

# Chapter 12 – Credit Support

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## Learning Objectives

What you should achieve after completing this chapter:

- Be able to state the rationale for credit support in lending;
- Understand the various forms of common credit support used in lending;
- Appreciate the circumstances under which credit support is appropriate; and
- Be able to know the implications of each credit support in lending.

## 1. Introduction

As mentioned in the earlier chapter, the primary repayment source for any loan should generally be the cash flow from the borrower's operations. However, there may be times when lenders cannot rely on the borrower's operations to generate the necessary cash flow to repay their loans. In such a case, they may rely on a second way out that is more tangible in the form of the collateral taken. Nevertheless, there may be times that the borrower is financially strong and requires lenders to extend credit without any tangible collateral. Hence, lenders may have to look to other forms of credit support to justify the lending position.

There is also nothing to prevent lenders from requiring further credit support that is not tangible but that may enhance the credit in addition to the tangible second way out. Effectively, the rationale for the credit support includes:

- Establishing a financial recourse to a third party in the event of default;
- Extracting a moral commitment from a third party to influence a credit outcome;
- Preventing other lenders from having a priority over your financial institution; and
- Locking in the financial support of a third party in the company.

## 2. Guarantees

A guarantee is an undertaking by a party to the lender to pay up in the event the borrower has defaulted. Prior to default, the lender has a secondary claim but if the borrower defaults and is unable to make good, the lender will then have a primary claim against the guarantor who essentially steps into the shoes of the borrower as a primary debtor. A guarantee is evident by a letter or an agreement.

A lender may request for a third party's guarantee, either from an individual or a corporate body. This will establish a financial recourse to the guarantor(s) in the event the borrower defaults with the lender. The credit will be enhanced to the extent that the lender has secured further commitment from the guarantor(s) to honour the loan.

Lenders should not place too much emphasis on the guarantor(s)'s financial worth. Establishing recourse towards a guarantor does not guarantee recovery of loan defaulted. The lender is hoping for a strong sense of moral commitment on the part of the guarantors to settle any outstanding loans to avoid being sued by the lender.

## 2.1 Who should provide guarantee?

It is a common practice that personal guarantees are not normally obtained when loans and credit facilities are extended to public listed companies. This is not because of the fact that they are public listed companies but because they are financially strong (in order to meet listing requirements) and the shareholdings become very diversified with a significant public holding.

Some credit officers are under the wrong impression that lenders always require the personal guarantees of directors. Quite often in their credit proposal, it is mentioned that the personal guarantees of directors are required without specifying the names of the guarantors. It is important for credit officers to understand that the role of a director does not automatically include an obligation to stand as guarantor for the company's borrowings. It is perfectly normal for a nominee director not to provide his personal guarantee for the company's borrowings, as he does not derive any benefit from committing himself.

Generally, personal guarantees should be considered as a non-negotiable requirement when the lenders are dealing with companies that are not listed on the stock exchange. Credit officers should make their best attempt to secure personal guarantees of the following categories of individuals:

- **Significant shareholders** who are also directors. This will ensure the directors' commitment in managing the business properly and responsibly. They should provide financial support to the borrower when necessary and stick with the company through good and bad times.
- **Majority shareholders** who may not be directors. This is to ensure that the persons "pulling the strings" from behind become financially committed to the lender for the borrowings.
- **Beneficiary shareholders** who may not be officially reflected as shareholders in the records of the Companies Commission of Malaysia. In this case, the interests of these beneficiary shareholders are being held in trust by the "official" shareholders.

As for the corporate guarantees' requirement, it is more complex and due credit consideration must be given as to whether the guarantees are required, and if so, from whom. It is important for lenders to note that the taking of corporate guarantees is subject to the provisions of the Companies Act 1965, which disallows guarantees to be given on behalf of unrelated companies unless it can be proven that there is commercial benefit accruing in doing so. This provision does not apply if the corporate guarantor is an exempt private company.

However, lenders can explore the following possible corporate guarantors:

- A private exempt company related to the borrower by way of common shareholders. This is a form of horizontal guarantee.
- The borrower's parent company, also known as downstreaming of guarantee.
- The borrower's subsidiary, also known as upstreaming of guarantee.
- A fellow subsidiary of the borrower of the same group, a form of horizontal guarantee.

## 2.2 Types of guarantees

Guarantees can be taken in various forms depending on the bargaining power of the guarantors and borrower in relation to the lender.

### (a) Joint and several basis

There are two or more guarantors who are each liable for the full amount of liability owing by the company subject to the limit of the guarantee. The lender is at liberty to recover the full amount owing from any combination of the guarantors. The lender can take legal action against all the guarantors and end up recovering the full amount from one or two or all of the guarantors. It is also possible that if all the guarantors have only the “shirt on their backs”, the lender may not be able to recover anything at all. It is the best type of guarantee as it provides the lender with wide options to proceed with. It is also the most common type of guarantee that the lender obtains, particularly for personal guarantees.

