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Essay

TOPIC: COMMERCIAL BANKS

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Commercial banks

Bankers are justifiably nervous about making loans to start-up businesses, since the failure rate is high. Most local bankers will only extend loans to a start-up if they are comfortable with the situation and the qualifications of the borrower.

What makes bank lenders comfortable? Bankers ask Three Big Questions before they lend money, and rarely part with their capital if they cannot obtain satisfactory answers to all three:

1. Will the borrower be able to pay me back?

2. Is the borrower's character such that he or she will pay me back?

3. If the borrower fails to repay me, are the marketable assets that I can put my hands on?

In seeking an answer to the first of the questions, a banker will evaluate the entrepreneur and the business plan:

- Does the applicant understand the market and have a feasible plan for satisfying it?
- Does the entrepreneur have the experience or knowledge – or both – required to operate this type of business successfully?
- Is the business plan realistic, complete, and based on reasonable assumptions?
- Are the revenue and cost projections realistic and conservative?

The banker will also address the adequacy of the venture's financing, since inadequate financing is a major reason for business failure.

Lenders generally answer the second question, "Is the borrower's character such that he or she will pay me back?" by examining the loan applicant's credit history. Whether it's a car loan, a home mortgage, or a business loan, a banker will seek evidence that the applicant pays his or her bills on schedule.

The third question, "What can I put my hands on?" is about *collateral*. Collateral is an asset pledged to the lender until such time as the loan is satisfied. In an automobile loan, the lender retains title to the vehicle and makes sure that you've made a sufficiently large down payment so that the bank can repossess the car, sell it, and fully reimburse itself from the proceeds if you fail to make timely loan payments. Business loans are similar. The lender wants to see assets that, in the case of business failure, can be sold off to satisfy the loan. Those assets might be current assets such as cash, inventory, and accounts receivable; they might be also be fixed assets such as vehicles buildings, and equipment.