What banks look for when reviewing a loan application

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Not all banks are created equal, but many of them focus on the same areas throughout the loan review process. Learn what documentation, projections and narratives you'll need to prepare as well as tips to ensure you negotiate the best loan package available.

Whether you are applying to a bank for:

A line of home equity credit

A line of credit for business working capital

A commercial short-term loan

An equipment loan

Real estate financing

Some other type of commercial or consumer loan

Many of the same basic lending principles apply.

Five keys of loan applications

1. The most fundamental characteristics most prospective lenders will concentrate on include:

2. Credit history

3. Cash flow history and projections for the business

4. Collateral available to secure the loan

5. Character

6. Myriad pieces of loan documentation that includes business and personal financial statements, income tax returns, a business plan and that essentially sums up and provides evidence for the first four items listed

The first three of these criteria are largely objective data (although interpretation of the numbers can be subjective). The fourth item—your character—allows the lender to make a more subjective assessment of your business's market appeal and the business savvy of you and any of your fellow operators. In assessing whether to finance a small business, lenders are often willing to consider individual factors that represent strengths or weaknesses for a loan.

Tools to use

To give you an idea of what banks specifically focus on when reviewing a loan request, the Tools & Forms section contains a sample business loan application form that is typical of the kind of documentation you'll need to complete as part of your loan application package.

We also include an internal bank loan review form used by one small community bank to make its own review of a small business loan.

Credit history

Lenders will want to review both the credit history of your business (if the business is not a startup) and, because a personal guarantee is often required for a small business loan, your personal credit history. We recommend obtaining a credit report on yourself and your business before you apply for credit. If you discover any inaccuracies or problems, you can correct them before any damage to your loan application has occurred. If you can, find out which credit reporting company your prospective lender uses and request a report from that company.

Reviewing your commercial credit history

Before you apply for commercial credit, you should review a credit report on your own business, if your business has been in existence for a while. You can obtain a free Business Information Report on your own business from Dun & Bradstreet.

If D&B does not yet have any information on you, they will allow you to voluntarily obtain a listing by providing them with some basic information about your business.

Most conventional lenders will expect a minimum of four or five trade experiences listed on a business report before they consider the business creditworthiness. If you have been operating your business without credit, or with personal assets, you should consider making some trade credit purchases in order to establish a credit history for your enterprise.

Reviewing your consumer credit history

Consumer credit agencies are required to remove any information from the report that cannot be verified or has been shown to be inaccurate. However, before you submit a letter disputing any debt to the credit reporting company, it's often a good idea to contact the relevant creditor directly. If an error was made, you can often clear up the dispute more quickly if you take the initiative.

If the dispute is not resolved and your credit report is not adjusted, you have the right to file a statement or explanation regarding the alleged debt with the credit report. If your credit report does have some tarnish on it, you might consider requesting that any creditors with whom you have had a good credit history, but who did not report the transactions, be added to the report. For a minimal fee, most credit bureaus will add additional creditor information.

Work smart

The three major consumer credit reporting companies are TransUnion, Experian, and Equifax. Dun & Bradstreet is the largest business credit reporting agency.

Providing collateral to secure a loan

When it comes to obtaining a secured loan, providing collateral is a must. To a bank, collateral is simply defined as property that secures a loan or other debt, so that the lender may be seize that property if the you fail to make proper payments on the loan.

Understanding your collateral options

When lenders demand collateral for a secured loan, they are seeking to minimize the risks of extending credit. In order to ensure that the particular collateral provides appropriate security, the lender will want to match the type of collateral with the loan being made.

The useful life of the collateral will typically have to exceed, or at least meet, the term of the loan. Otherwise, the lender's secured interest would be jeopardized. Consequently, short-term assets such as receivables and inventory will not be acceptable as security for a long-term loan, but they are appropriate for short-term financing such as a line of credit.