This could be due to the ignorance of the guarantors in not realising the true extent of their commitment in providing such a guarantee. However, the guarantors cannot plead ignorance when legal action is taken against them upon default by the borrower. They are advised and have the right to seek legal counsel before executing any guarantee.

If the lender decides to pursue only one of the guarantors and is fully repaid, the lender will not pursue the remaining guarantors. However, the remaining guarantors remain liable to the guarantor who fully repaid the lender for their pro-rata share of the loss. The guarantors can be individuals or companies.

As an example, assume there are three guarantors in a loan arrangement. Upon default, the amount owing to the bank is RM3

million. The company is not able to honour the amount outstanding. The lender is not restricted to recovering a maximum of RM1 million from each guarantor. It is possible for one guarantor to honour the entire RM3 million and in turn take the necessary action to recover from each of the other two guarantors for a fair share, i.e. RM1 million from each of them.

**(b) Proportionate basis**

In this instance, each guarantor will only be responsible for an agreed proportion of outstanding liability subject to the limit of the guarantee. Their respective proportion normally corresponds with their ownership percentage in the company. This type of guarantee is more common in lending to a joint venture or a borrower with corporate shareholders. No parent companies would want to expose themselves to 100% of the borrower's (or subsidiary's) debt to the lender if they own less than 100% of the borrower (or subsidiary). However, as individual guarantors become more sophisticated and educated, they will become more unwilling to sign joint and several guarantees having understood the full implications. As the financial industry becomes more competitive, it may lead to lenders agreeing to the borrower's request for a guarantee on a proportionate basis, rather than on a joint and several basis.

Using the same earlier example, if the three guarantors provided a proportionate guarantee of one-third each (which corresponds to their ownership in the company), and if the borrower defaults, the maximum amount that the lender can only recover from each guarantor is only RM1 million.

If any of the guarantors are unable to honour the amount, then it will be a loss to the lender. No other guarantors will be called upon to honour the loss.

**(c) Limited guarantee**

The word "limited" does not refer to a dollar amount. It refers to a specific event.

For instance, let us assume the borrower wants to borrow money for a turnkey project involving constructing a plant with specific machinery installed, and a test run and transfer of technology from the project owners before the project can generate cash flow. If the lender is confident about the project's cash flow generation potential upon the plant's successful completion, and the project owners refuse to provide a guarantee for the loan amount, it is

possible to negotiate for a guarantee up to the point of completion. By doing so, if the project fails to be completed and hence is unable to generate cash flow, then the project owners will be responsible for any outstanding amount owed by the borrower. However, if the project is completed but subsequently not able to generate the amount of cash flow required to honour its obligations to the lender due to unforeseen circumstances at the operating stage, there is no financial recourse to the project owners.

**(d) Indirect guarantee**

As the name suggests, such guarantee may not tantamount to a guarantee in the true sense of the word. Normally, it requires the “guarantor” to undertake to cause certain action to take place or cause certain action not to take place. Otherwise, the lender will have a financial recourse to the “guarantor”.

For instance, the lender may require a letter of undertaking from the parent company not to divest its shares in the subsidiary that is the borrower. If the parent company sells its shares, then the lender can have a financial recourse to the company. However, if the borrower defaults and the parent company did not divest its shares then the lender will not have any financial recourse to the parent company.

Among all the forms of credit support addressed in this chapter, guarantees would be considered the best for the lender. In the event of default, being guaranteed enables the lender to possibly enforce on the guarantor(s) in an attempt to recover the outstanding loan.

### **3. Indemnity**

Under section 77 of the Contract’s Act 1950, it is defined as a contract by which one party promises to save the other from loss caused to him by the conduct of the promisor himself or by the conduct of any third party.

The standard clauses in the printed form of guarantees usually include an agreement on the part of the guarantor to be liable as the principal debtor. This makes the liability of the guarantor co-extensive with the customer. Thus, the document is actually an indemnity.

When a lender is indemnified, effectively the indemnitor promises to:

- Pay all damages which he may be compelled to pay in any suit in respect of any matter to which the promise to indemnify applies. For example, negotiating export documents under a Letter of Credit with discrepancies.

- Pay all costs which he may be compelled to pay in any suit if, in bringing or defending it, he did not contravene the orders of the promiser, and acted as it would have been prudent for him to act in the absence of any contract of indemnity, or if the promiser authorised him to bring or defend the suit.
- Pay all sums which he may have paid under the terms of any compromise of any suit if the compromise was not contrary to the orders of the promiser, and was one which it would have been prudent for the promisee to make in the absence of any contract of indemnity, or if the promiser authorised him to compromise the suit – section 78 of the Contracts Act 1950.

