COMMERCIAL LENDING PROCESS AND BUSINESS DEVELOPMENT CALL

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Commercial Lending Process

- Just as a business banker should be aware of the participants and the environment in which commercial lending takes place, the lending process must also be understood.
- Although commercial lending mutually benefits both banks and businesses, not every loan does. Neither a bank nor a business profits from a loan that cannot be repaid.
- To identify the loans that should not be made from the ones that should, banks rely on an investigative process that begins with an application for credit from a business. Application for credit is often done verbally during one or more meetings between the bank and prospective borrower.
- Along the way, there may be credit inquiries, on-site visits, an evaluation of business plans, an analysis of financial statements, a collateral valuation, an analysis of the potential for the sale of other bank products, a presentation to the loan committee, and initial preparation of loan documents.
- The commercial lending process may seem lengthy and complex, but it is necessary to understand and follow because the alternative—loan loss and foreclosure—is highly undesirable.

Making a good commercial loan

- To make a good loan, the business banker first identifies a prospect or, if the business has approached the bank, obtains an application for credit that gathers all pertinent facts.
- First and the follow up meetings with the customer, credit investigations, and on-site visits provide the foundation to begin analyzing a commercial loan request.
- Financial statement analysis, which is at the heart of any credit evaluation process and paints a picture of a business's operational and financial performance, is completed.
  - By analyzing past and current financial records, such as income statements and balance sheets, a business banker can arrive at a good estimation of a customer's ability to repay a loan.
- After conducting exhaustive calls, a thorough credit investigation, and a detailed financial analysis of the prospective borrower, it is still possible to make a bad loan even though the potential borrower is completely qualified to receive a loan.
  - For example, structuring a loan with inappropriate principal amounts, incorrect repayment terms, and too little collateral can lead to problems.

Making a good commercial loan

- Assume that the borrower is an acceptable credit risk and a properly structured and fairly priced loan has been agreed upon. The next step is to get both the borrower and the bank to agree to the proposed terms of the loan. If a disagreement arises, the business banker must be able to renegotiate mutually acceptable conditions.
- Once all parties are in agreement over the terms and conditions of the loan, that understanding should be put in writing mentioning the exact obligations of both.
- And comes the loan closing, in which the terms and conditions are reiterated and the proper signatures on the loan documents are obtained.
- Good lending practice requires an annual or more frequent review of financial statements and regular monitoring to determine how the business is performing and to confirm or change the credit risk rating. If, after these precautions, the loan becomes a problem, a business banker has options to minimize the bank's loss.

Before the Meeting

- Credit investigation aims at evaluating the willingness and capacity of the borrower to repay ie. customer's creditworthiness, and starts at the first interaction with the borrower.
- Business bankers keep these five Cs in mind to avoid overlooking major factors, while evaluating the customer.
  - Character
  - Capacity
  - Capital
  - Condition
  - Collateral

With the five Cs in mind, a business banker is ready to conduct the business development call to ascertain whether the loan request warrants further consideration and the additional time and expense involved in a full credit investigation, follow-up meetings, and financial statement analysis.

The Five Cs of Credit

- Character
  - Character refers to the customer's willingness and determination to fulfill a loan obligation and is probably the single most important component of a customer's makeup.
  - If their business experiences financial difficulties, business people of good character make every effort to repay a loan and work openly and cooperatively with their banker.
  - Conversely, persons lacking character assign a low priority to repaying debts and are quick to default on any loan commitment at the first sign of financial trouble.
  - Character can be partially confirmed by determining how the customer paid previous obligations. The character of a business customer is best judged through a long relationship.
  - Customers, suppliers, creditors, and business contacts can provide valuable insights into the character of a prospective borrower.
  - Social reputation also indicates character.

The Five Cs of Credit

- Capacity
  - Loans are repaid from the cash flow generated during a company's operating cycle. Capacity, which defines management's ability to generate enough excess cash to satisfy all obligations, also refers to the ability to manage cash and cash flow.
  - Past financial performance and comparison with other businesses in the same industry are good indicators of how well it is run.
  - If a business has been successful over time and its management team has diverse abilities, then the prospects for loan repayment are generally good.
  - It is more difficult to evaluate the capacity of a new business, or one in the start-up or growth stages of the business life cycle. In such cases, managerial experience and training are critical considerations.
  - A business banker should consider whether any of the managers have been involved in another business and, if so, how that company fared. Past business failures bode poorly for any future endeavors.

