# Introduction

Commercial loans are extensions of credit to finance commercial or industrial business activities. OTS generally separates commercial lending into commercial (or nonresidential) real estate lending and other commercial (non real estate) lending. Commercial loans may be extended on a secured or unsecured basis with a wide range of purposes, terms, and maturities. While the types of commercial loans can vary widely, the following types comprise most commercial lending at saving associations:

- Working capital or seasonal loans
- Term business loans
- Agricultural loans
- Loans to individuals for business purposes

Making commercial loans provides the following benefits:

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- Necessary financing for community development and stability.
- Cross-selling opportunities for savings associations to offer other financial services to business owners and their employees.
- Higher yields than loans having similar terms but less credit risk.
- Potentially less interest-rate risk than residential mortgage loans because many commercial loans are short-term in nature and often contain variable-rate pricing features.
- May provide greater portfolio diversification. This helps to mitigate the cyclical nature of a portfolio dominated by one loan type or a single systemic risk factor, such as residential real estate.

Commercial lending can be profitable and allow savings associations to diversify their portfolio while serving the needs of their customers and communities.

While commercial lending can be profitable and provide many benefits, it is not without risks. Any potential regulatory concerns about commercial lending is usually due to loan size, concentration risk, the required expertise needed to safely and profitably operate a commercial lending operation, and the time and cost of acquiring and developing such expertise. The quality and experience of the commercial lending staff is an important consideration for an institution contemplating or planning entry into

commercial lending. You must assess the overall adequacy and effectiveness of an existing commercial lending function. In addition, management of the institution should carefully evaluate the following factors:

- Credit-risk levels
- Potential for profitability
- Compatibility of commercial lending with the association's overall strategic goals
- Necessary staff expertise
- Market competition and demand for profitable and prudently underwritten commercial loans

## REGULATORY LIMITS

Federally chartered savings associations are subject to an investment limit of 20 percent of assets in commercial loans if the institution invests at least 10 percent of assets in loans to small businesses. See the following discussion on lending to small businesses.

OTS does not require an association to aggregate commercial loans held by its service corporation with its own commercial loans in calculating compliance with the investment limit. If, however, the savings association assumes recourse, guarantees, or otherwise obligates itself in connection with the service corporation's outside funding of its commercial lending activities, then it must include the amount in its commercial lending limit. OTS continues to limit a federal thrift's investments in service corporations to a maximum of three percent of assets.

Federal savings associations may make loans secured by nonresidential real estate, which includes commercial real estate, in amounts up to 400 percent of capital. Pursuant to § 541.23, loans secured by a combination of farm residences and farmland are residential real estate and, thus, are not subject to the 400 percent limit.

Finally, the Home Owners' Loan Act (HOLA) allows federal savings associations to hold loans fully guaranteed by a federal government agency without investment restrictions. When a savings association originates or invests in loans guaranteed by the Economic Development Administration (EDA), the Small Business Administration (SBA), or the Farmers Home Administration (FmHA), only the unguaranteed portions of those loans count against the commercial lending limits.

Commercial Lending Limits

| Loans secured by business or agricultural real estate | 400% of capital |
| --- | --- |
| Guaranteed portion of EDA, SBA, and FmHA loans | No limit |
| Other commercial loans | 20% of assets provided at least 10% of assets are to small businesses. |

## RISK MANAGEMENT

Savings associations with a commercial lending program must formulate, adopt, and implement a sound underwriting policy to guide staff and to ensure that it properly identifies, measures, monitors, and controls its commercial lending risks. The degree to which an association is successful both in competing in the commercial loan market and in properly managing and controlling credit risk depends mainly on the soundness of its lending practices. The association can best achieve sound loan portfolio management by developing and implementing both of the following:

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

Your evaluation of a savings association's program and its underwriting policies should center on whether the following conditions exist:

- The loans follow the association's policy guidelines.
- The loans meet regulatory requirements and adhere to OTS and applicable interagency guidelines.
- The policy and the loans conform to safe and sound practices.
- Concentration risks are identified, monitored, and controlled.

Each savings association operates with its own set of unique characteristics, tailoring lending policy and procedures to its goals, objectives, strategies, strengths, and weaknesses. You should recognize that all sound loan policies contain certain common elements. Examination Handbook Section 201, Lending Overview, outlines and discusses these elements, and some of the major risk factors of problem credits. This section also discusses effective systems of internal loan review.

## Safe and Sound Administrative Procedures

The following standards exemplify essential components of a commercial lending program. The list is not exhaustive, but rather focuses attention on key areas. A savings association should develop a policy appropriate to its own operations.

### Objectives

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

### Policy Development

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

- Types of loans and investments to make and those to avoid based on their high-risk nature or the association'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 assessing and obtaining guarantees and endorsements.
- Acceptable limits considering maximum maturities, amortization requirements, and line-of-credit renewals.
- Procedures for handling loan requests that do not meet articulated policy statements but are worthy of consideration.
- Credit file content requirements, such as:
  - Loan offering sheets
  - Records of officer, committee, and board approvals
  - Business and guarantor credit reports
  - Financial statements and analysis
  - Memoranda supporting analysis of the credit.

