INTRODUCTION

Commercial loans are extensions of credit to finance commercial or industrial business activities other than for the acquisition or holding of real estate (although real estate may be used in part to secure such loans). Commercial loans may be secured or unsecured and include equipment financing loans, business lines of credit, and working capital loans. Loans to individuals for business purposes are also categorized as commercial loans.

A number of factors motivate thrift institutions to engage in commercial lending activities. First, commercial loans offer more attractive yields than loans with less credit risk. Second, because many commercial loans are short-term in nature and often contain variable-rate pricing features, commercial lending generally poses less interest-rate risk than residential mortgage loans. Third, commercial lending provides the opportunity to enhance growth and income through the cross-selling of services, particularly to owners and employees of small and medium-sized firms. Fourth, it enables institutions to achieve greater portfolio diversification, which mitigates the cyclical nature of a portfolio dominated by real estate.

The fact that federally chartered savings associations are presently restricted to investing no more than 10% of total assets in commercial loans should not serve to downplay the importance of or lessen the attention given to the commercial lending area by regulators. While many thrifts have been reluctant to use their expanded powers to make commercial loans, many of those that have, in order to compete with commercial banks and gain market share, have provided financing to businesses during the start-up and early growth stages of operation, when the risks are highest. Institutions involved in early-stage financing must recognize the risks and keep them within reasonable bounds. Failure to do so may result in credit losses that outweigh the benefits the institution is attempting to achieve through portfolio diversification.

The thrift industry's cautious move thus far into commercial lending may be due in part also to the lack of expertise in this area and the high cost of acquiring and developing that expertise. For this reason, the quality of the commercial lending staff is an important consideration for the institution contemplating or planning entry into the commercial lending arena and for the regulator in assessing the overall adequacy and effectiveness of an existing commercial lending function. In addition, management (directors and officers) should carefully evaluate the likely credit-risk levels, the potential for profitability, the compatibility of commercial lending with the thrift's overall strategic goals, the necessary staff expertise, and the demand for prudently underwritten commercial loans.

Types of Commercial Lending

Commercial loan terms vary depending on the needs of the borrower and considerations of the institution, such as the life of any pledged collateral and the cash-flow sources of the business. Firms engaged in manufacturing, distribution, retailing, and service-oriented business often use short-term working capital loans.

Seasonal Loans

Seasonal loans provide funds for a firm's seasonal financing needs. Seasonal loans have a self-liquidating feature. They are repaid at the end of the business cycle when the business converts inventory and receivables into cash. Working capital loans are usually secured by inventory and accounts receivable.

Manufacturing firms use such loans to build up their inventories of finished goods in order to meet increasing sales demand. Farmers may use seasonal loans to finance the planting, cultivation, and harvesting of crops.

Seasonal lending is often financed through a revolving line of credit (line). The credit decision is often made well in advance of funding so that funds are available when they are needed. The borrower then obtains advances on the line in order to finance its business activities and pays down the line as inventory and accounts receivable are converted to cash and the debt is liquidated. The process is repeated the next season without the need to apply for a new loan. A prudent lender will often require that the line be paid off completely at least once a year. The lender will also require and monitor periodic financial statements from the borrower in order to determine the creditworthiness of the borrower on an ongoing basis.

Term Loans

Term business loans, granted for the acquisition of capital assets such as plants and equipment, have assumed an increasing importance to businesses. If a business wants to purchase equipment to enhance its operational efficiency, term loans allow the business to finance the purchase over the economic life of the asset and thereby preserve working capital for short-term needs. Term loans, however, often carry greater risks than short-term advances because of the length of time the credit is outstanding.

Although a borrowing company may be financially healthy when the loan is made, it may experience financial difficulties during the loan term. Also, the collateral value could deteriorate over time. (An example of this is the rapid decline in the price of oil in the early 1980s, which had a disastrous effect on oil exploration companies and the value of oil drilling equipment.) Because of the potential for additional risks, term loans are usually secured and require regular amortization payments. Also, loan agreements may contain restrictive covenants during the life of the loan.

