Estimating Funds Requirements—Short-Term Sources of Funds

Butler Lumber Company

After a rapid growth in its business during recent years, the Butler Lumber Company in the spring of 1991 anticipated a further substantial increase in sales. Despite good profits, the company had experienced a shortage of cash and had found it necessary to increase its borrowing from the Suburban National Bank to $247,000 in the spring of 1991. The maximum loan that Suburban National would make to any one borrower was $250,000, and Butler Lumber had been able to stay within this limit only by relying very heavily on trade credit. In addition, Suburban was now asking that Butler Lumber secure the loan with its real property. Mark Butler, sole owner and president of Butler Lumber Company, was therefore looking elsewhere for a new banking relationship where he would be able to negotiate a larger and unsecured loan.

Butler had recently been introduced by a friend to George Dodge, an officer of a much larger bank, the Northrop National Bank. The two men had tentatively discussed the possibility that the Northrop Bank might extend a line of credit to Butler Lumber up to a maximum amount of $465,000. Butler thought that a loan of this size would more than meet his foreseeable needs, but he was eager for the flexibility that a line of credit of this size would provide. After this discussion, Dodge had arranged for the credit department of the Northrop National Bank to investigate Mark Butler and his company.

The Butler Lumber Company had been founded in 1981 as a partnership by Mark Butler and his brother-in-law, Henry Stark. In 1988 Butler bought out Stark's interest for $105,000 and incorporated the business. Stark had taken a note for $105,000, to be paid off in 1989, to give Butler time to arrange for the financing necessary to make the payment of $105,000 to him. The major portion of the funds needed for this payment was raised by a loan of $70,000, negotiated in late 1988. This loan was secured by land and buildings, carried an interest rate of 11%, and was repayable in quarterly installments at the rate of $7,000 a year over the next 10 years.

The business was located in a growing suburb of a large city in the Pacific Northwest. The company owned land with access to a railroad siding, and two large storage buildings had been erected on this land. The company's operations were limited to the retail distribution of lumber products in the local area. Typical products included plywood, moldings, and sash and door products. Quantity discounts and credit terms of net 30 days on open account were usually offered to customers.

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EXHIBIT 1
Operating Statements for Years Ending December 31, 1988–1990, and for First Quarter 1991 (thousands of dollars)

	1988	1989	1990	First Quarter 1991
Net sales	$1,697	$2,013	$2,694	$718[a]
Cost of goods sold				
Beginning inventory	183	239	326	418
Purchases	1,278	1,524	2,042	660
	$1,461	$1,763	$2,368	$1,078
Ending inventory	239	326	418	556
Total cost of goods sold	$1,222	$1,437	$1,950	$ 522
Gross profit	475	576	744	196
Operating expense[b]	425	515	658	175
Interest expense	13	20	33	10
Net income before taxes	$ 37	$ 41	$ 53	$ 11
Provision for income taxes	6	7	9	2
Net income	$ 31	$ 34	$ 44	$ 9

[a]In the first quarter of 1990 sales were $698,000 and net income was $7,000.
[b]Operating expenses include a cash salary for Mr. Butler of $75,000 in 1988, $85,000 in 1989, $95,000 in 1990, and $22,000 in the first quarter of 1991. Mr. Butler also received some of the perquisites commonly taken by owners of privately held businesses.

Sales volume had been built up largely on the basis of successful price competition, made possible by careful control of operating expenses and by quantity purchases of materials at substantial discounts. Much of the moldings and sash and door products, which constituted significant items of sales, were used for repair work. About 55% of total sales were made in the six months from April through September. No sales representatives were employed, orders being taken exclusively over the telephone. Annual sales of $1,697,000 in 1988, $2,013,000 in 1989, and $2,694,000 in 1990 yielded after-tax profits of $31,000 in 1988, $34,000 in 1989, and $44,000 in 1990.[1] Operating statements for the years 1988–1990 and for the three months ending March 31, 1991, are given in Exhibit 1.

Mark Butler was an energetic man, 39 years of age, who worked long hours on the job. He was helped by an assistant who, in the words of the investigator of the Northrop National Bank, "has been doing and can do about everything that Butler does in the organization." Other employees numbered 10 in early 1991, 5 of whom worked in the yard and drove trucks and 5 of whom assisted in the office and in sales.

As part of its customary investigation of prospective borrowers, the Northrop National Bank sent inquiries concerning Mark Butler to a number of firms that had business dealings with him. The manager of one of his large suppliers, the Barker Company, wrote in answer:

> The conservative operation of his business appeals to us. He has not wasted his money in disproportionate plant investment. His operating expenses are as low as they could possibly be. He has personal control over every feature of his business, and he possesses sound judgment and a willingness to work harder than anyone I have ever known. This, with a good personality, gives him a good turnover; and from my personal experience in watching him work, I know that he keeps close check on his own credits.

All the other trade letters received by the bank bore out this opinion.

[1]Sales in 1986 and 1987 amounted to $728,000 and $1,103,000, respectively; profit data for these years are not comparable with those of 1988 and later years because of the shift from a partnership to a corporate form of organization. As a corporation, Butler was taxed at the rate of 15% on its first $50,000 of income, 25% on the next $25,000 of income, and 34% on all additional income above $75,000.

