Standardization of Loan Docs

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Introduction

It is fairly common among Indian corporates to incur indebtedness through a mix of debt securities and bank loans. Debt securities are usually in the form of debentures, bonds and commercial papers sourced through a public or private issuance. With the size of the Indian credit industry running into several lakh crores, it would be a welcome change if the documentation for availing credit/debt securities was regularized. Internationally, LSTA, LMA and APLMA have played a major role in standardizing documentation across US, Europe, Middle East, Asia Pacific, and Africa. These documents provide for standard terms and conditions for secondary market transactions coupled with individualized Trade Confirmation (which contain negotiated deviations between the parties)[1].

While India has no standard loan documentation practice across banks, the Indian Bank's Association (IBA) has been looking to revamp the Indian debt market by introducing standardized documentation and has circulated standard facility documentation for consortium lending, which is followed by most public sector Indian banks. Usually, lenders follow their own individual formats for bilateral financing transactions; however, the clauses across banks are similar. While traditional banks are stringent with their documentation and typically do not deviate from their standard documentation (this is primarily owing to their strict bureaucratic internal policies, which restrict them from being very flexible in negotiations), non-banking financial companies (NBFCs) are slightly more lenient in their financing terms compared to banks.

The standardization of loan documents would primarily focus on adding standard clauses to the body of the document/agreement and the deviations would be added as schedules such that the main body of the documents remains standard and unchanged for all loans. This will allow borrowers and investors to easily review and assess only the case specific deviations rather than having to compare each clause of an entire loan document.

Standard Provisions In Indian Loan Documentation

Rate of Interest

The interest is calculated by reference to a bank rate, which is the benchmark rate. The Reserve Bank of India provides the formula that a bank must use to calculate its marginal cost of funds-based lending rates (MCLR). The bank treats this as the base rate and charges a spread over and above the benchmark rate in accordance with the thresholds prescribed. NBFCs often have their own benchmark rates and spreads for calculating the interest rate and these vary with each institution[2].

Under the external commercial borrowing (ECB) regulations, the interest rate linked to a foreign loan provided in foreign currency may be linked to the six-month LIBOR rate of different currencies or any other six-month interbank interest rate applicable to the currency of borrowing (e.g., EURIBOR) to determine the all-in cost for the loan.

Yield Protection Provisions

Almost all loan documentation in India includes provisions for increased cost, prepayment premiums and withholding tax gross-up provisions. The increased cost provisions are standard clauses in a loan transaction, wherein an obligation is imposed on the borrower to make good any additional cost incurred by the lender on account of changes in the laws and regulations and compliance thereof.

Financial Maintenance Covenants

Financial covenants included in bank loan documentation usually provide for maintenance of debt service coverage ratios, regulation of cash burn, maintenance of minimum net worth, maintenance of EBITDA ratios, maintaining a minimum specified credit rating, security cover ratio and end-use restrictions on borrowed funds. These covenants are usually stricter in loans that are given to special purpose vehicles, which are very common in project financing transactions. However, the financial covenants are generally more relaxed in general corporate financing in large corporates that have multiple verticals and revenue generating streams.

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[1] https://m.rbi.org.in/Scripts/PublicationReportDetails.aspx?UrlPage=&ID=940#CHF1

[2] For example, Indiabulls Housing Finance Limited follows a benchmark rate called the "IWLR" or the Indiabulls Wholesale Lending Rate.

These financial covenants are usually tested on a periodic basis (decided on a case to case basis by each institution) to ascertain the financial health of the borrower and aids the creditor in determining its financial projections regarding such credit facility.

Mandatory Prepayment

When a borrower under debt has received an influx of money owing to the occurrence of an event - for instance, the sale of a branch of the business, the sale of property owned by the business, or proceeds of insurance - the creditor may seek for mandatory prepayment of the loan from those proceeds. The debtor is mandatorily obliged in such an event to direct the proceeds resulting from those events to the payment of the loan, albeit prior to the maturity date, and is not permitted to reinvest the same into its business. Prepayment premiums are usually not imposed upon the occurrence of a mandatory prepayment event. However, in some instances, such prepayment may result in adverse tax consequences, in which case the mandatory prepayment may not be enforced.

Indemnification

Where a creditor incurs expenditure or undertakes a liability on behalf of the borrower, the creditor may require the borrower to repay the expenditure or indemnify it for any loss caused. Those terms are generally included in the loan documentation and may include indemnification for any default and repayment of transaction costs, amendment costs, stamp duty, security agent or trustee fees, the cost of litigation, etc., in relation to the loan transaction. The obligation on the debtor is waived only when the loss or cost is incurred by the creditor owing to its own gross negligence or wilful misconduct.

Event of Default

Where the borrower defaults in making payments in line with the financing documents and agreed commercial terms, the creditor has a right to declare an event of default under the documents. Usually, apart from repayment of the borrowed amount, the borrower is also mandated to adhere to certain terms and conditions mentioned in the loan documents, viz., maintenance of financial covenants, creation, and perfection of security etc., failing which the creditor may increase the rate of interest, accelerate repayment of loan, recall undisbursed amounts, or enforce security to recover the dues. These clauses are usually highly negotiated and linked with the risk appetite of the lender, the credit rating and financial health of the borrower and such other factors.

Conclusion

A significant part of concluding a loan transaction is negotiation of terms and conditions between the concerned parties. In the Indian scenario, this may take months before a consensus is reached. A large number of deals fall through after months of negotiation when terms are not agreed upon. During such time, the parties have several rounds of reading (presumably, through each clause of the document) and incur significant expenses linked to engagement of counsels over an extended period of time and the time consumed. With standardization of loan documents, the scope of negotiation is reduced greatly as only the commercial terms (contained in separate schedules) are negotiated upon while the standard terms remain the same.

In preparing this article, Anuj Kaila was assisted by Navolina Mujumdar.

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