An association should not view its policy as static. Management should review the policy periodically to ensure that the policy reflects current and reasonably anticipated competitive economic and market

conditions. The review 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 association's strategic business plan is important.

### Administration

The board of directors may delegate the underwriting authority, but remain responsible for the overall lending program. The underwriting policy should contain clear lines of authority and responsibility. The savings association must maintain experienced and properly trained lending and investment personnel, communicate underwriting and lending policies to them, and ensure that staff follows established policies. The savings association should take corrective action when personnel violate the approved policy.

### Lending Authority

The policy, or an appendix of the policy, should clearly state in dollar terms lending and investment for individual officers and for officers working in concert. The policy should also define levels of approval or commitment requiring prior loan committee or board approval.

As a general rule, the higher the dollar amount of the loan or the greater the credit risk, the higher the level of approval should be. The board of directors should review and approve any loan large enough to adversely affect the association should the borrower default.

The board of directors should ratify all significant commercial loans either prospectively or through a subsequent events reporting system. The policy should express maximum dollar-volume lending limits for a single borrower as the total liability of the borrower, not the dollar volume of the credit requested. Loan officers presenting or considering a credit must determine all liabilities the borrower owes or likely will owe (actual and contingent) to the association or other creditors. 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 committee, the frequency of meetings, and loan approval responsibilities. Rotational board membership is advisable so that all directors receive exposure to the commercial lending process in depth. The loan committee should also arrange for regular reviews of existing problem credits, identification of problem relationships, and plans to enforce remedial action.

### Pricing the Product

The policy must contain a framework for pricing decisions that takes into account types of credits and their relative risks, competitive market conditions, quality of the credit and liquidity of the collateral. Pricing decisions should also rely on availability of funds, compensating deposit balances, and the potential for, or advisability of, cross-marketing other association services.

## Loan Analysis

A savings association should focus its commercial lending and attendant credit analysis on the borrower's ability to repay through cash flow generated in the normal course of the borrower's business operations. The association should analyze seasonal or working capital lines to determine the borrower's ability to repay through conversion of current assets to cash in the normal operating cycle of the business. The association's term credit analysis should evaluate the ability to repay through cash flow generation (profits adjusted for noncash expenses). The association should base such analysis 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. Estimates and timing differences in recognizing transactions can materially distort reported results. Savings associations should periodically review financial statements and update them as necessary, even after it grants the loan. If the primary source of repayment is gone, the association should consider the loan to possess a well-defined weakness. See Section 260, Classification of Assets, for additional information.

Saving associations should not minimize the importance of collateral positions, endorser or guarantor support, and similar circumstances that improve the borrower's credit position. Collateral liquidation, however, is a last resort for repayment, not a primary factor the savings association should rely upon when making the decision to extend credit. The association should negotiate the maturity and amortization terms of a loan in relation to the useful life of the asset being financed. The association should take into account both physical and economic usefulness, and the likelihood of technological obsolescence.

Asset-based financing for items such as supervised accounts receivable or inventory lending and factoring to relatively undercapitalized firms should be undertaken with caution. Such activity is only suitable for associations willing to invest in the special lending staff and operational procedures necessary to monitor and manage such credits.

## Documentation

OTS strongly encourages institutions to document credit files as completely as possible, given the size and complexity of the loan. 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 required for large complex loans and those to large businesses.

OTS recognizes that many small businesses do not have audited financial statements and sophisticated business plans; however, savings associations can still make prudent underwriting decisions based on more limited, but reliable, financial data. Good credit decisions are possible, especially when the savings association evaluates that information along with their personal knowledge and experience with the borrower and his or her business. Each institution should maintain documentation that provides management with the ability to accomplish the following:

- 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 based on cash flow analysis and financial strength of the obligor.
- Ensure that a claim against the borrower is legally enforceable.
- Demonstrate appropriate monitoring of the loan.
- Ensure adequate collateral, valuation methodology, and lien status.

## Participation Credits

Savings associations can diversify their lending operations by buying participating interests in loans originated by other lenders. While there are no additional risks inherent in commercial loan participations, the association 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 institution not participate in the credit. Please refer to the discussions in Handbook Section 201, Lending Overview, for additional guidance on participation loans.

## Follow-up of Credit Relationships

Risk controls are critical at the outset of a relationship between a savings association and its borrower. Careful follow-up of the relationship is also necessary to ascertain the borrower's current and ongoing financial condition. Standard follow-up techniques include:

- Collateral inspection
- Calls on customers
- Inspection of business premises
- Trade checks
- Obtaining and evaluating borrower interim financial statements.

The association should carefully monitor term loan contract provisions to determine departures from agreements by the borrower. Any such departures may signal a developing problem, a potential default, or a compromise of the association's position regarding funds owed or collateral pledged.

### Outside Support

Associations 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 or 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. Prudent lenders will not approve credits that they do not fully understand. Associations 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.

## LOAN PORTFOLIO MANAGEMENT

Effective management of the loan portfolio and the credit function is fundamental to the savings association's safety and soundness. Loan portfolio management (LPM) is the process by which risks that are inherent in the credit process are managed and controlled. To manage their portfolios, bankers must understand not only the risk posed by each credit but also how the risks of individual loans and portfolios are interrelated. These interrelationships can multiply risk many times beyond what it would be if the risks were not related. Practices such as viewing the loan portfolio in its segments and as a whole, as well as considering the relationships among portfolio segments and among loans, provide a more complete picture of the institution's credit risk profile and more tools to analyze and control the risk.