EXHIBIT 2
Balance Sheets at December 31, 1988–1990, and March 31, 1991 (thousands of dollars)

	1988	1989	1990	First Quarter 1991
Cash	$ 58	$ 48	$ 41	$ 31
Accounts receivable, net	171	222	317	345
Inventory	239	326	418	556
Current assets	$468	$596	$776	$ 932
Property, net	126	140	157	162
Total assets	$594	$736	$933	$1,094
Notes payable, bank	$ —	$146	$233	$ 247
Notes payable, Mr. Stark	105	—	—	—
Notes payable, trade	—	—	—	157
Accounts payable	124	192	256	243
Accrued expenses	24	30	39	36
Long-term debt, current portion	7	7	7	7
Current liabilities	$260	$375	$535	$ 690
Long-term debt	64	57	50	47
Total liabilities	$324	$432	$585	$ 737
Net worth	270	304	348	357
Total liabilities and net worth	$594	$736	$933	$1,094

In addition to owning the lumber business, which was his major source of income, Butler held jointly with his wife an equity in their home. The house had cost $72,000 to build in 1979 and was mortgaged for $38,000. He also held a $70,000 life insurance policy, payable to his wife. She owned independently a half interest in a house worth about $55,000. Otherwise, they had no sizeable personal investments.

The bank gave particular attention to the debt position and current ratio of the business. It noted the ready market for the company's products at all times and the fact that sales prospects were favorable. The bank's investigator reported: "Sales are expected to reach $3.6 million in 1991 and may exceed this level if prices of lumber should rise substantially in the near future." On the other hand, it was recognized that a general economic downturn might slow down the rate of increase in sales. Butler Lumber's sales, however, were protected to some degree from fluctuations in new housing construction because of the relatively high proportion of its repair business. Projections beyond 1991 were difficult to make, but the prospects appeared good for a continued growth in the volume of Butler Lumber's business over the foreseeable future.

The bank also noted the rapid increase in Butler Lumber's accounts and notes payable in the recent past, especially in the spring of 1991. The usual terms of purchase in the trade provided for a discount of 2% for payments made within 10 days of the invoice date. Accounts were due in 30 days at the invoice price, but suppliers ordinarily did not object if payments lagged somewhat behind the due date. During the last two years, Butler had taken very few purchase discounts because of the shortage of funds arising from his purchase of Stark's interest in the business and the additional investments in working capital associated with the company's increasing sales volume. Trade credit was seriously extended in the spring of 1991 as Butler strove to hold his bank borrowing within the $250,000 ceiling imposed by the Suburban National Bank. Balance sheets at December 31, 1988–1990, and March 31, 1991, are presented in Exhibit 2.

The tentative discussions between George Dodge and Mark Butler had been about a revolving, secured 90-day note not to exceed $465,000. The specific details of the loan had not been worked out, but Dodge had explained that the agreement would involve the standard covenants applying to such a loan. He cited as illustrative provisions the

requirement that restrictions on additional borrowing would be imposed, that net working capital would have to be maintained at an agreed level, that additional investments in fixed assets could be made only with prior approval of the bank, and that limitations would be placed on withdrawals of funds from the business by Butler. Interest would be set on a floating-rate basis at 2 percentage points above the prime rate (the rate paid by the bank's most creditworthy customers). Dodge indicated that the initial rate to be paid would be about 10.5% under conditions in effect in early 1991. Both men also understood that Butler would sever his relationship with the Suburban National Bank if he entered into a loan agreement with the Northrop National Bank.

Note on Bank Loans

Bank loans are a versatile source of funding for businesses. For example, these loans can be structured as short- or long-term, fixed- or floating-rate, demand or with a fixed maturity, and secured or unsecured. While each potential borrower's business is unique, reasons to borrow generally include the purchase of assets, including new fixed assets or entire businesses; repayment of obligations; raising of temporary or permanent capital; and the meeting of unexpected needs. Loan repayment generally comes from one of four sources: operations, turnover or liquidation of assets, refinancing, or capital infusion. This note describes traditional bank lending products, the role of the lending officer, credit evaluation, and the structuring of credit facilities and loan agreements. Specialized loan and credit products are described in the Appendix.

Traditional Commercial Bank Lending Products

While increased competition has forced banks to develop innovative credit facilities and financing techniques, traditional products, which include short-term, long-term, and revolving loans, continue to be the mainstay of commercial banking.

Short-Term Loans

Short-term loans, those with maturities of 1 year or less, comprise more than half of all commercial bank loans. Seasonal lines of credit and special-purpose loans are the most common short-term credit facilities. Their primary use is to finance working capital needs resulting from temporary buildups of inventory and receivables. Reflecting their use, repayment of short-term loans typically comes from the routine conversion of current assets to cash. These loans may be either secured or unsecured.

A seasonal line of credit is used by companies with seasonal sales cycles to finance periodic increases in current assets, such as inventory. The amount of credit made available is based on the borrower's estimated peak funding requirements. The borrower may draw on the seasonal line of credit as funds are required and repay the line as seasonal sales lead to liquidation of inventories. Interest accrues only on the amount of borrowing outstanding. A bank's commitments under lines of credit may exceed its ability to fund them all simultaneously, though simultaneous demand is unlikely to occur. So as not to have a legal obligation to lend its capital to a borrower in the rare case that demand for funds does exceed supply, the bank may structure this facility with a provision that allows the bank to terminate the facility at its option or provide funding subject to availability.