Accounts Receivable Financing

Accounts receivable financing is a specialized area of commercial lending in which borrowers assign their interests in accounts receivable to the lender as collateral. Borrowers often include: businesses that, because of rapid growth, need year-round financing in amounts too large to justify unsecured credit; nonseasonal businesses that need year-round financing because working capital and profits are insufficient to permit periodic account cleanups (where the loan is fully repaid); businesses with inadequate working capital for its volume of sales and type of operation; and businesses whose previous unsecured borrowings are no longer warranted because of various credit factors.

Advantages of accounts receivable financing from the borrower's viewpoint include:

- the efficiency in which an expanding operation can be financed because borrowing capacity expands as sales increase;
- the borrower's ability to take advantage of purchase discounts because the company receives immediate cash on its sales and is able to pay trade creditors on a satisfactory basis;
- a revolving, expanding line of credit; and
- actual interest paid may be no more than that for a fixed-amount unsecured loan.

Advantages of accounts receivable financing from the lender's viewpoint are that it:

- generates a relatively high-yield loan, new business, and a depository relationship;
- permits continuing lending relationships with long-standing customers whose financial conditions no longer warrant unsecured credit; and
- minimizes potential loss when the loan amount is tied to a percentage of the accounts receivable collateral.

Although accounts receivable loans are collateralized, it is important to analyze the borrower's financial statements. Even if the collateral is of good quality and in excess of the loan, the borrower must demonstrate financial progress. Full repayment through collateral liquidation is normally a solution of last resort.

Commercial lenders use two basic methods to make accounts receivable advances. The first method is "blanket assignment," where the borrower periodically informs the lender of the amount of receivables outstanding on its books. Based on that information, the lender advances a percentage of the outstanding receivables. (The percentage is generally determined by the institution's lending policies and is specified in the loan agreement.) The receivables are usually pledged on a non-notification basis and payments on receivables are made directly to the borrower who then remits them to the lender. The lender applies all or a portion of such funds to the borrower's loan.

The second method is "ledgering the accounts," where the lender receives duplicate copies of the invoices together with the shipping documents and delivery receipts. Upon receipt of satisfactory information, the lender advances a percentage of the outstanding receivables. The receivables are usually pledged on a notification basis. With this method, the lender maintains complete control of the funds paid on all pledged accounts by requiring the borrower's customer to remit directly to the lender.

In the area of accounts receivable financing, an institution's lending policy should address the minimum level of credit information needed for the loan (such as statements of condition, operating and cash flow statements, and an itemized list of the borrower's real estate holdings). The policy should also address the maintenance of an accounts receivable loan agreement that establishes:

- percentage advance against acceptable receivables,
- a maximum dollar amount due from any one account debtor,
- the disclosure of financial information on debtor accounts,
- criteria for "acceptable receivables" in light of the turnover of pledged receivables,
- the aging of pledged receivables, and
- allowable concentrations of debtor accounts.

Finally, the institution's internal audit department should periodically confirm a sample of accounts receivable amounts with the borrower's customers.

Secured Versus Unsecured Lending

Some lenders make unsecured commercial loans where no specific pledge of collateral is obtained from the borrower. A lender may make unsecured commercial loans if it has determined that the borrower is financially strong, it has a long history of satisfactory credit performance, and if the extension of credit is relatively small in relation to the company's net worth. Unsecured loans are usually made for short-term financing purposes. Periodic financial analysis of the borrower's financial condition is essential to the lending arrangement.

Combination Commercial and Real Estate Loans

Often commercial business loans are secured in part by accounts receivable, inventory, or other commercial property, and in part by commercial real estate. If the loan would only be made under the terms and conditions offered by the lender with the additional real estate collateral, the loan should be categorized as a real estate loan and is subject to the Real Estate Lending Standards rule discussed in Handbook Section 212, Real Estate Mortgage Lending. Often, however, the lender takes a security interest in the commercial real estate solely through an "abundance of caution," meaning that the lender would have granted the loan under essentially the same terms and conditions without the additional real estate collateral. In such cases, the loan can be categorized as a commercial business loan and would not be subject to the Real Estate Lending Standards rule.