A primary objective of loan portfolio management is to control the strategic risk associated with a financial institution's lending activities. Nine elements exist that should be part of the loan portfolio management process. These elements complement fundamental credit risk management principles as sound underwriting, comprehensive financial analysis, adequate appraisal techniques and loan documentation practices, and sound internal controls. The nine elements are detailed below.

- Assessment of the credit culture
- Portfolio objectives and risk tolerance limits
- Management information systems
- Portfolio segmentation and risk diversification objectives
- Analysis of loans originated by other lenders

- Aggregate policy and underwriting exception systems
- Stress testing portfolios
- Independent and effective control functions
- Analysis of portfolio risk/reward tradeoffs

## CREDIT RISK

For many saving associations, loans are the largest and most obvious source of credit risk. The risk of repayment, i.e., the possibility that an obligor will fail to perform as agreed, is either lessened or increased by the institution's credit risk management practices. The first defense against excessive credit risk is the initial credit-granting process, which includes sound underwriting standards, an efficient and balanced loan approval process, and a competent lending staff. Management of credit risk, however, must continue after a loan has been made, for sound initial credit decisions can be undermined by improper loan structuring or inadequate monitoring.

## LOAN APPROVAL PROCESS AND UNDERWRITING STANDARDS

An effective loan approval process establishes minimum requirements for the information and analysis upon which a credit decision is based. It provides guidance on the documents needed to approve new credit, renew credit, increase credit to existing borrowers, and change terms in previously approved credits. Generally, underwriting document standards should include the following items.

- Financial information including:
  - — Current and historical balance sheet and income data, normally this data is spread using software for analysis purposes and trend comparisons
  - — Balance sheet, income, and cash flow projections
  - — Comparative industry data as appropriate
- Financial analysis, including repayment capacity
- Collateral identification and valuation
- Guarantor support and related financial information
- Summary of borrower and affiliated credit relationships
- Loan Terms, including tenor and repayment structure

- Pricing information, including relationship profitability data
- Covenants and requirements for future submission of financial data
- Exceptions to policy and underwriting guidelines and mitigants
- Information fields to capture data for concentration reporting, identifying Shared National Credits (SNCs), etc.
- Risk rating or recommended risk rating

The loan approval process also includes who has the authority to approve credit or changes in credit terms. Loan authorities should be commensurate with the experience of the lender/credit officer and take into consideration the type of credit, the amount of the credit, and the level of risk involved.

## Managing Credit Concentration Risk

A credit risk concentration is any single credit exposure or group of exposures that could produce losses large enough, relative to an association's capital and earnings, to threaten its health, liquidity, or ability to maintain its operations.

There are several statutory and regulatory investment limits that serve to reduce certain concentration risk in savings associations. As noted above, HOLA limits savings association's investment in commercial loans to 20 percent of assets. Moreover, 12 CFR 560.93 limits, with some exceptions, an association's aggregate loans-to-one borrower to 15 percent of its unimpaired capital and unimpaired surplus. See Examination Handbook Section 211, Loans to One Borrower.

Credit risk concentrations, by their nature, are based on common or connected risk factors that could adversely affect the creditworthiness of borrowers that may not be linked for loans-to-one borrower purposes, but that still may be subject to a common economic event. Concentration risk arises in both direct exposures to economically linked borrowers and may also occur through guarantors or third party insurers.

Savings associations should maintain effective internal policies, systems and controls to identify, measure, monitor, and control their credit risk concentrations. Associations should also assess the extent of their credit risk concentrations in their assessment of capital adequacy. These policies should cover the different forms of credit risk concentrations to which the association is exposed. Such concentrations include:

- Significant exposure to an individual counterparty or group of related counterparties. In many jurisdictions, supervisors define a limit for exposures of this nature, commonly referred to as a large exposure limit. Associations might also establish an aggregate limit for the management and control of all of its large exposures as a group.
- Credit exposures to counterparties in the same economic sector or geographic region.

- Credit exposures to counterparties whose financial performance is dependent on the same activity or commodity.
- Indirect credit exposures arising from an association's CRM activities (e.g., exposure to a single collateral type or to credit protection provided by a single counterparty).

A savings association should clearly document its policies and procedures for managing credit risk concentrations, define concentrations relevant to the association, and document how it calculates these concentrations and their corresponding limits. Management should define such limits in relation to the association's capital, total assets, and its overall risk level.

Management should conduct periodic stress tests of its major credit risk concentrations and review the results of those tests to identify and respond to potential changes in market conditions that could adversely impact the bank's performance.

In the course of examinations and off-site monitoring, you should assess the extent of an association's credit risk concentrations, how they are managed, and the extent to which they are properly evaluated in relation to the adequacy of the association's capital. When concentration risk is significant, the association should consider performing stress tests. Supervisors should take appropriate actions when the association does not adequately address the risks arising from its credit risk concentrations.

## TYPES OF COMMERCIAL LENDING

Commercial loan terms vary depending on the needs of the borrower and considerations of the savings association, such as the economic life of any pledged collateral and the cash flow sources of the business. Below is a discussion of some common types of commercial loans.