Businesses use special-purpose loans to finance, on a temporary basis, increases in current assets resulting from unusual or unexpected circumstances. Funding is based on the borrower's estimated needs, with the bank agreeing to fund either all or up to some percentage of the full amount. The credit facility is most likely to require full payment of accrued interest and principal at maturity, that is, a "bullet." The term for

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such a loan is usually fixed and is determined by approximating the point in time when repayment can be made. The bank's principal risk with a special-purpose loan is default because of a change in the circumstances on which the repayment plan had been based. Therefore, from the bank's perspective, it is important that the source and timing of repayment be clear at the time of funding. Identifying alternatives to routine asset conversion as a source of repayment will further protect the bank.

Long-Term Loans

Introduced in the 1930s, long-term loans, or term loans, are relatively new in banking practice. Providing advantages in its flexibility to adapt to a borrower's special requirements, a term loan has the following characteristics:

- Original maturity of longer than 1 year
- Repayment provided from future earnings or cash flow rather than from short-term liquidation of assets
- Provisions of the loan arrangement detailed in and governed by a signed loan agreement between the borrower and the lender

Term loans are most often used for specific purposes such as purchase of fixed assets, acquisition of another company, or refinancing of existing long-term debt. The term loan may also be used in place of equity or a revolving credit facility to finance permanent working capital needs. The loan's amount and structure will closely match the transaction being financed. A term loan is typically fully funded at its inception, and principal and interest are repaid over a period of years from operating cash flows generated by the borrower. The tenor, or maturity, of term loans ranges from 1 to 10 years, with the average being from 2 to 5 years. Although the lender does not look to liquidation of the acquired assets as the primary source of funds for repayment, a term loan is likely to be secured. Most often, the security will be a claim on the assets purchased with the proceeds of the loan.

Revolving Loans

The revolving credit loan, a variation on the line of credit, has a commitment period often extending beyond 1 year, up to 3 or 4 years, and allows a business to borrow from a bank up to a maximum commitment level at any time over the life of a credit. The borrower's use of proceeds under a revolving loan tends to be not for an isolated transaction but to fund day-to-day operations, meet seasonal needs, or otherwise provide the borrower with a discretionary range of when and how much to borrow and when to repay the loan. Unlike a line of credit, a revolving loan is often used to finance permanent working capital needs when equity and trade credit are inadequate to support a company's sales volume.

Over the term of a revolving credit facility, the borrower has the right to repay a loan and later reborrow those funds. But this right to reborrow is effective only when the borrower is in compliance with the loan agreement's terms and conditions. The amount of commitment is based upon the value of the assets being funded as well as the borrower's creditworthiness. The borrower pays a commitment fee, based on the total amount of the revolving facility, to secure a formal commitment from the bank. Many revolving loans are structured to convert to term loans or to renew automatically at maturity. The latter structure, called an evergreen facility, automatically renews a revolving credit facility until either the bank or the borrower gives notice of termination. Like other credit facilities, a revolving line of credit may be secured or unsecured.

EXHIBIT 1
The Credit Proposal Memo

Source: Citicorp Institute for Global Finance.

The credit proposal memo and presentation typically includes the following information and analyses:

- Company background and relationship with the bank
- Purpose of the credit extension
- Financial statement analysis, cash flow projections, and debt service capacity
- Assessment of management process, strengths, and weaknesses
- Assessment of major risks, including impact of forecasted economic trends and the strength of competitors
- Analysis of repayment sources for all facilities and timing for those with a tenor, or maturity, of greater than one year
- Summary of loan structure and repayment terms
- Summary of key covenants and repayment terms of other instruments that might materially affect the position of the bank
- Statement of adherence to credit policy guidelines or explanation of exceptions
- Analysis of collateral
- Listing of noncredit products
- Trade or bank checkings
- Comment on trustee relationships

Role of the Loan Officer

"Banks succeed when the risks they assume are reasonable, controlled, and commensurate with their resources and credit competence. Lending officers, in turn, must accurately identify, measure, and manage risk if their banks are to succeed."[1]

The loan officer must balance two often conflicting responsibilities: those of a marketing officer and those of a credit officer. While budget pressures require the loan officer to develop new banking relationships, credit responsibilities require that these new relationships not sacrifice credit quality for short-term profits. "The costliest mistake that a bank management can make is to book unworthy loans in order to achieve budget goals."[2] The lending institution's credit policy should give loan officers guidelines to enable them to balance loan quality and quantity and achieve the bank's earnings objectives.

The lending institution and its shareholders expect loan officers to understand a credit thoroughly before approving the lending of the bank's capital. The credit proposal memo, described in Exhibit 1, includes the information and analyses used to evaluate a potential borrower's creditworthiness. Every commitment of a lending institution typically requires independent approval and the signatures of at least two senior lending officers, who are held directly accountable for the lending decision. Direct accountability is intended to make them more critical of any exceptions to the bank's credit policy.