Risk Containment

If management decides to implement a commercial lending program, it must formulate, adopt, and implement a sound underwriting policy to guide staff and to ensure prudent risk-taking in relation to the thrift's capital. The degree to which an institution is successful both in competing in the commercial loan market and in properly managing and controlling credit risk will depend to a large extent on the soundness of its lending practices. The best means for achieving sound loan portfolio management are the development and implementation of:

- Comprehensive written policies, procedures, and controls covering all aspects of the lending function; and
- Systems to monitor portfolio quality and adherence to policies and procedures.

Evaluation of a thrift's program and its underwriting policy should center on whether:

- the loans follow the guidelines set forth in the institution's policy,
- the loans meet regulatory requirements, and
- the policy and the loans conform to safe and sound practices.

While each institution operates with its own set of unique characteristics, which necessitates tailoring lending policy and procedures to individual goals, objectives, strategies, strengths, and weaknesses, it should be recognized that all sound loan policies contain certain common elements. These components, and the major sources or causes of problem credits that they are designed to prevent, are outlined and discussed in detail in the Thrift Activities Regulatory Handbook Section 210, Lending Risk Assessment. The elements that make up effective systems of internal loan review are also discussed in that section.

Guidelines on Safe and Sound Administrative Procedures

The following are standards that exemplify critical components of a commercial lending program. The list is not exhaustive but rather focuses attention on key areas. An institution should develop a policy appropriate to its own operations.

Objectives. The policy should state clearly the external and internal goals of the institution's commercial lending function. Examples of the former would include community service and target-market goals. Examples of the latter would include the integration of the commercial lending function into the asset/liability and profit planning strategies of the thrift.

Policy Development. The association's commercial lending policy should address the following elements:

- Types of loans and investments to be made and those to be avoided, based on their high-risk nature or the institution's lack of experience with such loans.
- An explanation of what constitutes acceptable collateral and the means of obtaining liens against such collateral as well as margin values required.
- Policy on obtaining guarantees/endorsements.
- Acceptable parameters with respect to maximum maturities, amortization requirements, and line of credit renewals.
- Procedures for handling loan requests that do not meet articulated policy statements but are deemed worthy of consideration.
- Credit file content requirements, such as loan offering sheets, records of officer, committee and board approvals, financial statements and analysis, and memoranda supporting analysis of the credit.

The policy should not be viewed as static. It should be reviewed periodically to ensure that it reflects current and reasonably anticipated competitive economic and money market conditions. The initiation and revision process should provide for input from lenders and marketing officers; evaluation and modification by senior management; and adoption, after thorough evaluation and analyses, by the board of directors. Consistency of the policy with the institution's strategic business plan is important.

Administration. The board of directors may delegate the underwriting authority but should remain responsible for the overall lending program. The underwriting policy should contain clear lines of authority and responsibility to ensure that it is communicated to and practiced by lending and investment personnel. Corrective action should be taken when the policy is violated.

Lending Authority. Lending and investment authority should be clearly stated in dollar terms for individual officers and for officers working in concert. For example, an individual officer may be authorized to approve or commit to loans and investments up to $50,000. Two officers together each approving the same loan package, may be authorized to approve loans and investments up to $100,000. The policy should also define levels of approval or commitment requiring prior loan committee or board approval.

The board of directors should ratify all significant commercial loans either prospectively or through a subsequent events reporting system. Dollar volume lending limits for a single borrower should be expressed in terms of the total liability of the borrower, not the dollar volume of the credit request under consideration. Loan officers presenting or considering a credit must determine all liabilities owed or likely to be owed (actual and contingent) to the institution. Examples would be other related or indirect loans, overdrafts, lines of credit, and letters of credit.

Loan Committee. The policy should set forth the composition of the loan and investment committee(s), the frequency of meetings, and loan and investment approval responsibilities. Rotational board membership is advisable so that all directors are exposed to the commercial lending process in depth. The loan and investment committee organization should also provide for a regular review of existing problem credits, the identification of problem relationships, and the development of action plans to enforce remedial action.