In addition, many lenders will require that their claim to the collateral be a first secured interest, meaning that no prior or superior liens exist, or may be subsequently created, against the collateral. By being a priority lien holder, the lender ensures its share of any foreclosure proceeds before any other claimant is entitled to any money.

Protecting your collateral

Properly recorded security interests in real estate or personal property are matters of public record. Because a creditor wants to have a priority claim against the collateral being offered to secure the loan, the creditor will search the public records to make sure that prior claims have not been filed against the collateral.

If the collateral is real estate, the search of public records is often done by a title insurance company. The company prepares a "title report" that reveals any pre-existing recorded secured interests or other title defects.

If the loan is secured by personal property, the creditor typically runs a "U.C.C. search" of the public records to reveal any pre-existing claims. The costs of a title search or a U.C.C. search is often passed on to the prospective borrower as part of the loan closing costs. In startup businesses, a commonly used source of collateral is the equity value in real estate. The borrower may simply take out a new, or second, mortgage on his or her residence. In some states, the lender can protect a security interest in real estate by retaining title to the property until the mortgage is fully paid.

Determining a loan-to-value ration

To further limit their risks, lenders usually discount the value of the collateral so that they are not extending 100 percent of the collateral's highest market value. This relationship between the amount of money the bank lends to the value of the collateral is called the loan-to-value ratio. The type of collateral used to secure the loan will affect the bank's acceptable loan-to-value ratio. For example, unimproved real estate will yield a lower ratio than improved, occupied real estate. These ratios can vary between lenders and the ratio may also be influenced by lending criteria other than the value of the collateral. Your healthy cash flow may allow for more leeway in the loan-to-value ratio. A representative listing of loan-to-value ratios for different collateral at a small community bank is:

Real estate: If the real estate is occupied, the lender might provide up to 75 percent of the appraised value. If the property is improved, but not occupied, such as a planned new residential subdivision with sewer and water but no homes yet, up to 50 percent. For vacant and unimproved property, 30 percent.

Inventory: A lender may advance up to 60 percent to 80 percent of value for ready-to-go retail inventory. A manufacturer's inventory, consisting of component parts and other unfinished materials, might be only 30 percent. The key factor is the merchantability of the inventory—how quickly and for how much money could the inventory be sold.

Accounts receivable: You may get up to 75 percent on accounts that are less than 30 days old. Accounts receivable are typically "aged" by the borrower before a value is assigned to them. The older the account, the less value it holds. Some lenders don't pay attention to the age of the accounts until they are outstanding for over 90 days, and then they may refuse to finance them. Other lenders apply a graduated scale to value the accounts so that, for instance, accounts that are from 31 to 60 days old may have a loan-to-value ratio of only 60 percent, and accounts from 61 to 90 days old are only 30 percent. Delinquencies in the accounts and the overall creditworthiness of the account debtors may also affect the loan-to-value ratio.

Equipment: If the equipment is new, the bank might agree to lend 75 percent of the purchase price; if the equipment is used, then a lesser percentage of the appraised liquidation value might be advanced. However, some lenders apply a reverse approach to discounting of equipment. They assume that new equipment is significantly devalued as soon as it goes out the seller's door (e.g., a new car is worth much less after it's driven off the lot). If the collateral's value is significantly depreciated, loaning 75 percent of the purchase price may be an overvaluation of the equipment. Instead, these lenders would use a higher percentage loan-to-value ratio for used goods because a recent appraisal value would give a relatively accurate assessment of the current market value of that property. For example, if a three-year-old vehicle is appraised at $15,000, that's probably very close to its immediate liquidation value.

Securities: Marketable stocks and bonds can be used as collateral to obtain up to 75 percent of their market value. Note that the loan proceeds cannot be used to purchase additional stock.

Establishing your cash flow from operating your business

The cash flow from your business's operations—the cycle of cash flow, from the purchase of inventory through the collection of accounts receivable—is the most important factor for obtaining short-term debt financing.