Evaluating Creditworthiness

Before a bank agrees to commit its funds to a company, its loan officers analyze the prospective borrower to determine creditworthiness. Loan officers have a responsibility to "grasp the quantitative and qualitative details of each transaction thoroughly, analyze

[1] P. Henry Mueller, "Lending Officers and Lending," in *Bank Credit*, ed. Herbert V. Prochnow (New York: Harper & Row, 1981), p. 92.

[2] P. Henry Mueller, *Perspective on Credit Risk* (Robert Morris Associates, 1988), p. 18.

its variables, and make adequate allowance for their impact."[3] Evaluation of a borrower's ability and willingness to repay a loan at maturity involves financial analysis, including forecasting and sensitivity analysis, a qualitative assessment of management's character and capability, due diligence, and an identification and analysis of risk.

Financial Analysis

A thorough financial analysis requires preparation of the following:

- Year-to-year comparisons of financial statements
- Cash flow statements
- Liquidity analysis
- Capital structure analysis
- Projections and sensitivity analysis
- Estimation of asset values: market value and liquidation value
- Comparison of actual versus budgeted performance

A first step in the financial analysis of a potential borrower is a determination of the quality of earnings and the strength of the balance sheet. To make this determination, the credit officer analyzes financial, operating, and leverage ratios, and trends in revenues and expenses over time, and compares such ratios to industry averages, looking for positive and negative changes in the company's profitability and industry position.

The historical financial condition of a borrower, however, is an incomplete indication of creditworthiness. Because the loan will be approved or denied based on, among other essential criteria, an assessment of a borrower's ability to repay the loan from future cash flow generated by operations, an estimate of a borrower's future financial condition is important to the lending decision.

Pro forma financial and operating statements are prepared so that the lending officer may assess the borrower's potential to generate sufficient free cash flow to make interest and principal payments when due. These projections and the underlying assumptions must be tested under various scenarios to establish the borrower's sensitivity to change. While one cannot possibly test for every possible event, worst-case scenarios will indicate just how poorly the business can perform before the borrower defaults.

Qualitative Assessment

Credit evaluation also requires assessment of the character and capabilities of the persons to whom a loan may be extended, that is, the persons responsible for achieving the goals of the operating and financial plans. Lenders must determine the quality, breadth, and depth of the management team. Assessing its ability to implement operating and financial plans gives the lender insight into the management team's capability. Banks pay a high price for hasty credit decisions. Though gauging the integrity of a new customer takes time, integrity is a critical component of any lending decision. Management's interests should be aligned with the company's and with the bank's interests and expectations. Ownership and compensation systems indicate management's stake in the business.

Due Diligence

Due diligence is the process of going out and "kicking the tires" of the potential borrower. While time-consuming, it is an important aid to understanding better how the prospective borrower does business. Due diligence can include plant tours, trade checks, and interviews with the borrower's competitors, suppliers, customers, and employees. Comprehensive due diligence also includes reviews of employee relations, compensation and benefits, management's planned capital expenditures, other debt obligations, and management information systems and technology. An environmental audit may also be necessary. Due diligence should also uncover any contingent liabilities that may materially affect the borrower's ability to repay the loan at maturity. Unfunded pension liabilities, pending or threatened legal proceedings, and guarantees by the borrower are some examples of contingent liabilities.

Risk Assessment

Risk assessment is another component of the credit evaluation process. The credit officer must identify and analyze the key risks associated with a specific credit. Some risks are associated with the borrower and his or her business; with potential changes in the environment; and with cyclical activity and regulatory or other unanticipated developments. The loan officer must make judgments about future conditions that could affect a borrower's willingness and ability to repay the obligation. Determining potential risks and assessing their level of severity, the probability that they will occur, and the estimated costs associated with their occurrence are critical. The structure of the credit facility and loan agreement attempts to minimize risk.

Determining the Bank's Willingness and Ability to Lend

In addition to conducting a thorough credit evaluation, the loan officer must determine whether approving a loan application is in the bank's best interests and within regulatory capital and operating guidelines. A bank's ability to lend is restricted by banking regulations that limit the amount of loans that may be extended to any one borrower. A bank may also establish an internal limit ("house limit") on the amount lent to a single borrower. What influences a bank's willingness to lend are its earnings targets and portfolio objectives. A bank attempts to maintain diversification in its portfolio of loans and investments to reduce its exposure to risk. These targets and objectives shape a bank's loan origination and acquisition strategy. Thus a potential borrower must not only meet the lending institution's credit standards but also be within its target lending market and legal lending capacity.

[3]Mueller, "Lending Officers and Lending," p. 40.

Structuring the Credit Facility and Loan Agreement

Once creditworthiness is ascertained and the bank decides it is willing and able to extend credit to a company, the bank and the borrower can begin to structure an appropriate credit facility and loan agreement. The strength and the nature of a credit and the bank's credit policy help to determine the terms and conditions defined in a loan agreement.

