try to avoid a later liability.

Confidentiality *Banking & Capital Markets, 2.10*	❖ During the course of due diligence, the borrower will invariably provide **sensitive commercial information** about its dealing with to the bank. ❖ Most borrowers will therefore require the lender to **sign a confidentiality letter** which contains an undertaking by the bank not to disclose confidential information other than in limited circumstances to aid syndication.

	❖ This bolsters the **common law duty of confidentiality** on the bank.

The Bank's Risk Assessment[1]

Overview	❖ A potential exam question will put students in the shoes of the **legal adviser for the arranging bank** during due diligence, and ask them to advise on: ➢ Potential **commercial risks** associated with the borrower. ➢ Steps the **bank can take to protect itself** and **limit its risk exposure**.

The Bank's Key Concerns	❖ Any bank who joins the syndicate will have three primary commercial concerns: 1. Will the bank be **repaid at the agreed time**? 2. Will the bank **make money from this transaction**? 3. What risks is the bank open to and **how can it protect itself?**

Potential Risks

❖ The following are common risks that are associated with a borrower in a commercial finance arrangement:

Business Prospects	❖ What is the nature of the borrower's business? ➢ What are the main **drivers of the borrower's revenue**? ➢ Are these **profitable** income streams? ❖ What is the borrower's relationship like with its customers? ➢ Are they **loyal**? ➢ Is the business **reliant on certain key contracts**? ➢ What is the **duration** of those contracts (long term) and what is the borrower's **relationship like with those parties?** ❖ Does the business have **plans for expansion?** ➢ If so, what are these, and are these sustainable? ❖ Is there a **takeover risk** (change of control)? ❖ Who are the borrower's **suppliers?** ➢ Are they in good standing? ➢ Does the borrower have a strong relationship with them? ❖ Are there any **reputational risks** to the borrower?
Market Conditions	❖ What is the **level of competition** in the borrower's market? ❖ Are there any **unfavourable consumer trends** away the borrower's offering? How easy is it for the borrower to respond to these? ❖ Consider **external risks** such as disease, war, natural disasters, fluctuations in commodity prices etc. ➢ To **what extent is the borrower exposed to these?**

[1] Workshop 1, Task 1

		➢ What are their plans to **<u>mitigate</u>** them? ❖ Is there a particularly profitable element of the business and is that **<u>subject to any risks?</u>** ➢ E.g., are all of the businesses' eggs in one basket?
	<u>Financial Prospects</u>	❖ **<u>Turnover</u>** – how much money does the borrower make? ❖ **<u>Profit</u>** – how much profit does the borrower make? Is this sufficient for them to fund the proposed interest on the loan? ❖ **<u>Cashflow</u>** – does the borrower have a reliable source of cashflow that it can use to meet interest payments, or are there any risks to that? ❖ **<u>Operating costs</u>** - What is the extent of the borrower's day-to-day liabilities, e.g., rents, business rates, shipping costs, etc. ❖ Are there any **<u>market trends that pose a threat to the borrower's profitabilit</u>**y? ❖ Could the borrower **<u>renegotiate any key contracts</u>**?
	<u>Assets</u>	❖ What **<u>assets</u>** does the borrower have? ❖ Are these **<u>appropriate for the lender to take security</u>**? ➢ E.g., land, plant and machinery. ❖ What is their **<u>value</u>**? ❖ Does the borrower **<u>own or lease</u>** these? ❖ Is there any **<u>existing security</u>** in place? ❖ Does the business have **<u>debts that it can call in</u>**; any bad debts? ❖ **<u>Intellectual property</u>**?
	<u>Debts</u>	❖ Does the borrower have **<u>current liabilities</u>** (such as a pension scheme deficit)? ➢ If so, what is the **<u>extent</u>** of these? ➢ Are there any material terms in other lending contracts that we need to be aware of, for example **<u>cross default</u>** provisions, or **<u>negative pledges</u>**?
	<u>Personnel Risks</u>	❖ Who are the **<u>key personnel members</u>**? ❖ Is there any risk they may leave during the loan term? ❖ If yes, who are their replacements? Are they competent? Does the lender want to meet them? ❖ Consider a change of control clause to mitigate this.