Pricing the Product. The policy must contain a framework for pricing decisions that takes into account types of credit, competitive market conditions, quality of the credit, liquidity of the collateral, availability of loanable or investable funds, compensating deposit balances, and the potential for or advisability of cross marketing other institution services.

Credit Underwriting Criteria

As discussed more fully in Section 212, Real Estate Mortgage Lending, the agencies have issued a proposed safety and soundness regulation that prescribes standards relating to credit underwriting. While these proposed standards offer a useful guide for examiners to assess an institution's credit underwriting policies, the application of sound underwriting principles to the lending process can also be considered within the framework of the five "C's" of credit: character, capacity, collateral, capital, and conditions.

Character: A positive assessment of the borrower's character is essential to the approval of any loan. The quality of character, however, is a particularly important credit consideration in the context of small business lending because, as a measure of the borrower's willingness and commitment to honor his or her financial obligations, it may help to compensate for weaknesses in other areas such as capital. The borrower's payment record on existing and previous loans with the institution and his or her credit history with other lenders provide evidence of the quality of the borrower's character that should be documented in the loan file. The borrower's reputation in his or her business or industry and in the community are also relevant to the assessment of character.

Capacity: The capacity to successfully operate the business and to repay debt are critical considerations. It is important that the lender have a clear understanding of the purpose of the loans and the source of repayment so that the terms of the loan can be structured in a way that is consistent with realistic prospects of repayment. Indications of either inadequate or questionable capacity to repay the debt are key factors that will affect a regulator's decision to adversely classify a loan.

The loan file should contain sufficient information on the borrower's financial condition, income, liquidity, current and projected cash flows, contingent liabilities, and other relevant factors to demonstrate the financial capacity of the business and, secondarily, any guarantors, to repay the loan. Insight into the financial capacity of the borrower may also be obtained by contacting trade groups and businesses with which the borrower does business, and through an analysis of deposit account relationships and tax returns. The accuracy of information on financial statements provided by the borrower and any guarantors should be confirmed by the lender.

In business start-up situations, the lender should obtain sales and profit projections and periodically compare actual operating performance against those projections.

In addition to financial capacity, savings associations should also assess the managerial capacity of the borrower. Management experience, knowledge, and past accomplishments in the borrower's particular business or industry are important considerations that should be reflected in the borrower's file.

Collateral: Although collateral will normally be a secondary source of repayment, for small business loans it may be an indispensable credit factor to support the decision to make the loan. When collateral is necessary to support the prudent underwriting of a loan, the agencies expect that the credit file will reflect an accurate valuation and contain documentation that reflects a perfected security interest and, where appropriate, hazard insurance. When loans are secured by a business' accounts receivable or inventory, the credit file should include documentation that appropriate controls have been established to protect the lender's interests. For example, the lender should periodically verify the existence and value of the receivables and obtain and confirm reports on the aging of the receivables. For inventory financing, lenders should establish requirements to curtail portions of loans collateralized with outdated or unsaleable inventory.

In some situations, however, collateral may not be critical to the credit decision and may have been taken primarily through an abundance of caution, or to ensure that it is not later pledged to another lender. In such cases, the agencies believe that it is appropriate to balance the cost of valuing and monitoring the collateral against its importance in the credit decision. For example, regulators should not be critical of a lender's decision to forego the expense of a formal appraisal if, through an abundance of caution, a mortgage is taken on the real estate.

Capital: Borrowers should demonstrate that they have sufficient capital and cash flow to withstand economic downturns. Many small businesses, however, are relatively thinly capitalized and illiquid and do not have access to external sources of capital. Very often, the small business must rely on bank or thrift borrowings, secured by equity in business assets or the personal assets of the business owner, to finance growth or to assist the business through a difficult period. Savings associations are encouraged to find ways to accommodate the credit needs of small businesses in their communities without exposing themselves to unwarranted credit risk.

