Module 1
The Lending Process

Learning Objectives:

After the completion of this Module you will be able to:

1. Explain the importance of the lending process
2. Describe the steps in the lending process
3. Identify borrowing structures and describe their advantages
4. Identify most important documentation required to evidence authority to borrow, indebtedness, collateral and loan conditions
5. Collateral valuation and factors associated to liquidity, marketability and control

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Introduction:

Banks offer a variety of loans to consumer, businesses and government entities.

Lenders are responsible for maintaining the quality of the Bank's loan portfolio by adhering to bank policy and complete the lending process with accuracy.

The lending process in tandem with other deposit and payment products is the cornerstone of banking.

Loans are one of the most significant sources of income for banks and it is usually the introduction for a client's bank relationship.

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The Credit Process and Major sources:

Consumers:

- Individuals have several options to secure financing.
- Main financing sources of credit include:
- Finance companies
- Insurance companies: With this source the individual can borrow against the value of the policy
- Investment Brokers: Individuals can borrow against the value of the securities.
- Credit from Retailers: Individuals can apply for a revolving credit at retailers that offer this service
- Mortgage bankers: Individuals can obtain financing for the purchase of a residence

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The Credit Process and Major sources:

Consumers:

- Other sources of credit for consumers include:
- - Banks and credit unions
- When consumers maintain depository accounts they can also use their deposits as collateral for the loans

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The Credit Process and Major sources:

Business:

- For years the traditional source of credit for businesses have been commercial banks.
- With the evolution of the financial systems additional sources of
- Financing emerged.
- This includes:
- - Savings banks
- - Captive finance companies: These companies are owned by a
- manufacturer and finance dealer inventory or grant loans to
- consumers to facilitate the purchase of its products.
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Lending and Main Loan Categories:

- In the banking industry loans are divided into categories for the purpose of facilitating government reporting, internal monitoring and planning:
- In banks loans are divided as follows:
- Consumer
- Real Estate
- Business loans
- Government and government sponsored loans

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Lending and Main Loan Categories:

- **Consumer Loans**:
- 1. The portfolio of consumer loans is often a large percentage of a bank's loan portfolio
- 2. Banks considered consumer an attractive source of income due to:
- - Interest income and incremental profit
- - Consumer loans are usually repaid as agreed.
- - This product is part of full service banking
- 3. Consumer loans are usually classified as:
- - Open end or revolving loans
- - Closed end or installment loans

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Lending and Main Loan Categories:

Consumer Loans:

- **Open end or Revolving loans**: In these type of consumer loan the
- individual can borrow up to a pre-approved limit.
- Examples of open-end loans are home equity line of credit and the credit cards.
- **Closed-end loans:** These loans have a specific amount and maturity date.
- These loans could be single payment loans or subject to a pre-established
- amortization schedule over the term of the loan.
- The closed-end loans may be secured or unsecured
- The Banks use a promissory note as evidence of indebtedness

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Lending and Main Loan Categories:

Business Loans:

- The most common types of business loans are:
- 1. Working Capital Loans
- 2. Revolving line of credit
- 3. Term Loan
- 4. Lease financing
- 5. Letter of credit
- 6. Asset-based loans

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Lending and Main Loan Categories:

Business Loans:

- The most common types of business loans are:
- 1. **Working Capital Loan**:
- **Term**: Short-term credit facility, typically with a term ranging from 30 - 90 days. **Purpose of the loan:** Finance daily business, trading activities and operational expenses.
- Example: Loan to finance inventory is repaid when the inventory is sold and converted to cash. This process is usually completed within one (1) year. However it depends on the length of the operating cycle.

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Lending and Main Loan Categories:

Business Loans:

- The most common types of business loans are:
- 2. **Revolving Line of Credit**:
- **Term**: One (1) year.
- **Purpose of the loan:** Line set-up for a specific amount on which the Borrower will draw from a limited time. Balance fluctuates from $0 to the maximum amount.
- This credit will be paid with the conversion of current assets to cash. However in this facility the assumption is there will always be a balance outstanding.
- The loan is repaid either when sales growth slow or converting line into a permanent loan.
- This facility is supported by a loan agreement that includes the stipulation of a conversion of the line of credit into a permanent working capital loan.

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Lending and Main Loan Categories:

Business Loans:

- 2. **Revolving Line of Credit**:
- Secured by short term assets line accounts receivable and inventory.
- Risks associated to this credit facility includes a scenario where the company is not
- profitable due to cost controls, failure to collect accounts receivable and the sale of inventory.

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Lending and Main Loan Categories:

Business Loans:

- **3. Term Loan**:
- **Term:** This credit facility is schedule to mature in more than one (1) year. Three – seven years . It is usually repaid in monthly, quarterly or annual installments. In some cases the repayment is established with a balloon payment with payment of principal due at a pre-determined date.
- **Purpose:** Finance the purchase of equipment, furniture, leasehold improvements or other fixed assets.
- This credit facility is considered long term financing.
- Usually the amount of the loan is disbursed in a lump sum with the principal and interest repaid in increments according to a regular, pre-determined schedule.

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Lending and Main Loan Categories:

Business Loans:

- **3. Term Loan**:
- In lending transactions the banks will match the loan amortization schedule to the cash flow generated by the business.
- The amount of down payment for a term loan varies depending on the estimated useful life of the asset to be purchase.
- The repayment amortization depends on the depreciable and useful life of the asset financed.

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Lending and Main Loan Categories:

Business Loans:

- **4. Lease Financing:**
- In this type of credit transaction there is a contract giving the right of use and possession of the asset for a specific repayment schedule.
- The Lessor is the party owing the leased property
- The lease contract may include the financing of more than one piece of equipment.
- Depending on the terms of the lease asset ownership may be transferred to the customer (lessee) once the lease term ends.
- A lease usually provides almost 100% financing, different from a terms loan that requires a certain percentage in down payment

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Lending and Main Loan Categories:

Business Loans:

- **4. Lease Financing:**
- Given the almost 100% financing provided this lending mechanism is usually very attractive for new and or rapidly growing companies where liquidity is limited.
- Repayment is usually originated from cash flows generated by multiple operating cycles.

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Lending and Main Loan Categories:

Business Loans:

- **4. Letters of Credit:**
- This type of credit facility is not considered a loan but the transaction is used to support purchases of inventory and other assets.
- The letter of credit guarantees the payments of a customer's draft up to specific amount over a certain time.
- This type of financing option substitutes the credit from a bank for the credit of the buyer of goods.
- This instrument authorizes the Seller to draw drafts on the bank and guarantees the payment of those drafts if the conditions of the transaction supported by the letter of credit are met.
- The letter of credit may be revocable or irrevocable

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Lending and Main Loan Categories:

Business Loans:

- **4. Letters of Credit:**
- This facility is under-written and analyzed as a loan as the Bank must pay even if the company is no longer in business.
- This transaction is secured and there is a formal agreement signed evidencing the transaction.
- Letters of credit are usually issued for most credit-worthy customers
- There are two (2) types of letter of credit:
- **Commercial:** This letter of credit is usually drawn for the benefit of the Seller after the customer is repaid by the customer. This instrument is issued for a term up to 180 days and at times it has the renewal option

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Lending and Main Loan Categories:

Business Loans:

- **4. Letters of Credit:**
- **Stand-by letter of credit:** Represent a source of funds available if needed.
- They are issued for one (1) year and may be renewed automatically.

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Lending and Main Loan Categories:

Business Loans:

- **5. Asset Based Loans:**
- This is a short term loan secured by business/trading assets such as inventory or accounts receivable.