Typically, short-term loans are not made pursuant to a loan agreement, or if so, the loan agreement is far less comprehensive than that used for long-term or revolving loans. The loan agreement discussed in this note applies to term and revolving loans and includes the following sections:

- Amount and terms of the credit facility
- Conditions precedent
- Representations and warranties
- Covenants of the borrower
- Events of default

Amount and Terms of the Credit Facility

This first section of a standard loan agreement describes how much and when the borrower may borrow, the interest provisions, repayment terms and additional fees, the intended use of loan proceeds, and any security interest taken by the bank.

The amount of a bank's commitment under a credit facility may be stipulated or based on a formula, for instance, a percentage of accounts receivable. The interest rate charged for use of those committed funds may be based on either a fixed or a floating rate. The use of a fixed or a floating interest rate, the method for determining the floating rate and reset periods, if applicable, and the method for computing accrued interest are negotiable factors. Interest can be computed on the basis of a 360- or a 365-day year. Computation using a 360-day year yields a higher effective rate for the borrower.

Additional fees the bank may charge include commitment and closing fees. The borrower pays a commitment fee to compensate the bank for its use of the bank's capital over the duration of the commitment. This fee typically ranges from .25% to .75% per year. The borrower may also pay a closing fee on the day the loan closes, that is, the date the loan's legal framework is in place. This payment compensates the bank for work done thus far in evaluating the borrower's creditworthiness and setting up a credit facility for it. In a competitive situation, this fee may be .25% to .375%; in a high-risk situation, it can be as much as 2.00% to 2.50% of the amount of the commitment. A penalty or default rate of interest may also be stipulated. Applied in the event that payments are not made when due, this rate is set high enough so that it would not be to the borrower's economic advantage to delay payments.

The option to prepay and the option to reduce the total commitment are provisions negotiated in this section of the loan agreement for term loans and revolving loans, respectively. These provisions distinguish most bank financing from alternative sources of funds. Under a revolving credit facility, the right to reduce the amount of the commitment is valuable to the borrower should the company's financing needs change. Reducing the amount of the commitment will reduce the commitment fee paid by the borrower, since it is based on the total commitment.

In the case of a term loan, the loan agreement may provide for full or partial prepayment of the loan at the borrower's discretion, with or without a premium or upon occurrence of certain events. The option to repay provides a route of escape from covenants that may become overly restrictive. Prepayment also works in favor of the borrower should the cost of other sources of funds decline significantly over the term of the loan, making refinancing more economical. Recognizing the value of this right, a borrower may agree to tighter covenants or a higher rate of interest than if locked in by prepayment restrictions.

A description of the use of loan proceeds is also included in this first section of the loan agreement to assure the bank that the borrower intends to use the loan proceeds in the manner understood by the bank.

An additional provision negotiated in this section of the loan agreement is the taking of collateral or guarantees to secure a loan. A claim on certain assets of the borrower can mitigate the bank's loss should the borrower default. Assets used as collateral are typically those purchased with the loan proceeds; levels of collateral are typically commensurate with the creditworthiness of the borrower. It is often to the bank's advantage to take as much security as possible against a loan.

If the borrower defaults on a secured loan, the bank has the right to take control of and liquidate the pledged assets. Funds from the liquidation are applied against the amount outstanding on the defaulted loan. If default is on an unsecured loan, the bank is only a general creditor of the business, and recovery of the principal is less likely.

Conditions Precedent

The conditions precedent are requirements the borrower must satisfy before the bank has a legal obligation to fund a commitment. These conditions may include any business transactions that must be completed or events that must have occurred. Other standard items in this section are the opinions of counsel, certificate of no defaults, the note, and resolutions of the borrower's board of directors authorizing the transaction. The condition precedent will also include a material adverse change clause encompassing both balance sheet condition and operations (income statement and prospects). This clause serves an important protective function for the lender in the case that a material adverse change occurs prior to funding and is not yet reflected in the financial statements.

Representations and Warranties

In considering a loan application, the lender relies on certain information furnished by the borrower and has thereupon made assumptions about the borrower's legal status, creditworthiness, and business position. It is upon these assumptions that the bank has agreed to lend money to the borrower. The representations and warranties section documents the information and assumptions relied upon. By executing the loan agreement, the borrower confirms the accuracy and truth of the information provided as of the date of execution. Misrepresentation constitutes an event of default. Principal representations and warranties include:

- Financial statements are correct, and there has been no material adverse change in the financial condition of the borrower
- The borrower is not subject to any litigation, pending or threatened, or party to a contract that could effect a material adverse change in the business position of the borrower
- Other facts pertinent to the credit judgment are correct
- No factual misstatement or omission in information furnished
- Due incorporation
- Continued existence
- The loan agreement will be legal, valid, and binding when signed
- No need for third-party consent
- Corporate authority
- No violation of existing agreements
- No violation of laws
- All tax returns have been filed; all taxes have been paid
- Collateral offered is owned by the borrower and free of liens

The material adverse change clause is designed to cover circumstances in which the borrower's ability to perform obligations under the loan agreement is thrown into doubt. With regard to the financial statements, the material adverse change clause is used to verify that there has been no material adverse change in the borrower's financial condition or operations since the date of the financial statements relied upon for the credit evaluation. This section may also contain a representation as to the accuracy of other information not included in the financial statements, including nonpublic information such as cash flow statements and projections, supplied by the borrower to the bank and fundamental to the credit decision.