## LENDING TO SMALL BUSINESSES

For purposes of the regulatory limitations, OTS defines small business loans as:

- Any loan to a farm or business that meets the Small Business Administration (SBA) definition of a small farm or business, or
- Any business loan for $2,000,000 or less or any farm loan of $500,000 or less.

The federal banking agencies support lending to small business borrowers. See the *Interagency Policy Statement on Documentation for Loans to Small- and Medium-Sized Businesses and Farms*, which clarifies the expectations as to appropriate minimum standards for analyzing and documenting such loans.

### Review of Loans to Small-Business Borrowers

You should determine if the institution's policies, practices, procedures, and internal controls for its commercial lending activities are adequate and determine if lending personnel are knowledgeable,

experienced, and operating within established policy. You should also evaluate and test policies and procedures to ensure that the institution maintains the following standards:

- Adequate financial information on and credit evaluation of the borrower. Please see the "Loan Approval Process and Underwriting Standards" section of this handbook for further information on underwriting document standards.

- Perfected security interest in and adequacy of pledged collateral when the collateral is an integral part of the lending decision.

You should also evaluate the institution's procedures for ensuring that they perform collateral valuations promptly. An excess volume of credit collateral exceptions may indicate poor loan administration practices, which should be properly addressed during the examination process.

When evaluating loans to small-business borrowers, you should apply the standard interagency classification definitions. See Examination Handbook Section 260. The performance of the loan according to reasonable terms is the primary consideration in evaluating small-dollar commercial loans. For example, you should not automatically conclude that minor inadequacies in loan documentation indicate loan weaknesses that warrant adverse classification. Your analysis should focus primarily on the borrower's ability to repay the loan (through cash flows generated by the normal course of business operations) and secondarily through the quality and composition of the collateral.

In determining the appropriate rating for a loan, you should consider all relevant information on repayment history and prospects. This can include qualitative assessments by the loan officer based on his or her knowledge of and prior experience with the borrower.

## Start-up and Business Acquisition Loans

Many savings associations provide financing to businesses during their start-up and early growth stages of operation, when the risks are highest. Advantages of such early-stage financing is that it provides funding for much needed community development, results in higher yields, and because of the relatively small size of the loans, provides diversification among many borrowers. Associations involved in such lending must recognize the risks involved with such lending and control them. Typical risks may include:

- The high rate of start-up business failures.

- Inadequate borrower experience with the business.

- Inadequate available business documentation.

- Inadequate business liquidity and capital.

- Inadequate or overly-optimistic business plans.

Failure to identify, monitor, and manage such risks could result in credit losses that outweigh the benefits of higher yields or portfolio diversification. Savings associations should maintain sound policies and procedures over such lending, have experienced staff, and ensure continued risk management for its start-up and acquisition lending.

## Leveraged Lending

Leveraged lending is a type of corporate finance used for mergers and acquisitions, business recapitalization and refinancing, equity buyouts, and business or product line build-outs and expansions. It is used to increase shareholder returns and to monetize perceived "enterprise value" or other intangibles. In this type of transaction, debt is commonly used as an alternative to equity when financing business expansions and acquisitions.

Although leveraged financing is more prevalent in large banks, it can be found in financial institutions of all sizes. Large banks increasingly follow an "originate-to-distribute" model with respect to large loans. This model, whereby a savings association, bank or group of banks arrange, underwrite, and then market all or some portion of the loan facilities to third-party investors, allows the financial institutions to earn fees while limiting their overall exposure to the borrower. Smaller financial institutions can participate in the leveraged loan market by either purchasing participations in these large corporate loans or by making direct extensions to smaller companies.

Leveraged transactions, in general, are characterized by a high level of debt, increased volatility of corporate earnings and cash flow, and limited avenues of secondary support. Additionally, a leveraged loan is a transaction where the borrower's post-financing leverage, when measured by debt-to-assets, debt-to-equity, cash flow-to-total debt, or other such standards unique to particular industries, significantly exceeds industry norms for leverage.

### *Policies on Purchasing Participations in Leveraged Loans*

Savings associations purchasing participations and assignments in leveraged loan arrangements must make a thorough, independent evaluation of the transaction and the risks involved before committing any funds. They should apply the same standards of prudence, credit assessment and approval criteria, and "in-house" limits that would be employed if the purchasing organization were originating the loan. At a minimum, policies should include the following requirements:

- Obtaining and independently analyzing full credit information both before the participation is purchased and on a timely basis thereafter.
- Obtaining from the lead lender copies of all executed and proposed loan documents, legal opinions, title insurance policies, UCC searches, and other relevant documents.
- Carefully monitoring the borrower's performance throughout the life of the loan.
- Establishing appropriate risk management guidelines.

### *Internal Reviews on Leveraged Credits*

Savings associations engaged in leveraged finance need to ensure that their internal review function is appropriately staffed to provide timely and independent assessments of leveraged credits. Reviews should evaluate risk rating integrity, valuation methodologies, and the quality of risk management. Because of the volatile nature of this type of lending, portfolio reviews should be conducted on at least an annual basis. For many institutions, the risk characteristics of the leveraged portfolio, such as high reliance on enterprise value, concentrations, and adverse risk rating trends or portfolio performance, will warrant more frequent reviews. See interagency policy statement on leveraged lending.