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	Any ongoing litigation?	❖ Is the borrower **involved in any ongoing disputes**, either brought by it or against it? ❖ Are any **future disputes threatened** (e.g., the borrower has received a letter of claim, etc.)?
	Insurance	❖ Does the borrower have **sufficient insurance in place** in respect of material risks that the business faces?
	Purpose of the loan.	❖ **Why** does the borrower need the money? ❖ Consider **risks specific to that purpose**; ➢ E.g., if for share acquisition, then the lender has an interest in knowing whether there are any risks associated with the target company which the borrower might inherit. ❖ How **quickly** does the borrower need the money, and is that realistic for the lender?
	Extent of the Loan	❖ **How much** does the borrower need? ❖ Is there a realistic prospect of the borrower being able to afford this?
	Legal and regulatory risks?	❖ Are there any **regulatory risks** to the borrower's business? ❖ E.g., environmental risks; potential fines, clean-up costs, etc.
	Structure of the Borrower	❖ Is the borrower part of a **group of companies**? ❖ Are other group members able to serve as **guarantors**? ❖ Is "**structural subordination**" a risk? ➢ Structural subordination refers to the risk that a lender **will not have access to the assets of a borrower company's subsidiaries** until after **all of the subsidiaries' creditors have been paid** and their remaining assets distributed up to the parent company. ➢ Therefore, whilst subsidiary companies are owned by a parent, and therefore reflect its value, the subsidiary's assets may be **beyond the parent company lender's reach if the subsidiary itself owes money to a lender**. The parent's lender is "structurally subordinated" to the subsidiary's lender.

Protection Methods

❖ The bank can consider the **following protective measures** in order to manage its risk.

❖ You should **apply any proposed protective measures to the facts of the question**.
- ➢ Is the proposed measure appropriate to the transaction you are advising on?
- ➢ Consider both the nature of the risk, and the nature of the borrower (e.g., their assets, etc.).

Protection Method	**What is it?**	**Pros**	**Cons**
Security *Banking & Capital*	❖ The lender receives some form of right over the borrower's	❖ Provides the lender with a reliable means through which they can	❖ The strength of the security depends on the **nature of it** (i.e., fixed charge vs

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	Markets 12.3-12.5	property, that can be used to enforce the loan in the event that the borrower defaults.	**recoup their losses if the borrower defaults**, invariably by selling the secured property.	floating charge), the **value of the secured asset**, and its **priority in comparison to other creditors** of the borrower (though the bank can mitigate this risk by "perfecting" the security i.e., registering it to give notice to third parties). ❖ The lender may have to spend **time and resources enforcing the security**.
	Guarantees *Banking & Capital Markets 13.2.1*	❖ A promise by a third party to **assume responsibility for the debt of the borrower if the borrower fails to repay the loan.**	❖ This provides the lender with a mechanism of **recovering from a separate legal entity,** who should not generally be suffering from the same financial issues as the borrower.	❖ The strength of a guarantee is **contingent upon the financial strength of the guarantor** (which the lender may need to expend time and resource investigating).
	Comfort Letters *Banking & Capital Markets 13.2.2*	❖ A letter from a third party (usually a parent company, in respect of its subsidiary) that provides assurance that **the subsidiary has the ability to pay and perform its obligations under the loan agreement.**	❖ Provides **additional reassurance to the lender** about the borrower's financial situation.	❖ The letter is **not normally legally binding**, so will provide little to no protection if the borrower actually defaults.
	Due Diligence	❖ Thorough investigation of the **borrower's**	❖ Helps the lender to **assess the borrower's**	❖ May be **time-consuming and**

