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A Guide to Business Credit

The need for financing is a critical and perennial concern for the owners of small businesses. Indeed, few things are as crucial to the health of a small business operation. The personal resources of their owners launch many small businesses. But they can quickly reach the stage where the owner must look to the credit market for financial help in expanding operations. The banking industry is an important source of working capital. However, entrepreneurs may not realize that applying for commercial credit is a more customized process than obtaining consumer credit, and requires a great deal of preparation by the business applicant. This brochure may help to de-mystify the process and improve your chances of getting the credit you need.

Types of Loans

Banks and other financial institutions can assist you by providing funds through personal or commercial credit. Examples of personal credit include automobile loans, credit cards, and home mortgages. Commercial credit includes business loans; here are some of the options:

Short-term loans are one of the most common types of business loans and are usually for less than one year. They can provide interim working capital for a business temporarily in need of cash, and are typically repaid in a lump sum when inventory or accounts receivable are converted into cash.

Intermediate-term loans are often used for a business start-up, the purchase of new equipment, expansion, or an increase in working capital. The maturity dates range from one to three years.

Long-term loans generally are made for major capital improvements, acquiring fixed assets, or business start-ups. The term of the loan runs for periods of three to five years and is usually based in part on the life of the asset financed. Repayment is usually made in monthly or quarterly installments.

A line of credit offers you the ability to borrow money repeatedly, up to your credit limit, without having to reapply. A line of credit is particularly important to businesses that experience seasonal fluctuations. The lender generally will perform a review once a year, at which time the borrower is asked to provide updated financial statements.

The Credit Application Process

Applying for commercial credit can be tedious. It calls for more documentation than you might initially have expected and certainly a lot more than when you apply for consumer credit. For lenders, extending credit to an entrepreneur usually means customizing the loan to suit the credit needs of that business. So don' be disheartened by the amount of paperwork needed to accompany the application. Instead, *be prepared!*

Among the best assets you can bring to the lender is a well thought-out and documented business proposal. You need to clearly state the purpose of the loan (will the money be used for temporary working capital, buying equipment, or expanding facilities); the amount of funds needed and for how long; and a repayment schedule. Your business proposal should include the following information:

- **Business description** that tells the nature of the business, describes the product and its market, identifies its customers and competition.
- **Personal profile** that outlines the background and experience of each of the principals in a resume.
- **Proposal** that states the type of loan requested and its purpose.
- **Business plan** that outlines your corporate strategy for the next three to five years; it will aid you and the lender in determining whether the business will generate the cash flow needed to repay the loan.
- **Repayment plan** that tells how you propose to repay the loan or outlines a repayment schedule. The lender will be expecting you to repay the borrowed funds from the profits produced by the business. As a contingency, you might need to develop a plan on how you would repay the loan if the profits alone turned out to be inadequate.
- **Supporting documentation** will include copies of pertinent papers that support the information contained in your loan proposal-for example, a lease, certificate of incorporation, partnership agreement, letters of reference, contracts, invoices or vendor quotes.
- **Collateral** that you will use to secure the payment of the loan. Collateral can include business and personal assets such as inventory, equipment, and accounts receivable or real estate, stocks, bonds, and automobiles.
- **Financial statements,** both personal and for the business. The business financial statement should be provided for the last three to five years of operation including a year-to-date interim report. It should contain a balance sheet showing business assets and liabilities, and a profit-and-loss statement showing revenues and expenses. The lender uses this information to calculate a debt-to-worth ratio for the business. Be prepared to provide copies of tax returns for the business for this same period.The personal financial statement should list your assets and your liabilities. Identify the names in which title to each asset is held and its fair market value. You should be prepared to provide copies of your personal tax returns. You may be asked for a list of credit references. Lenders will check your personal as well as your business credit rating. Lenders will carefully examine your financial statements and business projections. As a borrower, you must be fully prepared to answer questions about them.

- **Personal guarantees** of the owners or other principals usually are required, even from an established business. The lender also may request another party's guarantee such as a cosigner or a surety, or may request a government guarantee from the U.S. Small Business Administration or other government agency. In addition to the personal guarantee that you give, under the Equal Credit Opportunity Act the lender is allowed to require another person's guarantee should your application fail to meet the lender's standards of creditworthiness. If all or most of the assets listed on your personal financial statement are owned jointly with your spouse, or with someone else, the lender is likely to require such a guarantee. But the lender may not require that your spouse be the guarantor. In the case of secured credit, the lender is allowed to obtain a spouse's or other co-owner's signature on certain documents when the applicant offers, as security for the loan, property that the two own jointly. In this case, the spouse or other co-owner may be asked to sign documents---such as a mortgage or other security agreement that would be necessary under applicable state law to make the property available to satisfy the debt.

Sources of Technical Assistance

Before you approach a lender, you might want to seek the advice of another, more experienced "set of eyes" to review your business proposal, particularly if you are a first-time borrower. By doing so, you'd be getting the loan package in shape to make it easier for the lender to reach a favorable credit decision. There are some business support groups whose members could counsel you on how your package looks. A qualified counselor might even discover that you really don't need more money, and instead suggest better inventory control, improved marketing techniques, or other changes that could actually solve your growth problems. One source of counseling available to small businesses is the Service Corps of Retired Executives (SCORE), which is sponsored by the U.S. Small Business Administration. Others might include accountants and financial advisers.

Once you are satisfied that your proposal is in good shape to present to a lender, set up an appointment to discuss your application. You will find that the lender can also be an excellent source of business and financial counsel.