## Working Capital and Seasonal Loans

Firms engaged in manufacturing, distribution, retailing, and service-oriented businesses often use short-term working capital and seasonal loans for temporary capital in excess of normal needs. Additionally, these loans provide businesses with short-term financing for inventory, receivables, the purchase of supplies, or other operating needs during the business cycle. These loans are often appropriate for businesses that experience seasonal or short-term peaks in current assets and current liabilities. Such loans have a self-liquidating feature, as businesses repay these loans at the end of the cycle when the business converts inventory and receivables into cash. Inventory and accounts receivable generally secure these loans.

Manufacturing firms use such loans to build up their inventories of finished goods to meet increasing sales demand. Retailers that rely heavily on a holiday season for sales or manufacturers that specialize in summer clothing are other examples that may use such loans. Farmers, also, may use seasonal loans to finance the planting, cultivation, and harvesting of crops.

These types of loans are often structured in the form of an advised line of credit or a revolving credit. An advised revocable line of credit is a revocable commitment by the financial institution to lend funds up to a specified period of time, usually one year. Lines of credit are generally reviewed annually by the lender, do not have a fixed repayment schedule, and may not require fees or compensating balances. In the case of unadvised lines of credit, the financial institution has more control over advances and may terminate the facility at any time, depending on state law or legal precedents. A revolving credit is valid for a stated period of time and does not have a fixed repayment schedule, but usually it has a required fee. The lender has less control over a revolving credit since there is an embedded guarantee to make advances within the prescribed limits of the loan agreement. The borrower may receive periodic advances under the line of credit or the revolving credit. Repayment of the loans is generally accomplished through the conversion or turnover of short-term assets. Interest payments are usually paid throughout the term of the loan, such as monthly or quarterly.

The structure of working capital and seasonal loans can vary, but they should be closely tied to the timing of the conversion of the financed assets. In most cases, the credit facilities are renewable at maturity, are for a one-year term, and include a clean-up requirement for a period sometime during the low point or contraction phase of the business cycle. The clean-up period is a specified period (usually 30 days) during the term of the loan in which the borrower is required to pay off the loan. Although

this requirement is becoming less common, it may provide the lender with an indication that the borrower is not dependent on the lender for permanent financing.

A monthly or quarterly review of a company's balance sheet and income statements are helpful in the analysis of the borrower and these particular loans. The analysis should focus on accounts receivable, accounts payable and inventory turnover. Additionally, the financial statements can be used to identify the peak and contraction phases of the business cycle for the company, and the loan should be structured accordingly. The lender's primary objective is to determine whether the advances are being used for the intended purposes (inventories or payables) and not for the acquisition of fixed assets or payments on other debts.

### Term Business Loans

Term business loans, granted for the acquisition of capital assets such as plants and equipment, have assumed increasing importance. If a business wants to buy equipment to enhance its operational efficiency, term loans allow the business to finance the purchase over the economic life of the asset. This preserves working capital for short term needs. Term loans, because of the length of time the credit is extended, may carry greater risks than short term advances.

Term business loans are generally granted at a fixed or variable rate of interest and have a maturity date in excess of one year. They are intended to provide an organization with the funds needed to acquire long-term assets, such as physical plants and equipment, or finance the residual balance on lines of credit or long-term working capital. Term loans are repaid through the business's cash flow, according to a fixed-amortization schedule, which can vary based on the cash-flow expectations of the underlying asset financed or the anticipated profitability or cash flow of the business.

In most cases, the terms of these loans are detailed in formal loan agreements with affirmative and negative loan covenants that place certain conditions on the borrower throughout the term of the loan. Generally, loan agreements substantially enhance a borrower/banker relationship because they encourage and promote more frequent communication between the parties. In affirmative covenants, the borrower pledges to fulfill certain requirements, such as maintain adequate insurance coverage, make timely loan repayments, or ensure the financial stability of the business. Negative or restrictive covenants prohibit or require the borrower to refrain from certain practices, such as selling or transferring assets, defaulting, falling below a minimum debt-to-equity ratio, or taking any action that may diminish the value of the collateral or impair the collectability of the loan. Covenants should not be written so restrictively that the borrower is constantly in default over trivial issues; however, violations should be dealt with immediately to give credibility to the agreement. Violations of these covenants can often result in acceleration of the debt maturity. A formal loan agreement is most often associated with longer-term loans. If a formal agreement does not exist, the term loans should be written with shorter maturities and balloon payments to allow more frequent review by the lender.

Although a borrowing company may be financially healthy when the savings association makes the loan, the business may experience financial difficulties during the term of the loan. In addition, the collateral value usually deteriorates over time. Many types of business equipment retain very little of their original values if liquidated. Because of their additional risks, lenders generally structure term loans

as secured loans and require regular amortization payments. (See Appendix A, Security Interests Under Article 9 of the UCC, for more information about secured loans.)

