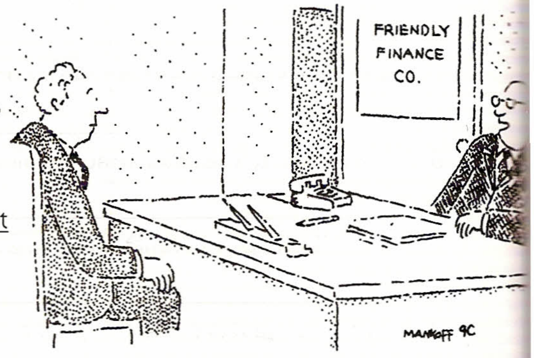
5 Loans and credit

AIMS

To learn about: lending decisions; key vocabulary of loans and credit
To learn how to: give advice and make suggestions
To practise: making lending decisions; giving advice to clients

Lead in

- How do commercial banks make a profit?
- How do banks decide who to lend money to?
- How do they decide what rates to lend at?
- How can large corporations raise finance?
- Why do large companies generally prefer not to borrow from banks?



"We'd like to lend you the money, but we're afraid we might lose you as a friend."

Reading: Banks and bonds

1 Read the texts below and then answer the questions on the opposite page.

Finance Glossary
www.finance-glossary.com

Corporate bonds are issued by companies to raise capital. They are an alternative to issuing new shares on the stock market (equity finance) and are a form of debt finance. A bond is basically an IOU (short for 'I owe you') – a promise to pay back your original investment (the 'principal') at a maturity date, plus interest payments (the 'yield' or 'coupon') at regular intervals between now and then. The bond is a tradeable instrument in its own right, which means that you can buy and sell it during its life, and its value will tend to rise and fall as interest rates change.

Thirty or forty years ago, large companies that wanted to borrow money generally got loans from banks. Then they discovered that they could borrow at a lower rate by raising money directly from the public (and from institutional investors like insurance companies and pension funds), by issuing bonds. This process of disintermediation – cutting out the intermediary (the bank) between the borrower and the lenders – is obviously *not* a good thing for commercial banks. They now have to lend their money to borrowers that are less secure than large corporations.

Companies and financial institutions are given investment ratings, reflecting their financial situation and performance, by ratings companies such as Standard & Poor's and Moody's. The highest rating (AAA or Aaa) is given only to top-quality institutions, with minimal credit risk. Today, only one of these is a bank (Rabobank, in the Netherlands). The only other AAA ratings – and there are very few – belong to large corporations.

On the other hand, companies use investment banks to issue their bonds for them, permitting banks to make money from fees rather than from interest.

1 What are the two main ways in which large companies and corporations raise capital?
2 What might explain why only one bank has a AAA rating?
3 What form of income do banks now get from large companies?

2 **Use a word from each box to make word combinations from the text. You can use some words more than once. Then use some of the word combinations to complete the sentences below.**

credit	date
debt	finance
equity	instruments
financial	payments
interest	performance
investment	rating
maturity	risk
tradeable	situation

1 Bondholders get ___________ ___________ until the bond's ___________ ___________.
2 Because bonds are ___________ ___________ you can sell them at any time, but their price will depend on the company's ___________ ___________ and the level of interest rates.
3 Only companies with hardly any ___________ ___________ get a AAA ___________ ___________.

Vocabulary

You are going to listen to an interview about lending decisions. Before you listen, check your understanding of the words and phrases in the box by matching them with their definitions (1–10).

collateral	credit rating	maturity	portfolio	cost of funds
EBIT	operating cash flow	credit limit	margin	overhead costs

1 the abbreviation for a company's earnings before interest and taxes
2 all the securities and financial assets held by a financial institution or an individual
3 an evaluation of a borrower's ability to pay interest and pay back a loan in the future
4 something of value that secures a loan or other credit; if the borrower cannot repay, the lender can sell it to pay off the loan
5 the date on which a loan must be repaid, or the length of time until this date
6 the difference between the interest rate a lender pays and the rate it charges its borrowers
7 the expenses of operating a business that are not directly related to individual products or services (e.g. electricity, telephones, administrative costs)
8 the maximum amount that a bank will lend to a customer
9 the money generated from a business's normal activities
10 the price (interest rate) that a financial institution must pay for the use of money