#### 4. Insurance Policies

Life insurance policies are a straightforward form of lending credit support or security. It is important to know how to secure this form of security or credit support. It is also useful to know some of the special types of life policy and the particular problems they pose in taking them as security or credit support. Where a customer defaults, the bank will wish to realise its security or have a recourse to a second way out. Quite frequently, a policy assigned to the bank will mature, either through the death of the life assured or through his survival to the maturity date. The procedure for dealing with such policies must be known.

The advantages and disadvantages of life policies as lending securities are as follows:

##### Advantages

- (a) Easily and accurately valued by obtaining a surrender value from the company.
- (b) Simple to assign, whether by way of an absolute or equitable assignment.
- (c) Takes little time to perfect the security.
- (d) Where an absolute assignment has been taken, the security can be quickly and easily realised by surrendering the policy to the company.
- (e) Where the bank is relying on the earning capacity of the customer to repay a debt, the bank will be repaid by the death benefit from the policy should the customer die prematurely or is permanently incapacitated.

##### Disadvantages

- (a) The policy will lapse unless the regular premium payments are maintained or unless there is enough cash value. The customer may be unwilling or unable to pay the premiums. Though the bank has authority to pay the premiums and debit the customer, it may be of little advantage to do so where this simply increases an already doubtful borrowing.

- (b) The company may refuse to pay out on the policy because of a technical defect in the policy, or a breach of the conditions of the policy. A life policy is a contract of utmost good faith. The customer may have deliberately lied about or concealed material facts which would have influenced the company's willingness to take the policy.
- (c) The policyholder may have breached a condition in the policy. For example, where he is killed in motor racing and the policy contains a covenant not to engage in dangerous sports.
- (d) The customer may have committed suicide within the first year of the policy and the policy does not allow payment.

To overcome the problem of monitoring the premium payments, lenders would prefer a single premium payment, e.g. Mortgage Reducing Term Assurance (MRTA) for housing loans. It is also becoming common for lenders to take up reducing term assurances for hire-purchase facility.

A term policy is an increasingly common form of life assurance because of the high level of life cover, which can be obtained for a minimal outlay. Its main characteristics are as follows:

- (a) The policyholder enters into a contract with a life assurance company.
- (b) The policy holder agrees to pay either a single premium or regular premiums during the currency of the policy.
- (c) In consideration of the premiums, the life assurance company will pay a fixed capital sum during the currency of the policy.
- (d) Payment will only be made at the death or total permanent disability of the policyholder during the currency of the policy. If the policy holder survives the term of the policy, no payment will be made by the insurance company.
- (e) Consequently, a term life policy never acquires a surrender value.

#### **4.1 Value as security**

##### **(a) Term policy**

At first sight, a term life policy has no value as security for a bank borrowing. But it can be worthwhile to take an assignment over a term policy. Where the bank is relying on the earning capacity of a customer to repay borrowing, the premature death or total permanent disability of the customer could cause problems. However, if the customer had assigned to the bank a term life policy, the proceeds at his death or total permanent disability can be used to partially or fully repay outstanding loan balance depending on the amount payable under the policy.

This can be particularly useful where lending is to professionals such as doctors and solicitors. They may not have sufficient assets to charge to the lender, particularly early in their careers, but they do have good earning prospects.

In the case of joint applicants, for a housing loan, a reducing term policy can be taken for the loan amount in the name of the actual person repaying the loan. Let us take the example of a husband and wife taking a loan. The husband is earning and the wife is not. So it is advisable to buy a MRTA policy on the loan amount under his name. However, if both are working then the MRTA could be taken in the ratio of 50:50. In the event of the death of, say, the husband, the insurance company will repay partially the amount of loan outstanding.

In dealing with a company that is very dependent on a “key” man, term insurance on his life can be taken and assigned to the lender. In such a case, the first way out must be the cash flow generating ability of the company relating to the purpose of the lending. The second way out may be a tangible security. The “key” man insurance is to mitigate the risk of the death of the “key” man that may set back the company. The proceeds from the insurance policy will enable the company to continue to service its debt obligations to the lender, buy some economic time for a new “key” man to be found or to consider other options.

**(b) Whole life insurance**

This policy has a cash value after a number of years as long as the premiums are paid. Even if the premiums are not paid further, the cash value is still intact. There will be an automatic policy loan to pay further premiums until the policy loan is fully used up. Then the policy will have a paid-up value that the lender can still hold on to. This type of policy can also be used to mitigate the “key” man risk. However, the premium is higher as compared to term assurance. If there is a confirmed cash value, the policy can serve as a collateral.