If Your Application Is Not Approved

Most lenders, banks especially, are conservative in granting business loans. Given the obligation to their stockholders and depositors, they need to be sure there's a good chance the loans they make will be repaid.

If your application for credit is not approved, find out the reasons why. Some of the reasons that lenders often give for denying a business loan include, for example, insufficient owner's equity in the business; lack of an established earnings record; a history of slow or past-due trade or loan payments; or insufficient collateral. Finding out the reasons may help you qualify the next time you apply. The lender will keep you informed about the status of your application. If you are considered a "small business" (when your business revenues are $1 million or less, or when you are applying to start up a business), a lender has 30 days to let you know, either orally or in writing, whether or not you get the loan. The 30-day period begins after the lender has received all of the information needed to evaluate your credit request. If your application is denied, the lender must give you either:

- a written statement of the reasons for denial, or
- a written notice telling you of your right to obtain the reasons in writing. This notice may be given to you during the application process or at the time of the denial.

The lender also will keep for one year the records relating to your application.

Different rules apply for larger businesses (those with more than $1 million in revenues). Within a reasonable period of time after getting all the necessary information on which to base a decision, the lender must decide and let you know whether or not you get the credit. Then you'll have 60 days in which to ask for a written statement of the reasons why you were denied credit; this is important to remember because the lender need not notify you of this right. The creditor will keep records of your application for at least 60 days after telling you of the credit decision. If within the 60 day period you request that records be kept longer, or ask for a written statement of the reasons for denial, records will be kept for one year.

Equal Credit Opportunity Act

Obtaining credit can be a difficult process for any business owner and especially for first-time borrowers. But keep in mind that different lenders have different standards; if you did not meet the standards of a particular institution, you may still qualify elsewhere. If you have a full understanding of why the initial lender didn't approve your application, with time and more attention to these areas, you can improve your proposal as a result and may succeed the next time you apply.

Women and minority applicants may be concerned that they have received less favorable treatment, which is unrelated to their creditworthiness. All business applicants have certain protections against unlawful discrimination under the Equal Credit Opportunity Act. The Act makes it illegal for lenders to deny your loan application, discourage you from applying for a loan, or give you less favorable terms than another applicant because you are a woman or a minority group member.

Under the law, a lender may not take factors such as sex, race, national origin, or marital status into account.

In addition, the lender may not ask for information about your spouse unless your spouse has some connection to the business, or unless you are relying on your spouse's income to support your credit application or relying on alimony, child support, or separate maintenance payments to establish creditworthiness. But the lender may ask you for information about your spouse if you are living in, or you are relying for security on property located in, a community property state (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, or Wisconsin).

Whether your business is large or small, if you are not granted the credit, be sure to discuss any questions you may have with the lender.

If You Need Help

If you are not granted credit by the lender and you believe the lender may have acted unlawfully, you can seek further assistance from the regulatory agency that supervises the institution. A list of some of the agencies is contained in this brochure for your reference. If it becomes necessary to seek legal assistance, the Act provides some remedies. If you have been denied credit because of unlawful discrimination and are able to prove it, courts may award actual damages and in some circumstances may impose punitive damages against the lender. If a lawsuit alleging discrimination is successful, the court also may award court costs and attorney fees.

Federal Enforcement Agencies

All creditors are subject to the Equal Credit Opportunity Act (ECOA) and Regulation B (issued by the Federal Reserve Board), which contains specific rules governing credit transactions. The following is a list of the federal agencies that enforce the ECOA and Regulation B for particular classes of financial institutions. Any questions concerning a particular financial institution should be directed to its enforcement agency.

State Member Banks of the Federal Reserve System
Division of Consumer and Community Affairs
Mail Stop 800
Board of Governors of the Federal Reserve System

20th & C Streets, N.W.
Washington, D.C. 20551
(202) 452-3693
www.federalreserve.gov

National Banks
Office of the Comptroller of the Currency
Consumer Assistance Unit
1301 McKinney Street
Suite 3710
Houston, Texas 77010
(800) 613-6743
www.occ.treas.gov

Non-Member Federally Insured Banks
Federal Deposit Insurance Corporation
Office of Compliance and Consumer Affairs
550 17th Street, N.W.
Room PA-1730, 7th Floor
Washington, D.C. 20429
(202) 942-3100 or
(800) 934-FDIC (934-3342)
www.fdic.gov

Savings and Loan Associations
Office of Thrift Supervision
Consumer Programs
1700 G Street, N.W., 6th Floor
Washington, D.C. 20552
(202) 906-6237 or
(800) 842-6929
www.ots.treas.gov

Federal Credit Unions
National Credit Union Administration
Office of Public and Congressional Affairs
1775 Duke Street
Alexandria, Virginia 22314
(703) 518-6330
www.ncua.gov

Small Business Investment Companies
Consumer Affairs
Small Business Administration
409 Third Street, S.W.
Washington, D.C. 20416

(800) U-ASK-SBA (827-5722)
www.sba.gov

Other Lenders

Federal Trade Commission
Consumer Response Center
600 Pennsylvania Avenue, N.W.
Washington, D.C. 20580
(202) 326-3758 or
(877) FTC-HELP? Toll free (877-382-4357)
www.ftc.gov

Alternative Sources of Capital

The U.S. Small Business Administration (SBA), the federal agency created specifically to assist and counsel small businesses, suggests the following sources of capital in addition to banks:

Friends, Relatives, Individuals
Savings and Loan Associations
Insurance Companies
Finance Companies
Mortgage Companies
Small Business Investment Companies
Venture Capital Firms
State Government Financing Sources
Pension Funds
Government Agencies (such as SBA)
Private Foundations