Because a term loan is repaid from excess cash flow, the long-term viability of the business is critical in determining the overall quality of the credit. In evaluating long-term earnings, the examiner must develop a fundamental understanding of the company's industry and competitive position in the marketplace. Most of the analysis will be conducted based on the historical performance of the business and its history of making payments on its debt. Any historical record of inconsistencies or inability to perform on existing debt should prompt an in-depth review to determine the ability of the borrower to meet the loan's contractual agreements.

## Asset-Based Lending

Asset-based lending (ABL) is a borrowing relationship in which lenders closely control credit availability and collateral. Additionally, lenders use a borrowing-base formula (derived by multiplying the value of eligible collateral by an advance rate or discount factor), control cash receipts, and carry out field audits. Borrowers often require daily loan advances to operate their businesses and lenders make daily adjustments to the available credit. Collateral consists predominantly of accounts receivable and inventory. Because greater emphasis is on collateral (than in cash flow lending), ABL is structured so that collateral will be readily available if the loan must be liquidated.

Asset-based lending is a specialized area of commercial lending in which borrowers assign their interests in certain accounts receivable and inventory, and in selected cases fixed assets, to the lender as collateral. The primary repayment source for these loans is the conversion of the pledged assets into cash. This specialized lending differs from a commercial loan in which a financial institution takes a security interest in all accounts receivable and inventory owned or acquired by the borrower.

Many borrowers whose financial condition is not strong enough to allow them to qualify for regular, secured commercial loans may use asset-based loans to meet their financial needs. Some examples of asset-based borrowers include:

- Rapidly growing businesses that need year-round financing in amounts too large to justify commercial lines of credit secured by blanket liens on accounts receivable and inventory.
- Nonseasonal businesses that need year-round financing because working capital and profits are insufficient to permit periodic account cleanups (where the borrower fully repays the loan).
- Businesses with inadequate working capital for their volume of sales and type of operation.
- Businesses that cannot obtain regular commercial loan terms because of deteriorating credit factors.

Looking at it from the borrower's viewpoint, asset-based lending includes the following advantages:

- The business can finance an expanding operation efficiently because the business's borrowing capacity expands along with increases in levels of accounts receivable, inventory, and sales.

- The business can take advantage of purchase discounts because it receives immediate cash on its sales and is able to pay trade creditors satisfactorily.

Asset-based lending from the lender's viewpoint has the following advantages:

- Generates a relatively high-yield loan, new business, and a depository relationship that provides income and enhances the savings association's ability to monitor changes in the borrower's cash flow and overall financial condition.
- Permits continuing lending relationships with long-standing customers.
- Minimizes potential loss when the loan is collateralized by a percentage of the accounts receivable and inventory.

Although asset-based loans are collateralized, savings associations must also analyze the borrower's financial statements. Particular emphasis should be given to trends in working capital, review of trade reports, analyzing both the turnover of accounts receivable and inventory, and the review of both the agings of receivables and payables. Even if the collateral is of good quality and in excess of the loan, the borrower should demonstrate financial stability and progress. Repayment through collateral liquidation is a solution of last resort. Any collateral pledged on the loan will likely be much less attractive if it is needed to liquidate the loan. Thus, a lender should recognize the difference between "market value" and "liquidation value" of the collateral.

### *Pledged Receivables, Borrowing Base, and Payments on the Receivables*

Standard procedures require that financial institutions obtain a monthly aging report of the accounts receivable pledged. The eligible receivables borrowing base (base) is then calculated by deducting the various classes of ineligible receivables. Usually the eligible receivables base will be adjusted daily during the month following receipt of the aging report.

If the accounts are ledgered, the base will be increased by additional sales, as represented by duplicate copies of invoices together with shipping documents and/or delivery receipts received by the financial institution. The receivables base will be decreased daily by accounts-receivable payments received by the borrower, who then remits the payments to the savings association.

If accounts are not ledgered, but a blanket assignment procedure is used, the borrower periodically informs the savings association of the amount of receivables outstanding on its books. Based on this information, the bank advances the agreed percentage of the outstanding receivables.

Another method of payment in which the financial institution has tighter control is the lockbox arrangement. Under this arrangement, receivables are pledged on a notification basis and the borrower's customers remit their payments on accounts receivable directly to the savings association through deposit in a specially designated account.

## Asset-Based Loan Agreements

An asset-based loan agreement is a contract between a borrower and the financial institution that sets forth conditions governing the handling of the account and the remedies available in the event of default. Additionally, advance rates for collateral (depending on the type and nature of the collateral) are outlined in the agreements. The following areas should be addressed in the loan agreement:

- **Eligible accounts receivable.** This involves identifying classes of receivables that will not be regarded as acceptable collateral. Certain types of receivables carry a higher degree of risk relative to the willingness and ability of account debtors to pay and, by their very nature, should be excluded from the lending formula. Types of ineligible receivables are discussed later in this section.

- **Percentage advanced against eligible or acceptable accounts receivable.** Receivable advance rates will vary depending on the nature of the receivables. Typically, the advance rate for eligible receivables is in the range of 70 to 80 percent of current receivables. Lower advance rates may be warranted when there is heightened risk, so as accounts age, the advance rates decrease. Advance rates should take into consideration dilution trends, diversification, and the overall quality of the borrower's customer base. The advance rate must serve the two primary functions of providing adequate cash flow for the borrower and providing a margin that gives adequate protection for the lender. Protection for the lender requires a sufficient margin for the continual cost of collection and absorption of dilution in the receivables.