**(c) Endowment**

This policy has a greater element of savings than protection. If the policy already exists for many years before it is assigned to the lender, the cash value will be intact and can be surrendered to obtain the cash value to settle the loan. In this respect, such policies are more of a security rather than a credit support.

## 5. Undertakings

Undertakings are part of security documentation. The documentation of a loan entails the selection and completion of the proper legal instruments to protect the lender. Further, this will embody the agreements and the execution of those documents by borrowers and lenders. Besides this, obligations of other parties to the whole transaction need to be obtained.

One form of tying up other parties is by way of obtaining undertakings, representing promises to carry out certain obligations and responsibilities, and they complement the main security documentation. Undertakings can come in various forms either before (precedent to drawdown) or during (post drawdown) the currency of the loan. Some undertakings can

- Strengthen the potential enforcement of collateral which cannot really be considered as credit support as it does not lend much weight in influencing a credit initiation decision such as
  - Obtaining an undertaking from a developer to forward the document of title when individual titles are issued after subdivision of the master title.
  - Obtaining an undertaking from the paramount chargee (i.e. Developer's banker or bridging financier) to forward the discharge of charge when redemption sums are paid
- Enhance the credit and thereby influence the credit initiation decision such as:
  - Undertaking from the Parent Company ***not to divest*** its shareholdings in a subsidiary company (i.e. the borrower) if parental support is seen to be critical to the viability of the borrower's operations
  - Undertaking ***not to encumber*** any of the company's assets now or in the future without the lender's consent if the lender wants its lending to be protected by meaningful unencumbered assets to ensure a fair chance of recovery particularly if the lending was extended on an unsecured basis

Some undertakings are tantamount to indirect guarantee such as if the parent company were to divest their shareholdings when they undertake that they would not. The lender with such undertaking may be able to have a financial recourse on the parent company at that point.

## 6. Statutory Declarations

The purpose of a statutory declaration is to extract a statement of truth from a person ***under oath***.

A uniform law was enacted in 1949 to apply to all the states in the Federation: the Statutory Declarations Ordinance 1949 – F.M. Ordinance No. 49 of 1949. This Ordinance made it “lawful for any President of a Sessions Court, Magistrate or Commissioner for Oaths appointed under the Commissioner for Oaths Ordinance,

1947, to take and receive, in any Malay State, the declaration of any person voluntarily making the same” in the prescribed form.

The Statutory Declarations Act 1960: Act No. 20 of 1960 – revised and published as Laws of Malaysia Act 13 – repealed the 1949 Ordinance and remains in force throughout Malaysia.

### **6.1 Statutory Declarations Act, 1960**

This Act provides for making and taking of statutory declarations and for the purposes connected therewith.

**Section 2** – It is lawful for the following persons to take and receive the statutory declaration of any person voluntarily making the same:

- Sessions Court Judge
- Magistrate
- Commissioner for Oaths
- Notary Public – subject to provisions of section 4 of the Notaries Public Ordinance 1959.

**Section 3** – Any false declaration is punishable under the Penal Code thus acts as a good deterrent for any person to try to make false statements.

#### **Section 4 – Fees**

A person making any declaration by virtue of the provision of this Act shall pay to the officer or Commissioner taking the same a fee.

In banking practice, **statutory declarations** are taken under the following circumstances:

- In lieu of bankruptcy search;
- When the original sale and purchase agreement is lost; and
- For first home and owner occupied premises.

All declarations are made in accordance to the form of declaration as per Schedule 2 of the Act.

Statutory declarations are not credit support but assist in mitigating certain weaknesses in the process of gathering information.

## **7. Summary and Conclusion**

Credit support can be said to complement the main security documentation. For unsecured credits, they could be the only documentation. Lenders may have their own standard forms in obtaining support of this nature. It is important to obtain legal advice and amend these forms in line with changes in the law from time to time.

**Practice Questions**

1. Explain the rationale for obtaining credit support.
2. Increasingly, guarantors (personal or corporate) are requesting for proportionate liability sharing in extending their guarantee. Assume that two guarantors agree to proportionately guarantee up to RM5 million each with the original loan amount of RM10 million. The outstanding debt stood at RM6 million at the point of default and the borrower is unable to settle, what is the maximum amount of recourse that the lender has against each of the guarantors?
3. What is the meaning of indirect guarantee? Give examples of circumstances when such guarantees are requested.
4. What is the meaning of limited guarantee? Give examples of circumstances when such guarantees are requested.
5. Distinguish between guarantee and indemnity.
6. List the advantages and disadvantages of obtaining insurance an policy as a support.
7. How are “key” men protected through insurance coverage?
8. Under what circumstances are letters of undertaking used?