The Five Cs of Credit

- Conditions
  - **Conditions, or external variables, include the state of the economy, potential changes in interest rates, the company's industry type, and the national and world political environment. For example, slow housing starts will adversely affect a carpet retailer.**
  - **To evaluate conditions, a business banker can search the Internet and review newspapers, periodicals, business information services, and general and specialized mercantile credit agencies.**

The Five Cs of Credit

- Collateral
- Collateral is the asset or assets pledged to secure a loan. Most commercial loans are secured by accounts receivable, inventory, equipment, or real estate.
- A borrower can pledge collateral to offset weaknesses in four of the five Cs. A business banker, concerned about an industry's overall financial condition, for example, may choose to not lend to a new business in that particular industry unless certain assets are pledged as collateral. There is, however, no substitute for character.
- However, collateral itself does not repay loans (only cash does) and therefore, the mere existence of collateral should not justify making a loan.
- Collateral provides the bank a secondary source of repayment if the primary source of repayment is not available. To repay a loan, collateral must be liquidated (turned into cash). An attempt by the bank to sell a company's assets (collateral) often encourages the debtor to seek protection by filing for bankruptcy or by raising legal objections.

The Five Cs of Credit

- Capital

  Also called equity or net worth, capital primarily consists of share capital and retained earnings. In the five Cs of credit, capital is the reserves a business has in the event of a problem. The following are the primary considerations in evaluating capital adequacy:

  - The amount of capital (equity) the owners have invested in the business
  - The amount of future funds available from creditors and owners
  - How effectively total capital is employed
- It is often a negative sign if the owner's equity is considerably less than the capital provided by creditors.
- The adequacy of capital levels varies by industry. For example, industries with high fixed asset needs usually require more capital. business that primarily relies on borrowed funds to maintain its operations are more risky.

Business Development Calling Skill and Conducting the meeting

A good lender lends by looking at the eyes as much as by looking at the financial statement.

The ability to conduct successful calls and meetings, an acquired skill, is developed through countless calls on commercial customers.

- Make the customer feel relaxed
  - Whenever possible, initial calls should be held at the customer's business.
  - A small amount of light conversation before the interview is helpful.
  - Negative comments about a customer's business usually serve no purpose, but occasional, complimentary remarks may produce additional information
  - Treats prospective borrowers as they would like to be treated

Business Development Calling Skills

The four Hs of Business Development Call questions.

The ultimate lending question is "What is causing the need to borrow funds?" The answer to this question leads to the following Four Hs of loan interviewing:

- ☐ How much money is needed? (amount)
- ☐ How will it be used? (purpose)
- ☐ How long do they need it? (term)
- ☐ How will the money be repaid? (repayment source)

- Be properly focused
  - Have a clear understanding of what information is needed to make an informed loan decision.
  - Do not scrutinize every aspect of a customer's business in the first meeting. Additional information can be obtained later.
  - A checklist, set of questions, or outline of topics should be ready. It ensures that basic information is not overlooked. Concentrate on obtaining basic information on the following five specific areas:
    - The customer's business
    - The loan request and cause of the borrowing need
    - The customer's ability to repay the loan
    - The availability of collateral
    - The customer's present banking relationships

Business Development Calling Skills

- Be efficient with time
  - Time is a valuable commodity for both the business banker and the customer. Any prolonged deviation from the business at hand is costly for both the customer and the bank.
  - If the discussion digresses, the lender needs to steer it back to more pertinent matters.
  - Move on to next topic if no further probe is required. Although thoroughness is an objective, the lender should not spend too much time on a limited topic.
  - It is pointless to continue when it becomes apparent that loan has unacceptable risk or lending policy does not allow it. At an opportune time customer be told so as politely as possible.