- **Percentage advanced against eligible inventory.** Advance rates on inventory are usually lower than those on receivables because inventory is less liquid. Inventory advance rates typically range from 35 to 65 percent for finished products. Marketability and accessibility of the inventory are key factors in determining the advance rate. Proper evaluation of the liquidation value of inventory requires a firm understanding of marketability in all the various stages (raw materials, works-in-process, finished merchandise).

Factors to consider when evaluating the quality of receivables pledged:

- **The turnover of pledged receivables and the borrower's credit limit.** If the turnover is decreasing, the quality of receivables may be deteriorating.

- **Aging of accounts receivable.** The association should obtain a monthly aging report of the accounts receivable pledged. You should note the percentage of accounts delinquent compared to the following numbers:

  — Total accounts pledged.

  — Concentrations, if any.

  — Accounts with past due balances that also have current amounts due.

- **Concentration of debtor accounts**. A savings association may be vulnerable to loss if a large percentage of assigned receivables are concentrated in a few accounts. Lenders normally consider receivables to be concentrated if there are single customer accounts representing 10 percent or more of the total receivables portfolio. Lenders that extend credit to borrowers with a concentrated customer base should limit concentrated accounts to no more that 10 to 20 percent of the receivables borrowing base. Some lenders will use a percentage that is also subject to a dollar limit. Alternatively, lenders may reduce the percentage advanced against such concentrations. Exceptions to concentration limits should be rare and based on unique circumstances that mitigate the concentration risk. The institution should routinely monitor the level of the largest customer accounts and monitor for concentrations.

- **Ineligible receivables.** The lender should not normally lend against some receivables. Also, the loan agreement may specify that certain receivables are ineligible as collateral because of the type of receivable or the delinquency status. The following types of receivables are usually considered ineligible:

  — Financially weak customers.

  — Due from officers and employees and affiliated companies. The financial conditions of affiliates may deteriorate simultaneously. Additionally, although such receivables might be valid, the temptation for the borrower to create fraudulent invoices is great.

  — Receivables subject to a purchase money interest, such as floor plan arrangements. The manufacturer will frequently file financing statements when they deliver merchandise to the borrower. That filing usually gives the manufacturer a superior lien on the receivable. An alternative would be an agreement with the manufacturer that subordinates rights to the receivables to the savings association.

  — Delinquency status. Accounts that are past due 30 days or more beyond the normal trade terms are considered delinquent. The normal practice is to consider accounts ineligible when they exceed three times the terms, e.g., 90 days for 30-day terms and 21 days for 7-day terms. In addition, most underwriting agreements specify that all accounts of a single party will be designated ineligible collateral when any (or some percentage) of that customer's receivables become ineligible. This is referred to as "cross-aging."

- **Financial strength of debtor accounts.** The association should maintain credit information and trade reports on large debtor accounts as part of the borrower's credit file. You should ascertain whether the debtor accounts are significant to the borrower's business, are well-rated, and financially strong.

- **Dilution.** The borrower and their lender are exposed to dilution risk, which is the possibility that non-cash credits will reduce, or dilute, the accounts receivable balance. Returns and allowances, disputes, bad debts, and other credit offsets create dilution. While percentages vary by industry, dilution is usually 5 percent or less of receivables.

Lenders should analyze trends or other significant changes in dilution rates. Field auditors for the financial institution should review and test selected credit memos. These reviews are important because a rise in dilution rates can signal a decline in product or service quality, which can lead to financial problems for the borrower.

### *Field Audits Conducted by the Financial Institution for Asset-Based Lending*

Field audits are integral to controlling and monitoring asset-based lending for the financial institution. They help detect fraud and financial weakness. Additionally, they are a way to confirm the quality of the borrower's financial data, receivables and inventory, and internal controls.

Field audits should be conducted before a new account is booked and regularly thereafter. The audits should occur at least annually, and if risk dictates, quarterly or monthly. Individuals who conduct the audits for the financial institution should be independent of the credit function.

The scope of the field audit should include:

- Verification that the information on the borrowing-base certificate reconciles to the borrower's books.
- A review of concentrations of accounts.
- Verification of submitted aging reports.
- A determination if any accounts receivable are being settled with notes receivable.
- A review of trends in accounts receivable, accounts payable, inventory, sales, and costs of goods sold.

## Floor Plan Loans

Floor plan, or wholesale, lending is a form of retail goods inventory financing in which each loan advance is made against a specific piece of collateral. As each piece of collateral is sold by the dealer, the loan advance against that piece of collateral is repaid. Items commonly subject to floor plan debt are automobiles, large home appliances, furniture, television and stereo equipment, boats, mobile homes, and other types of merchandise usually sold under a sales finance contract.

This type of financing involves all the basic risks inherent in any form of inventory financing. However, because of the banker's inability to exercise full control over the floored items, the exposure to loss is generally greater than in other similar types of financing. Most dealers have minimal capital bases relative to debt. As a result, close and frequent review of the dealer's financial information is necessary. In analyzing that data, it is important to review the number of units sold and the profitability of those sales. A comparison should be made between the number of units sold and the number financed to ensure that inventory levels are not excessive.