The representations and warranties section also contains material adverse change standards with respect to actual or threatened legal proceedings where the outcome

could significantly affect the strength of the borrower's credit standing in the eyes of the bank. These standards may also be broadened to include circumstances that may not be reflected immediately in the borrower's financial statements or result in litigation.

Covenants of the Borrower

Covenants are a heavily negotiated part of loan agreements. As representations and warranties verify certain statements by the borrower at the date of execution of the loan agreement, covenants carry forward the representations and warranties, and establish the borrower's ongoing obligation to maintain a certain status for the loan's duration. Covenants set minimum standards for a borrower's future conduct and performance and thereby reduce the risk that the loan will not be repaid. Violation of a covenant creates an event of default and gives the bank the right to refuse to make additional advances.

The use of certain covenants depends upon such factors as the nature of the borrower's business, the financial condition of the borrower, and the term of the loan. If credit risk is high, covenants may be tied directly to detailed financial projections provided by the borrower. If credit risk is low, a few general financial benchmarks may be sufficient. In any case, covenants should be no more restrictive than the policies any prudent manager would follow to maintain or build a solid credit rating, but they should be designed to give early warning of deterioration in the financial condition of the borrower. Covenants should also be drafted to allow for normal seasonal and cyclical variations of the borrower's business so that an event of default is not likely to occur.

Affirmative Covenants

Affirmative covenants stipulate actions the borrower must take and would normally take even if the loan were not in effect. Generally, they include the following:

- Application of loan proceeds to specified purpose
- Financial covenants
- Reporting requirements
- Compliance with laws
- Preservation of corporate existence
- Rights of inspection
- Maintenance of insurance
- Maintenance of properties
- Maintenance of records and books of account

As in the first section of the loan agreement, the borrower must assure the bank that the proceeds of the loan will be used in the manner the bank understood in its decision to extend credit.

Financial covenants are those based on information contained in the borrower's financial statements and focus on the borrower's financial position and overall operations. Financial covenants establish guidelines for operation of the borrower's business, carry forward the borrower's representations and warranties regarding its financial position, further help the bank to gather information about the borrower, and permit exercise of remedies upon default. Financial covenants establish minimum financial tests with which a borrower must comply. These tests can specify dollar amounts, such as (tangible) net worth and working capital, or ratios such as the current or quick ratios, net worth ratios, leverage ratio, and fixed-charge coverage ratio. Financial covenants should signal financial difficulty and be triggered long before liquidation or bankruptcy filing becomes necessary. They may be used like other affirmative and negative covenants to guide management decisions on an ongoing basis, or serve only as periodic tests.

To keep the bank informed of financial and operating performances, the borrower covenants that he or she will meet certain established reporting requirements and provide such information to the lender in a timely fashion. This information allows the bank's lending officer to monitor the borrower's financial condition and compliance with covenants.

Negative Covenants

The negative covenants tend to be more significant and more heavily negotiated than affirmative covenants because they place clear restrictions upon managerial decisions. These restrictions are intended to prevent management decisions that might impair the borrower's liquidity or solvency, or jeopardize the bank's claim against the borrower's earnings and assets.

Negative covenants typically include the following:

- Restrictions on mortgages, pledges, or other encumbrance of assets (negative pledge)
- Limitation on total indebtedness
- Restrictions on payment of cash dividends
- Restrictions on repurchase of shares
- Restrictions on mergers
- Restrictions on sale of assets
- Restrictions on sale subsidiaries
- Limitation on capital expenditure
- Restrictions on engaging in other businesses
- Restrictions on voluntary prepayment of other indebtedness
- Limitation on investment of funds
- Limitation on loans and advances
- Limitations on leasing arrangements

The negative pledge covenant is designed to prevent the borrower from creating liens on its assets or earnings for the benefit of other lenders. Its purpose is to provide a pool of assets that will be available for payment of unsecured creditors' claims equally, without preference of one over another in the event of default. The negative pledge is typically given to an unsecured creditor.

Restrictions on total indebtedness apply to a variety of debt instruments and often include capital lease obligations, deferred payment obligations, unfunded vested pension liabilities, guaranteed indebtedness, and indebtedness of others secured by property of the borrower. This restriction is usually stated as a specified amount or in the form of a ratio (total debt to total assets, to working capital, or to [tangible] net worth) and serves to limit the amount of additional indebtedness the borrower may incur over the term of the loan. The restriction may differ for short- and long-term obligations, and exceptions to the limit may be made for certain debt instruments such as subordinated debt.

In restricting the borrower's ability to merge or transfer a substantial part of its assets, the bank is ensuring the survival of the borrower's obligation. With reference to the sale or transfer of assets, those assets or subsidiaries fundamental to the bank's credit analysis should be specified as restricted from sale or transfer. Assets not involving the transfer of the borrower's business in or near its entirety should not be restricted by this covenant.

Restrictions on the use of funds for dividend payments, repurchase of shares, capital expenditures, or otherwise are included so that the bank may be further assured that

cash will be available to make interest and principal payments when due. These restrictions and limitations also ensure the borrower's general adherence to its operating plan.