Conditions: The economic environment and the market in which a business is competing are key factors that will contribute to the success or failure of a business. The credit analysis supporting loans to small businesses should reflect a consideration of these external factors, including, for example, the market for the products of the business, the customer base, the level of competition, any competitive advantage or disadvantage the business may have, and the likely effect of national and local economic conditions on the success of the business.

Loan Analysis. Commercial lending and attendant credit analysis should focus on the borrower's ability to repay through cash flow generated in the normal course of the creditor's business operations. Seasonal/working capital lines should be analyzed to determine the ability to repay through conversion of current assets to cash in the normal operating cycle of the business. Term credit analysis should evaluate the ability to repay through cash flow generation (profits adjusted for non-cash expenses). Such analysis should be based on current and complete financial data such as comparative balance sheets, detailed income and expense data, and statements of the sources and uses of funds between fiscal periods. Supplementary interim financial statements may be useful but should never be the sole basis for a credit decision. These statements can be flawed due to the use of estimates and timing differences in recognizing transactions that can materially distort reported results. Statements, once procured, should be periodically reviewed and updated as necessary, even after the loan has been granted. If the primary source of repayment is gone, the loan should be considered as possessing a well-defined weakness. See Section 260, Classification of Assets, for additional information.

The importance of collateral positions, endorser/guarantor support, and other such factors used to improve the credit position should not be minimized. Collateral liquidation, however, is a last resort for repayment, not a primary factor to be relied upon in the decision to extend credit. The maturity and amortization terms of a loan should be negotiated in relation to the useful life of the asset being financed, taking into account both physical usefulness and the likelihood of technological obsolescence.

Specialized asset-based financing for items such as supervised accounts receivable or inventory lending and factoring to relatively undercapitalized firms is appropriate only for institutions willing to invest in the specialized lending staff and operational procedures necessary to police such high-risk credits.

Participation Credits. There is no inherent objection to investing in commercial credits through the vehicle of participation loans. The association, however, may not transfer the responsibility for risk analysis to the lead institution. Each participating institution is responsible for arriving at its own credit decision based on adequate credit information. Inability to obtain sufficient data from the lead lender to properly evaluate the credit mandates that the credit participation be denied. Please refer to the discussions in Handbook Section 211, Loan Portfolio Diversification and Section 212, Real Estate Mortgage Lending, for additional guidance on participations.

Follow-up of Credit Relationships. Risk controls are critical at the outset of the relationship. Careful follow-up of the relationship is also necessary to ascertain the borrower's current and ongoing financial condition. Collateral inspection, calls on customers, inspection of business premises, trade checks, and the obtaining and evaluation of interim financial statements are standard follow-up techniques. Term loan contract provisions should be carefully monitored to determine departures from agreements with the thrift since any such departures may signal a developing problem, a potential default, or a compromise of the thrift's position with respect to funds owed or collateral pledged.

Outside Support. Institutions should take advantage of outside support systems and educational opportunities to develop and enhance lending and investment expertise.

Experienced and competent legal assistance is particularly important in developing a commercial lending function. Properly executed legal documentation is critical in establishing and maintaining collateral liens, endorser/guarantor liability, and in working out problem credits through restructuring, liquidation, or rehabilitation of the credit.

Marketing Risk Assumption. Associations entering the commercial lending field must be careful to maintain credit quality while developing loan volume. A prudent lender will not approve a credit that is not fully understood. Lenders must be comfortable with the business, source of repayment, value and lien status of collateral, quality and character of management, and any other critical factor bearing upon evaluation of the credit.

Lending to Small Businesses

On March 30, 1993, in response to the concerns about the availability of credit to small business borrowers, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, and the Federal Reserve Board (the agencies) issued the "Interagency Policy Statement on Documentation for Loans to Small- and Medium-sized Businesses and Farms." The agencies issued this policy statement to confirm their support for lending to small businesses on a sound basis and to clarify their expectations as to appropriate minimum standards for analyzing and documenting such loans.