Replaced by Comptroller's Handbook - Agricultural Lending

As with all inventory financing, collateral value is of prime importance. Control over collateral value requires that the institution determine the collateral value at the time the loan is placed on the books. The collateral should be periodically inspected to determine its condition and to impose a principal curtailment requirement that is sufficient to keep collateral values in line with loan balances.

See Examination Handbook Section 216, Floor Plan and Indirect Lending.

## Secured Versus Unsecured Lending

Most lenders require security for their large-dollar commercial loans. Some lenders make unsecured commercial loans. For example, lenders may be more inclined to make unsecured loans for short-term financing purposes to borrowers with significant deposit accounts with the institution. Periodic financial analysis of the borrower's financial condition is essential to the lending arrangement. When making unsecured commercial loans, a lender should require the following circumstances:

- The borrower is financially strong.
- The borrower has a long history of satisfactory credit performance.
- The extension of credit is relatively small in relation to the company's net worth.

## Combination Commercial and Real Estate Loans

Institutions often secure commercial business loans in part by accounts receivable, inventory, or other commercial property, and in part by commercial real estate. If the association only makes the loans under terms and conditions offered with the additional real estate collateral, you should regard them as real estate loans subject to the real estate lending standards rule discussed in 12 CFR 560.100-101. Some lenders take a security interest in commercial real estate solely through an "abundance of caution." This means that the loan is otherwise fully secured with other commercial business collateral and the real estate is only a small portion of the collateral. In such cases, you may regard the loan as a commercial business credit that is not subject to the real estate lending standards rule.

## Agricultural Lending

The purposes, terms, and considerations regarding agricultural lending are quite similar to those already discussed. Generally, agricultural advances will fall within three broad categories: seasonal (short-term) loans, intermediate, and long-term loans.

Agricultural borrowers frequently use seasonal loans for the purchase of feeder livestock, feed, and such expenses as chemicals, fuels, and labor associated with yearly crop production. Repayment is generally dependent on the successful production and sale of crops, or the profitable feeding and sale of livestock.

Borrowers use longer-term advances for such things as the purchase of machinery, breeding herds, dairy herds, feeding and confinement facilities, and in some cases, acquisition, or improvement of real

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estate. As with any type of term loan, regular repayment is dependent on the additional cash flow the borrower expects to generate because of these purchases. Two risks particularly evident in agricultural lending are the possibility of adverse weather conditions, and sizable and uncontrollable fluctuations in commodity prices. To some extent, the purchase of crop insurance, some types of hedging and forward contracting, and producer participation in various types of government-sponsored programs may lessen these two risks. When coupled with general economic uncertainties, it is necessary for associations to ensure that they carefully tailor agricultural loans to an individual borrower's existing and projected repayment ability.

An association's agricultural lending policy should address at least the following areas:

- Acquisition of credit information such as property, operating, and cash flow statements.
- Factors that might determine the need to acquire the collateral.
- Acceptable collateral margins.
- Perfecting of liens on collateral (see Appendix A).
- Lending terms.

**Carryover Debt for Agricultural Lending**

Carryover debt refers to restructured, short-term loans resulting from the farmer's inability in a prior cycle to generate sufficient cash flow to liquidate that cycle's production loans. It represents a substitute for investment capital and must be serviced through future cash flow, sale of unencumbered assets, or other sources. By it nature, carryover debt suggests a well-defined credit weakness. However, the examiner should not automatically classify carryover debt and should carefully examine all relevant data to ensure an accurate rating. Factors for the examiner to consider include:

- The size of the carryover debt in relation to the size of the debtor's operation.
- Whether the obligor can service the carryover debt, as well as all other debt, within a realistic time frame.

When carryover debt is not covered by collateral and repayment capacity is not evidenced, a loss classification may be appropriate.

## REFERENCES

### United States Code (12 USC)

§ 1464(c) Investment Authority

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## Code of Federal Regulations (12 CFR)

| | |
|---|---|
| § 541.5 | Commercial Paper |
| § 541.20 | Loans |
| § 560.1 | Lending |
| § 560.3 | Definitions – Small Business Loans and Loans to Small Business |
| § 560.30 | Lending and Investment Powers |
| § 560.41 | Leasing |
| § 560.93 | Loans to One Borrower |
| § 560.100-101 | Real Estate Lending Standards |
| § 560.120 | Letters of Credit and Other Independent Undertakings to Pay Against Documents |
| § 560.160 | Asset Classification |
| § 560.170 | Records for Lending Transactions |
| § 563.43 | Loans to Affiliated Persons |
| § 563.170 | Establishment and Maintenance of Records |

## Office of Thrift Supervision Guidance

| | |
|---|---|
| CEO 11 | Interagency Policy Statement on Documentation for Loans to Small- and Medium-sized Businesses and Farms |
| CEO 252 | Office of Thrift Supervision Guidance on Commercial Real Estate (CRE) Concentration Risks |
| TB 70 | Interagency Statement on Sales of 100% Loan Participations |
| TB 78a | Investment Limitations under the Home Owner's Loan Act |

## Other References

Uniform Commercial Code – Section 9, Secured Transactions

Interagency Policy Statement: Leveraged Financing