Events of Default

The events of default section describes circumstances in which the bank has the right to terminate the lending relationship. Situations leading to the declaration of an event of default include the following:

- Failure to pay interest or principal when due
- Inaccuracy in representations and warranties
- Failure to abide by a covenant
- Bankruptcy, liquidation, appointment of receiver
- Entry of a judgment in excess of a specified amount
- Impairment of collateral: invalidity of a guaranty or security agreement
- Failure to pay other indebtedness when due or perform under related agreements: cross-default and cross-acceleration
- Change of management or ownership
- Extraordinary circumstances
- Expropriation of assets
- Material adverse change

Upon the occurrence of an event of default, the most common remedy lenders exercise is the renegotiation of the loan agreement. In some cases, usually where the circumstances are considered less significant, the loan agreement provides the borrower a period of time, referred to as a cure or grace period, to correct its breach of a covenant. If the default is cured, the bank is then required to continue providing the loan to the borrower.

In the case where the default is not cured and the loan agreement is not negotiable, the bank may accelerate the loan and terminate the lending relationship. The bank may also set off the borrower's deposits against its obligation to repay the loan and exercise its right to foreclose on security covered under a security agreement.

The cross-default provision gives the bank the right to declare an event of default when the borrower is in default on another obligation. This provision is designed to prevent the bank from being placed at a disadvantage if competition to obtain repayment begins among the borrower's creditors, that is, the borrower has defaulted under another loan agreement and the lender is demanding payment.

Although banks rarely exercise the right to accelerate loan repayment, having this right substantially strengthens a lender's negotiating position with the borrower and other creditors of the borrower if problems are encountered with the loan. Acceleration is used sparingly by banks, since use by one could cause its invocation by other creditors and precipitate a bankruptcy.

Sale of Loans to Third Parties

No longer is the price of a loan set at the discretion of the loan officer guided by the lending institution. With increasing pressure to sell loans to third parties, the market is becoming the most influential factor in setting price.

Certain changes in the regulation of banks and in the business of commercial banking have precipitated increasing sales of loans. Regulatory changes, including new risk-based capital guidelines adopted by the Basle Committee on Banking Regulations and

Supervisory Practices on July 11, 1988, require banks to be better capitalized (tangible net worth as a percentage of total assets). This is costly and restricts lending capacity. In addition to the risk-based capital guidelines, regulations and internal bank lending policies restricting the amount of loans a bank can make to one borrower or group of borrowers often force banks to sell off all or a portion of the loans they originate.

Several vehicles facilitate the sale of loans, some allowing an originating bank to maintain partial ownership of the loan or responsibility for its management. Participations, syndications, and asset sales are all examples of underwriting activities undertaken by banks.

Participations

A participation loan is a single loan made to a large borrower by more than one lender. Participation loans are made when the lead lender cannot lend to a large borrower because of legal or internal lending limits restricting the amount of bank capital that can be loaned to one borrower or classification of borrowers. The lead bank originates the transaction and maintains responsibility for servicing the loan.

Many loan participations come about through correspondent banking relationships. A correspondent bank performs services for a bank in a market that is inaccessible to the other. Both banks must evaluate the creditworthiness of the borrower and independently decide to enter into the participation. While credit decisions are made independently, risk may not always be shared equally in participations. Some participations are structured on a last in, first out (LIFO) basis so that the originator, or first in, takes a larger portion of the risk associated with the participation loan.

Syndications

Syndications are similar to loan participations, except that the syndicate members lend directly to the borrower. An originating bank, called the lead bank or manager, arranges a credit facility for a large borrower. The bank then sells off portions of the loan to other lenders.

Syndication has been used increasingly for several reasons, including the ability to spread risk across lenders, to lend to large borrowers when the size of the individual credit is larger than legal or internal standards would allow, and to integrate the borrower's banking relationships. The syndicate members' obligations are separate; one lender is not responsible for the commitment of another; however, the rights and obligations of all the parties (the syndicate members and the borrower) are governed by one agreement, the syndicate loan agreement. Each participant in a syndication shares in the loan's risks and makes its own credit decision.

There are two types of syndicates: best-efforts and firm (or underwritten) commitment. In a best-efforts syndicate, the manager will market the loan under the agreed-upon terms and conditions, but if the syndication is not fully subscribed, the loan will not be made and the manager retains no legal obligation to the borrower. In a firm commitment syndicate, the lead bank agrees to make the loan regardless of its ability to syndicate it completely.

In a syndicate, a borrower pays certain fees in addition to interest on the loan: a commitment fee based on the amount of the credit and the undrawn portion; a management fee paid to the syndicate managers as compensation for assembling the syndicate and servicing the loan; and participation fees to syndicate participants based on the amount of their commitments. Participation fees range from .25% to 1.50% and are used to attract lending institutions to a syndicate. The agency fee paid to the bank servicing the loan can range from $5,000 a year for a routine transaction to $500,000 a year for a more complex transaction.

Asset Sale

A relatively recent development has been the sale of loans to third parties. An asset or loan sale is similar to a syndicate except that the lead bank initially takes the credit on its books and then sells off most or all of the credit, retaining little or nothing for its own portfolio. In this transaction, all risk from the sold portion is eliminated for the originating bank, and the loan is removed from its balance sheet. The bank earns a fee for its efforts in originating the loan. An asset sale typically occurs as a second phase to a syndication.

