Who Gets the Loan?

What Kind of Criteria is Important When a Contractor Goes Hunting For Bank Credit

By Bryan E. Milling

Bank credit consideration can make a valuable contribution to the success of a business enterprise. Indeed, few businesses grow and prosper without a bank’s financial assistance. From another perspective, the failure to qualify for a bank loan can hamper the progress of a promising operation. Consequently, a business owner should recognize the credit criteria that justifies bank credit consideration. That recognition prevents any unrealistic expectations when the business owner requests a bank loan. Moreover, the basic financial criteria provide useful guidelines for management. The business that operates within those guidelines enjoys a measure of financial security, even though a bank loan doesn’t stand as an immediate concern.

Of course, in any circumstance, a bona fide purpose stands as necessary prerequisite for a business loan. That is, the loan must provide the financial lubrication that facilitates some profitable business objective.

That objective may be a higher sales volume that will increase the borrower’s profits. Or it may be an equipment purchase that helps increase earnings by reducing production costs. In any event, requesting an indefinite loan amount for some indefinite purpose guarantees declination.

Presuming the purpose warrants serious consideration of a loan request, a bank then examines the prospective borrower’s financial circumstances. Naturally, that examination focuses on the income statements that gauge the firm’s financial performance, and the balance sheet that provides a view of the firm’s condition.

Ideally, the income statements should display profitable operating results. Moreover, those results should appear over several consecutive operating periods.

Unfortunately, demonstrating profitable operations for one month or one quarter does not overcome the psychic obstacle that a long history of losses sets before a banker.

At the same time, an occasional loss doesn’t necessarily exclude a business from credit consideration. A sensible lender can understand the cause for a loss during a single operating period. But the borrower must demonstrate the changes in the firm’s circumstances that set the stage for a profitable future.

Of course, in any circumstance, a prospective borrower’s balance sheet must demonstrate that the business enjoys a satisfactory financial condition. That involves a number of financial considerations. However, two primary concerns typically orient a bank’s review of a business balance sheet.

The borrower’s liquidity stands as one of those concerns. Liquidity represents a firm’s ability to meet its current obligations in a timely manner. The more liquidity a business
displays, the more assurance a lender feels about the ultimate repayment of any credit consideration.

The current ratio provides the most important measure of a prospective borrower’s liquidity. That ratio summarizes the relationship between a firm’s current assets (cash, accounts receivable, and inventory) and its current liabilities (accounts payable, accruals, and any other obligations due within twelve months).

Thus, the current ratio for a business with $50,000 in current assets and $25,000 in current liabilities becomes:

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\frac{\text{Current assets}}{\text{Current liabilities}} = \frac{50,000}{25,000} = 2
\]

The firm has a two-to-one current ratio. According to the traditional rule of thumb, that represents the minimum level of liquidity necessary to qualify a business for a bank loan. Presumably, a lower current ratio raises questions about a firm’s ability to meet its current obligations promptly. Alternatively, a higher rate adds to the financial foundation necessary to justify a positive credit decision.

Of course, a rule of thumb isn’t etched in stone. In some circumstances, a current ratio that falls well below the traditional criterion may not eliminate the potential for a bank loan. In other circumstances, a higher ratio won’t offset a borrower’s negative attributes. But the two-to-one current ratio still stands as the common standard for the level of liquidity necessary to qualify a business for bank credit consideration.

A bank also is very concerned about a prospective borrower’s debt load. Another ratio provides the common criterion for evaluating that burden. That ratio relates a firm’s total debt to the total equity in the business.

Thus, we find the debt/equity ratio for a business with $40,000 in total liabilities and $20,000 in owner’s (or stockholder’s) equity as follows:

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\frac{\text{Total liabilities}}{\text{Owner’s equity}} = \frac{40,000}{20,000} = 2
\]

The business has a two-to-one debt/equity ratio. Creditors provide two dollars to the business for every dollar committed by the business owner. Generally, a higher debt/equity ratio disqualifies a business from bank credit consideration. A couple of premises presumably justify that traditional limit.

First, a bank views the owner’s equity in a business as the first line of defense against any financial setback a borrower might incur. Requiring at least one dollar in equity for every two dollars in debt helps insure that the owner—not the bank—will absorb any losses that develop from that setback. Experience proves that as a borrower’s debt/equity ratio rises above the two-to-one level, the financial protection provided by the owner’s equity shrinks dramatically.

The other premise that makes a higher debt/equity ratio unacceptable to a bank proceeds from a realistic view of human nature. Thus, bankers realize that a borrower is less concerned about protecting a lender’s interest than his own. Consequently, as
debt rises relative to a firm’s equity, many business owners tend to exercise less management caution. Presumably, risk becomes more acceptable when creditors will bear the brunt of a management mistake. From a banker’s perspective, requiring at least one equity dollar for every two provided by creditors helps discourage that attitude.

Of course, even sophisticated bank credit analysis is subject to error. Moreover, a business that initially appears credit worthy can sustain a setback that leads to financial failure. Consequently, a bank usually requires collateral as additional security for a business loan. That requirement is common even though a borrower satisfies the bank’s financial standards for credit worthiness.

Thus, to obtain a bank loan, a borrower must pledge all or a significant part of the firm’s assets to the bank. The bank then liquidates those assets should the business lose to capacity to repay the credit consideration. Fortunately, that need seldom arises. But collateral provides the bank with the additional protection necessary to justify loans to businesses operating in an uncertain economic environment.

Finally, we should note one other standard bank requirement. That is, a bank expects a business owner to become personally liable for any credit consideration extended to his firm. Moreover, that requirement exists even though the business entity is incorporated.

The requirement for personal guaranty again encourages management prudence while the business employs the bank’s funds. After all, the business owner reaps the benefits from the incremental earnings gained from a bank loan. Logistically, the owner should help bear the brunt of any loss the bank might sustain should the business fail.

Of course, a business owner might not like the idea of providing a personal guaranty for a bank loan. Indeed, he also may find the bank’s basic credit criteria unreasonable and the requirement for collateral unfair.

But a business owner should not overlook the golden rule that orients bank lending practices: “Those with the gold make the rules.” To obtain bank credit consideration, a borrower must satisfy the bank’s requirements.