Because of resource and other practical constraints, the financial information and business plans and projections supporting loans to small-business borrowers will often be less extensive and less detailed than would ordinarily be provided by big-business borrowers. The agencies recognize that, in the absence of audited financial statements and sophisticated business plans, prudent underwriting decisions can still be made based on more limited, but reliable, financial data when that information is combined with the lender's personal knowledge and past experience with the borrower and his or her business. The guiding principle that the agencies will follow in the evaluation of the loan underwriting and loan administration practices of financial institutions with respect to small-business lending will continue to be that each institution should maintain documentation that provides its management with the ability to:

- Make an informed lending decision and to assess risk as necessary on an ongoing basis;
- Identify the purpose of the loan and the source of repayment;
- Assess the ability of the borrower to repay the indebtedness in a timely manner;
- Ensure that a claim against the borrower is legally enforceable; and
- Demonstrate appropriate monitoring of the loan.

Review of Loans to Small-Business Borrowers

The agencies' examination review policy is that regulators are to primarily determine if the institution's policies, practices, procedures, and internal controls are adequate and to determine if lending personnel are operating within established policy.

Regulators routinely evaluate and test policies and procedures to determine whether they are adequate to ensure that the institution maintains adequate financial information on the borrower and a perfected security interest in pledged collateral (if the collateral is an integral part of the lending decision). Regulators should also evaluate the institution's procedures for ensuring that collateral valuations are performed in a timely manner. An excess volume of credit or collateral exceptions may subject the institution's loan administration practices to criticism.

When evaluating loans to small-business borrowers, regulators should apply the standard interagency classification definitions. Institutions are strongly encouraged to document credit files for small-business borrowers as completely as possible. The performance of the loan in accordance with reasonable terms, however, will be the primary consideration in evaluating small-business loans. Regulators should not automatically conclude that minor inadequacies in written loan documentation are indicative of loan weaknesses that warrant adverse classification. A regulator's analysis should focus on the borrower's ability to repay the loan (through cash flows generated by the normal course of business operations), rather than on documentation in the loan file.

In determining the appropriate rating for a loan, regulators should give consideration to all relevant information on repayment prospects, including qualitative assessments by the loan officer based on his or her knowledge of and prior experience with the borrower.

The March 30, 1993, joint policy statement also addressed a special policy for the documentation of small- and medium-sized business and farm loans. Under that policy statement and Thrift Bulletin (TB) 61 (issued on September 8, 1993), well-managed, well- or adequately capitalized institutions are allowed to establish a "basket" of small- and medium-sized business and farm loans that will not be subject to examiner criticism based on documentation. Under the proposed safety and soundness regulations, the interagency policy statement would continue to apply.

In an effort to make the loan documentation requirements for banks and thrifts consistent, the OTS amended its loan documentation regulation at 12 CFR § 563.170(c)(1) through (7) to conform to the interagency policy statement.

REFERENCES

United States Code (12 USC)

§ 1464(c)	Investment Authority

Code of Federal Regulations (12 CFR)

Subchapter C: Regulations for Federal Savings Associations

§ 541.5	Commercial Paper
§ 541.20	Loans
§ 545.12	Demand Deposit Accounts
§ 545.31	Election Regarding Classification of Loans or Investments
§ 545.46	Commercial Loans
§ 545.48	Letters of Credit
§ 545.50(c)	Consumer Loans
§ 545.53	Finance Leasing
§ 545.74	Service Corporations
§ 545.78	Leasing

Subchapter D: Regulations Applicable to All Savings Associations

§ 563.43	Loans to Affiliated Persons
§ 563.93	Loans to One Borrower
§ 563.160	Classification of Certain Assets
§ 563.170	Establishment and Maintenance of Records

Office of Thrift Supervision Bulletin

TB 61	Interagency Policy Statement on Documentation for Loans to Small- and Medium-Sized Businesses and Farms

Other References

Interagency Policy Statement on Documentation for Loans to Small and Medium-Sized Businesses and Farms

Uniform Commercial Code - Section 9, Secured Transactions