The Entrepreneur's Guide to Financial Maturity ®
Bank Financing - How Banks Judge Your Business Loan Application

Remember, the person writing your bank's advertisements is not the person who approves your loan. So, it's important to understand how your banker will look at your loan application.

There is an old adage "you can get as much money from a bank as you want as long as you can prove that you don't need it." Unfortunately there is still truth to this adage today. Remember, banks face extensive banking regulations and government oversight, so they lack some of the entrepreneurial spirit and willingness to take on too much risk.

Whether you are applying to a bank for a line of credit for business working capital line, a commercial short-term loan, an equipment loan, real estate financing, or some other type of commercial or consumer loan, many of the same basic lending principles apply. The most fundamental characteristics a prospective lender will want to examine are:

- Credit history of the borrower
- History and projections for the business
- Collateral that is available to secure the loan
- Character of the borrower
- Loan documentation

When making a loan, traditionally, banks focused primarily on:

- The borrower's credit score
- The value of the collateral
- The liquidity of the collateral

However many bankers claim that lending competition has forced them to focus more on a business's ability to repay the debt as it comes due, rather than

the collateral securing the loan. The reality is, due to banking regulations they have to take a belt and suspenders approach. The banks focus on a combination of both collateral and ability to repay.

Typically, banks do not want to enforce their rights to foreclosure or repossess collateral, and such actions merely highlight a poor lending decision. Nevertheless, banks still place considerable emphasis upon collateral, especially when the projected cash flow of the debtor is as fragile as it often seems to be in a small business.

Bankers look for an ideal loan applicant, who typically meets these requirements:

- For an existing business, a cash flow sufficient to make the loan payments.
- For a new business, an owner who has a track record of profitably owning and operating the same or a similar type of business.
- An owner with financial reserves and personal collateral sufficient to solve the unexpected problems and fluctuations that affect all businesses.

Bankers are most comfortable with Borrowers that are close to their ideal loan profile. However, economic realities dictate that banks must loan out the money deposited with them. To do this, they must lend to at least some people whose it not their ideal profile.

How can I qualify for a bank loan? Your job is to show how your situation is similar to the banker's ideal client. In presenting your situation you should view your loan request from their vantage point, being skeptical. After all why will your business succeed while the vast majority of new businesses fail? If you are lucky to survive remember, the large majority of survivors do not genuinely prosper. Why should the Bank take the risk?

Bankers are often overly cautious in making loans to small businesses. If you do not anticipate the tough questions and have specific answers, the bank will decline your loan request. If your loan application is denied, you should find out as much as you can about the review of your loan, which factors hurt you the most, how you can improve your chances for obtaining a loan in the future,

The bank will dictate the repayment terms of your loan, but your explanation of the source of the funds for repayment and how you will manage your overall debt will be crucial to the lender.

Most banks will require the following documentation:

- Business and Personal Financial Statements,
- Projected Cash Flows from operations
- Use of Proceeds from the Loan (a schedule showing what you will do with the loan proceeds)
- Income tax returns,
- Frequently a business plan or executive summary

The cash flow statement and projected income and balance sheets will be most relevant. The institution will want to know what the funds are being used for and whether the business's cash flow will be sufficient to monthly/quarterly payments and repay the loan. Some banks will require that your financial statements be prepared or reviewed by a CPA. Lenders sometimes contact the applicant's accountants and financial advisors directly to discuss a business plan or a financial statement. These conversations can have a powerful influence on the outcome of a loan application.

Some lenders rely heavily upon financial ratios in assessing the creditworthiness of a prospective borrower. With many small businesses these ratios may misrepresent the overall value of the enterprise. The most important assets of a small business are often the owner's experience, the potential value of existing and prospective customers, "goodwill" and other non-balance sheet items. Further, due to tax or strategic business purposes, companies may report of a cash basis, and therefore their financial statements will not reflect their accounts receivable, deferred income, and accrued expenses. In these and other situations, the financial ratios of the borrowing company may be understated. You should point out these situations to your banker.

Bankers will look at your commitment to the business, your customers and your creditors. You must demonstrate it with facts, revenues, customer loyalty and/or testimonials not rhetoric.

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P O Box 2365, Livingston, NJ 07039 MB@CreativeBusinessPlanning.com Tel : 973-736-2535 Fax : 973-736-1839