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Banking & Capital Markets, Chapter 2	**financial situation and business operations** before approving the loan.	**creditworthiness** and the risk of the loan.	**costly** for the lender. ❖ Does not account for **unforeseen future events.**
Interest Rate	❖ The offered rate at which interest is charged on the loan could be increased.	❖ Higher interest rates can **compensate the lender for added risk** of lending to a borrower.	❖ Raising the interest rate may **make the loan less attractive to the borrower.** ❖ If the borrower gets into financial difficulty, a **higher interest payment is only likely to exacerbate the issue**, and the lender still will not be repaid.
Increase the Repayment Period / Term	❖ The length of time over which the borrower is **required to repay the loan** could be increased.	❖ A longer repayment period can reduce the lender's risk by **spreading the borrower's payments over a longer period of time.**	❖ Will generally result in **lower incremental interest payments**, meaning the lender's profit will be spread over a longer period of time, which is likely to make the loan less attractive to the lender.
Reduce the Amount of the Loan	❖ **Lowering the amount of the loan** to reduce the lender's risk.	❖ **Reduces the lender's exposure** to risk.	❖ The lender **may need to sacrifice potential profits** by lending a smaller amount.
Change of Control Clause *Banking & Capital Markets, 9.2.3*	❖ A clause in the loan agreement that requires the borrower to **obtain the lender's consent before making any changes to the ownership or management** of the company.	❖ Protects the lender's interests by ensuring that the borrower **cannot make changes that may affect the way the borrower is run.** ❖ Will usually trigger a "mandatory prepayment" (not a	❖ Commercial problems may arise if an **unenthusiastic original management team are forced to remain in-place.**

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			default), which **should not trigger a cross-default.**	
	Change of Business Clause *Banking & Capital Markets, 8.3.6*	❖ A clause in the loan agreement that **requires the borrower to obtain the lender's consent before making any significant changes to their business**, such as changing the nature of their business or acquiring another company.	❖ Protects the lender's interests by ensuring that **the borrower cannot make changes to their business** that may affect the risk of the loan, and the borrower's the ability to repay.	❖ The lender may need to **spend time and resources to review and approve any proposed changes**.
	Financial Covenants *Banking & Capital Markets, 7.3*	❖ Clauses in the loan agreement that require the borrower to **maintain certain financial ratios, such as debt-to-income ratio or cash flow**, during the term of the loan.	❖ Provides the lender with a way to **monitor the borrower's financial health and ensure that the borrower is meeting their obligations** under the loan agreement.	❖ The lender may need to **spend time and resources to review and monitor the borrower's compliance** with the covenants.
	Information Covenants *Banking & Capital Markets, 7.4*	❖ Clauses in the loan agreement that require the borrower to provide the lender with **information to support its other covenants**, such as financial reports and other information about their business.	❖ Enables the lender to **stay informed about the borrower's financial situation and business operations.**	❖ The lender may need to spend **time and resources to review and analyse the information** provided by the borrower.
	General Undertakings	❖ Promises made by the lender, such as promises to **maintain certain business practices or to seek the lender's**	❖ Provides the lender with a **level of control over the borrower's business operations.**	❖ The lender may need to spend **time and resources to review and enforce compliance with the undertakings.**

			consent before making certain decisions.		
		Events of Default *Banking & Capital Markets, Chapter 8*	❖ Conditions specified in the loan agreement that, if breached, would **allow the lender to declare the loan in default** and allow for certain remedies under the agreement.	❖ Protects the lender if the borrower **fails to meet their obligations under the loan agreement.** ❖ Invariably, if triggered, this will allow the lender to **demand immediate repayment of the loan and any interest** (“acceleration”).	❖ If an event of default occurs, this **can exacerbate the poor financial situation of a borrower**, particularly as this will normally trigger cross-default clauses in its other commercial loan agreements.
		Negative Pledge Clause *Banking & Capital Markets, 13.3*	❖ A clause in the loan agreement that prohibits the borrower from using their assets as **security for any other loans without the lender's consent.**	❖ Protects the lender's interests by ensuring that the borrower's assets are **not used to secure other debts that may take priority** over the lender's claim.	❖ The clause will **limit the borrower’s ability to freely do business** which may lead to disputes down the line.
		Purchasing Derivatives	❖ Financial instruments, such as futures contracts or options, that are used to **hedge against changes in interest rates or other market conditions.**	❖ Can help the lender to **manage the risk of fluctuations in market conditions** and to protect against potential losses.	❖ Highly specialist area; can be complex and effective use will require the lender to have a **high level of expertise in financial markets.** ❖ Cost of purchasing the derivative.

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