Business Development Calling Skills

- Ask effective questions
  - Whether a response is informative depends on the type of question asked. A leading question such as “You’ll be able to repay this loan, won’t you?” is not very productive.
  - A more productive questions might be, “What is the source of funds will repay the loan” and “How would you prefer to structure loan repayment?” The answers to these questions will give some insight into the borrower’s ability to assess repayment terms and loan structure.
  - If the response is insufficient, it should be followed up with questions that pinpoint the exact nature of the repayment sources.
  - *Closed-end questions* are designed to elicit a limited response, for example, “yes” or “no.”
  - Closed-end questions are most useful when specific information is needed and are usually followed by an open-end question.

Business Development Calling Skills

- Ask effective questions
  - Open-ended questions, which encourage the free exchange of information, usually begin with: "what," "where," "when," or "how."
  - By asking, "What are your company's objectives for the upcoming year?" the lender is looking for some insight into the nature of the company's operations.
  - Open-end questions stimulate conversation and are mixed with closed-end questions. Because they provide more information, a business banker generally asks more open-end questions when conducting initial calls.
  - Use caution, however, when beginning open-end questions with "why." Excessive use of "why" may become offensive to the customer.

Business Development Calling Skills

- Ask effective questions
  - *Secondary questions*, or follow-up questions, help develop information uncovered in answers to open-end questions. If the response to "What are your company's objectives for next year?" is "To increase sales by 10 percent," then follow-up questions might be—"How do you plan to do that?" or "What additional funds will be required for that?"
  - The purpose of secondary questions is to elicit specific information not volunteered by the customer in the initial response.
  - *Probing techniques*—Probing is a simple way to assist the flow of information by prompting additional replies.
  - If used correctly, probes are natural and unremarkable. A well-placed "Oh?" or "I'm not sure I understand what you mean," may encourage the customer to supply additional important information.

Business Development Calling Skills

"Humans have two ears and one mouth, and they should be used in that proportion."

Often, in answering questions, customers reveal more in their actions than in their words.

- **Listen and observe carefully**
  - Information is best gathered by letting customer talk. Do not frequently interrupt the customer with comments or observations but listen carefully.
  - Note significant revelations, notice implied comments, and consider appropriate follow up questions.
  - Watch for mannerisms that reveal the customer's character and ability; for example, a customer that is uncomfortable or hesitant when talking about the company's operations may be indicating that something is wrong.
  - Any unusual behavior during a call should be noted and then followed up with a thorough investigation.

Business Development Calling Skills

- Take accurate notes
  - Unless possessed with a photographic memory, you must take notes. Key responses or observations may be forgotten unless notes are taken during the course of the meeting.
  - It is important, however, that note taking be unobtrusive and compatible with the flow of conversation. No dictation writing.
  - To create a relaxed atmosphere during the call, a lender may suggest that the customer also take notes to remember key points about the bank.

Business Development Calling Skills

- Be professional
  - Suppress personal bias. Loan opportunities are accepted or rejected on the basis of creditworthiness, not on irrelevant factors such as personality.
  - Do not downplay a significant fact, such as operating losses, merely because you like the customer and wishes the business to succeed. Alternatively, a real or imagined offence from a customer is not grounds for rejecting a loan.
  - Commercial lending requires measured objectivity, not snap judgments or hasty decisions. Be prepared to handle a customer upset by rejection. Do not respond in kind if there is verbal assault.

Business Development Calling Skills

- Ask for relevant documents
  - During or shortly after the initial personal interview, when it appears that further investigation is worthwhile, a business banker usually requests various relevant documents to support the loan request. These may be:
    - Financial Statements
    - Business Plans
    - Financial forecast
    - Management reports (Operating and Capital budget, Receivable analysis, Inventory analysis, Accounts payable analysis etc.)
    - Personal financial statements

Basic Loan interview Questions

A business development call is not an interrogation; neither is it an aimless chat.

- Questions about the business

(Questions can be used from the following areas on a selective basis, where you do not already know the information, or cannot readily get the information from a third-party source.)

- Who are the principal owners and what are the percentages of ownership? (full names, preferably)
- What is the legal status of the business—limited liability company, proprietorship, or partnership?
- Where is your business located and how long has it been in business in operation?
- What are your company's products or services?
- Is management separate from ownership? If so, who are the principal managers and their backgrounds/experience?
- How many employees are there and are any workers unionized?