Appendix
Specialized Loans and Credit Products

Trade Finance Products

Trade finance products are specialized bank products designed to reduce the risks and uncertainties associated with commercial transactions by substituting the bank's credit risk for that of the purchaser of the goods. Thus, they facilitate trade.

When entering into trade finance credit arrangements, the bank evaluates the obligor's creditworthiness in much the same way it evaluates other short-term credits. The most common trade finance products are letters of credit and banker's acceptances.

Letters of Credit (L/C)

A letter of credit represents a conditional promise to pay and is generally non-negotiable. It substitutes the bank's credit for that of its customers by providing a guarantee of payment to the third party upon the satisfaction of certain conditions. This differs from the banker's acceptance, which, in effect, is payment.

In trade finance, a letter of credit is usually issued by the purchaser's bank, which agrees to pay the purchaser's obligation to a seller upon receiving proof that a specified delivery has been made. The bank has no obligation to delve into the content of the underlying commercial transaction (i.e., the sales agreement between the seller and buyer) except as specifically required by the terms of the L/C. The purchaser agrees to pay the bank the sales amount plus a fee.

The term of an L/C is generally related to the expected amount of time needed to complete the transaction. It may be revocable or irrevocable. A revocable L/C can be withdrawn, without notice to the beneficiary, at any time prior to actual performance of the transaction. An irrevocable L/C cannot be withdrawn before its expiration.

Stand-by letters of credit differ from trade L/Cs in that the issuing bank agrees to pay the L/C beneficiary only if its client defaults on payment to the beneficiary. So, in the above example, the seller would collect from the issuing bank only upon default of the purchaser.

Banker's Acceptances

A banker's acceptance represents the bank's commitment to pay a specific amount of money on a specific date. This commitment arises when the bank agrees to pay the obligations of a purchaser to enhance its creditworthiness. The commitment is created when a seller prepares a time draft[4] ordering a buyer to pay for goods purchased upon their receipt. Once signed and acknowledged by the purchaser and "accepted" by the purchaser's bank, the draft becomes a banker's acceptance. The liability accepted by the bank is called acceptance liability.

[4]A time draft is one that is due upon presentation and acceptance by the purchaser's bank after a specified period of time, e.g., 30 or 60 days.

The banker's acceptance is a short-term instrument generally with a duration of six months or less. The purchaser on whose behalf the banker's acceptance was accepted repays the bank under agreed-upon terms from the proceeds on the resale of the purchased goods. Since it is a negotiable instrument, the holder of a banker's acceptance may sell it to a third party or the bank, usually at a discount, to receive payment immediately. Thus, the banker's acceptance can be used as a form of accounts receivable financing.

Factoring

Factoring is a method of accounts receivable financing in which the lender purchases the borrower's receivables. By purchasing a firm's accounts receivable, the bank assumes certain risks and activities it does not have with typical accounts receivable financing, in which a lender lends money to a company based on its accounts receivable balance. Factoring gives the bank legal ownership of the receivables and therefore the risk of accounts receivable defaults. The credit and collection functions formerly handled by the company may be undertaken by the bank. A lender may provide factoring services on a discount or maturity basis.

Discount factoring is a service in which the seller of the receivables receives payment from the bank before their expected maturities. The amount the bank is willing to lend is based on the accounts receivable balance less discounts and estimated returns and bad debts. Interest is charged on the basis of the average daily balances owed.

Maturity factoring differs from discount factoring in that the lender performs the credit and collection functions and pays the borrower on invoice due dates. The factor receives a fee based on handling costs and estimated bad-debt risk.

Asset-Based Lending

Traditional loans may be secured by the assets of the borrower, and repayment is assumed to come from operating cash flow or conversion of current assets to cash. Asset-based loans differ from traditional loans in that the borrower's ability to repay the borrowed funds from operating cash flows is less predictable. A lender making an asset-based loan looks mainly to the value of the assets securing the loan for repayment of the obligation. Asset-based loans are made against accounts receivable, inventory, and equipment.

In lending against accounts receivable, the asset-based lender agrees, after careful analysis, to lend up to a certain percentage of the accounts receivable. The percentage of face value the lender lends against will be based upon the age, quality, and concentration of accounts receivable, keeping in mind the liquidation value should the borrower default. Generally the lender will lend up to 80% of face value of the qualifying receivables amount. Qualifying receivables is the total amount less nonconforming receivables.

The analysis of inventory is similar to the analysis of accounts receivable, where current information and ongoing monitoring are key to successful lending. The lender will identify the percentage of inventory in raw materials, work-in-process, and finished goods inventories that qualifies to be lent against based on their potential liquidation value. The advance rate against inventory is relatively low, sometimes 50% or less. This conservatism reflects the concerns for spoilage, technical obsolescence, and frequent deep discounts in disposing of inventories very quickly.

In lending against equipment, the asset-based lender has little concern for historical cost, fair market value, or replacement value. The lender instead wants to determine the value in a forced liquidation sale after related expenses, for instance, the cost of removing the equipment. Asset-based lenders will typically lend up to 80% of the forced sale value of machinery and equipment.