Basic Loan interview Questions

- Questions about the business

(Questions can be used from the following areas on a selective basis, where you do not already know the information, or cannot readily get the information from a third-party source.)

- What is your company's position in the industry?
- Who are your competitors and what are their strengths and weaknesses?
- Who are the major suppliers and customers and what are their addresses?
- What are the normal credit terms offered by suppliers and given to your customers?
- What contracts or franchises are involved?
- Who is your accountant and what type of financial statements has your business prepared?
- Who is your lawyer and is there any pending litigation?
- Who is your insurance agent?

Basic Loan interview Questions

- Questions about the loan request

(Questions can be used from the following areas on a selective basis, where you do not already know the information, or cannot readily get the information from a third-party source.)

- How much money does your business need to borrow?
- What is the cause of the borrowing need?
- How did you arrive at the amount of your loan request?
- What future financing needs are you projecting?
- What terms are you requesting and how did you decide the loan terms?
- What is the purpose of the loan?

Basic Loan interview Questions

- Questions about the customer's ability to repay

(Questions can be used from the following areas on a selective basis, where you do not already know the information, or cannot readily get the information from a third-party source.)

- What are your earnings or profit history of the business?
- How much cash is the business generating from operations?
- What is the primary source of repayment for the loan?
- What is your secondary source of repayment if the primary source fails?
- If additional funds are needed, how will they be obtained?
- How much equity does the business have?
- What are the guarantors' names and what is the financial strength of the guarantors?

Basic Loan interview Questions

- **Questions about the Collateral**

(Questions can be used from the following areas on a selective basis, where you do not already know the information, or cannot readily get the information from a third-party source.)

- **What collateral do you plan to pledge?**
- **Who owns the collateral?**
- **Where is the collateral located?**
- **What special permits are required?**
- **How is the collateral valued, and does the value of the collateral fluctuate?**
- **Is the collateral for a special purpose?**
- **Is the collateral perishable?**
- **Will personal assets be pledged as security for the loan?**

Basic Loan interview Questions

- **Questions about the customer's banking relationship**

(Questions can be used from the following areas on a selective basis, where you do not already know the information, or cannot readily get the information from a third-party source.)

- **What banks do you currently use?**
- **Have you approached other banks with the loan request?**
- **How does this loan fit into your company's total banking and lending picture?**
- **Do you have loans outstanding and what are the nature and extent of these loans?**

Closing the Business Development call

After the initial business development calls, decide how to proceed with the loan request—refuse it, suggest other sources of financing, or pursue it.

- Rejection
  - Take responsibility and do not hide behind others by saying, for example, "I'm sorry, but the loan committee has turned down your loan request."
  - Any rejection should be done with polite firmness and with some specific reasons why the loan was rejected. Do not say one single reason was pivotal, making customer become fixated on that single issue. It helps to talk in terms of the entire credit risk profile not being acceptable at this time.

    This position allows the business banker to continue to call on the customer and be prepared when, sometime in the future, the credit profile improves.

Closing Business development Call

- Referral

  For loan requests that have merit but fall short of the bank's lending standards,

    - Offer advice on how to improve the loan request, such as by offering additional collateral or borrowing less money.
    - suggest alternative sources of financing. You should always keep the customer relations aspect in mind. Although the bank may be unable to grant this particular loan, the customer may be eligible for other bank services or may qualify for a different loan at a later date.
- Pursuing
  - If you decide to pursue the request further,
    - Summarize any pertinent commitments made during the course of the calls.
    - Send a brief letter (email) confirming what is to be done by whom and by when to help avoid confusion in the process.
    - Start collecting required documents, if not done so already.
    - Start credit investigation and financial analysis.

Recording the Business Development call

As soon as possible after conclusion of the initial business development call, you should review notes made about the customer and should prepare a summary report detailing what was learned, the likely loan request, and whether it makes sense to proceed in the lending process.

Need

- Recalling a meeting and summarizing it on paper also helps the business banker mentally synthesize a complete picture of the customer and the business.
- Writing a report of what happened during the meeting enables a business banker to pull all the details together.
- Any report on the findings of business development calls should become a part of the customer's credit file. These reports are a source of information for other bank officials who, at a later date, wish to learn more about the customer.

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Thank you