Business loans at large commercial banks: policies and practices

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Commercial bank lending was once a fairly simple business. Business loans were nearly all short term and carried fixed interest rates. Any other details, except possibly collateral requirements, were left to informal agreements between a bank and its customers.

Business lending began getting more complex in the 1930s as many banks started making term loans—loans with maturities of more than a year. Relations between banks and business borrowers have been growing more complex—and more formal—ever since, the formality of term loans now being applied to many short-term loans as well.

Part of the push for more complicated loan arrangements—and, therefore, a greater variety in the kinds of agreements—has been the need for banks and borrowers to protect themselves from movements in interest rates over the credit cycle. Increases in market rates boost bank costs of funding outstanding loans. They also increase the opportunities for more lucrative new credits elsewhere. Reductions in market rates lower the interest costs of other debt financing available to bank loan customers.

Floating rates have probably been the most important innovation in bank lending since the advent of the term loan. Provisions for adjusting loan rates periodically give banks and borrowers some protection against market rate fluctuations. By combining some of the advantages of term and short-term loans, floating rates have allowed banks to compete effectively for their share of the business credit market—even in the face of increased competition from the commercial paper market and other nonbank credit suppliers. At the same time, use of floating rates has encouraged changes in the other terms and conditions of business lending.

This article examines business lending practices at large banks, especially toward commercial and industrial loans. These loans to businesses other than financial institutions most clearly reflect the recent directions in bank lending policy. Pricing, maturities, and other lending terms depend on the particular bank and borrower negotiating the credit, as well as the use of the loan proceeds—such as, to provide working capital, cover accounts receivable, or finance expenditures on plant and equipment.

Term loans

Term loans range in maturity from just over a year to more than ten years. Banks once held loans with maximum maturities of five to seven years. For customers that needed longer terms, banks participated with other lenders. A bank might, for example, take the first five years of credit, with an insurance company taking the rest to maturity, often under different terms and conditions. Banks are more inclined now to take all the term credits themselves or to participate with other banks, each taking part of the loan for the whole maturity.

With the future always uncertain, lengthening the maturity structure of bank loan portfolios might seem to mean banks were taking more risks. But at least half the term lending at large banks calls for periodic adjustment of loan rates.

Costs are nearly always higher for initiating term loans than short-term loans. Considerable negotiation is required, usually at top levels of management and often with legal staffs representing the bank and the

borrower. And voluminous documentation is needed to cover both the terms and conditions of the loan. Administrative costs are also high, especially in the frequent situations where the bank and borrower need to keep in touch throughout the life of the loan.

Agreement has to be reached not only on the amount of the loan and its price but also any number of other points:

Loan commitment—an arrangement for the borrower to draw down loans and sometimes even a schedule for disbursing the funds. As the funds are made available to the borrower whether he uses them or not, a fee is sometimes charged on the amount of the commitment not used.

Fall of the Real Bills Doctrine . . .

Though term loans were sometimes made for special purposes, most banks offered only short-term credit until well into this century. This was because bank policies were based on the commercial loan theory of credit, an American adaptation of the Real Bills Doctrine in England.

According to this doctrine, the only appropriate bank loans were short-term, self-liquidating notes. By self-liquidating, bankers meant loans that led to enough increase in sales and near-term profits to cover repayment. Loans for plant and equipment did not usually qualify, the reasoning being that several years might be needed before returns on fixed capital were enough to retire the debt.

Some business loans were renewed routinely, even as early as the 1830s, with the result that nominally short-term credit arrangements were actually long term. Not until the 1920s, however, was the commercial loan theory seriously challenged. The idea that loans needed to be self-liquidating began losing credibility for several reasons:

- The realization that the commercial loan theory did not provide the monetary policy advantages its proponents claimed.
- The practice of financing long-term projects by borrowing from one bank to pay off another—sequential bank financing.
- The emergence of the view that banks could gain liquidity better from their non-loan assets and their liabilities.

Proponents of the Real Bills Doctrine had long argued that the requirement that bank loans be self-liquidating made the money supply expand and contract with the needs of business. However, bankers became increasingly aware, especially in looking back on the Panic of 1907, that the policy did not prevent severe contractions, bank deposit runs, or bank failures.

Many banks, meanwhile, had imposed the rule that customers had to have all their loans at the bank paid up sometime during the year. This clean-up rule, meant to strengthen the commercial loan theory, actually had the opposite effect. Annual clean-ups tended to encourage short-term borrowing first at one bank, then another, and then back at the first bank—all to extend effective credit periods for fixed-capital purposes.

Renewals, sequential financing across banks, and the clean-up rule together debased the short-term loan doctrine. It took a new theory of bank management, however, to utterly discredit the commercial loan theory.

The new theory took the view that as most business loans were not actually liquid, they did not serve as a funding cushion against unexpected deposit withdrawals. In place of short-term loans, the theory turned for liquidity to other assets—such as government and corporate securities, bankers' acceptances, and commercial paper—that could be sold with little loss of their capital value. A forerunner to modern liability management, the new theory also noted that banks could acquire liquidity through Federal Reserve borrowings and interbank sale of bonds under repurchase agreements.

Together, these changes both in attitude and in the structure of banks' short-term investment portfolios helped foster some growth of term lending in the 1920s.

Instalment schedule—a timetable for paying down the principal and interest. Payments are most often due monthly, quarterly, or semiannually.

Supporting balance requirement—the borrower's obligation to maintain demand deposits that help offset the cost of funding the loan. A bank may require that even a loan commitment be backed by demand deposits.

Collateral—property put up against a loan. Banker and borrower must agree on the physical nature of the collateral, its value, and the care to be taken in its handling and protection.

Protective covenants—a requirement that the borrower do certain things, as for example, keep working capital above some minimum level during the credit term or furnish the bank periodic financial reports. Covenants can also require that the borrower not do certain things without the bank's approval—for example, expand its fixed assets, undertake further external financing, enter a merger, or acquire an affiliate.

Some of the costs of initiating and administering term loans are charged directly to borrowers as fees. But there is, of course, an interest rate at which banks are willing to absorb the remaining costs of term lending.

Revolving credits

Revolving credits were once treated as short-term loans, which followed the banking convention that all loans had to be paid up sometime during the year—the annual clean-up rule. They now fall somewhere between term loans and short-term loans. Customers with revolving credits can borrow and repay repeatedly over the life of the agreement (usually two or three years) as long as the debt outstanding does not exceed the amount originally agreed on.

. . . and rise of term lending

Although Real Bills persisted into the 1930s, events gave impetus to term lending.

- The slack demand for short-term loans during the Depression—even at a prime rate of 1½ percent from 1933 on—gave banks incentives and opportunities to shift into some higher yielding term loans.
- The Banking Acts of 1933 and 1935 limited bank activities in corporate security markets, leading banks to substitute term lending.
- The establishment of deposit insurance in 1933 reduced the likelihood of financial panics and deposit runs, encouraging some lengthening of the maturity of bank loan portfolios.
- A change in Federal Reserve rules in 1933 allowing loans of all maturities to be used as assets for discounts and advances at Federal Reserve banks increased the liquidity of term loans.
- Under the revision of bank examination standards in 1934, term loans were no longer routinely classified as "slow."
- With modern amortization gaining general acceptance, term loans, which had usually called for payment of principal and interest at maturity, were made payable in annual, semiannual, quarterly, or monthly instalments. Instalment payments smoothed the flow of interest and principal back to the bank and, by demonstrating a borrower's ability to repay, helped banks monitor term loans and identify problem credits.
- Banks were encouraged to help finance the recovery, and followed the examples set by the Federal Reserve and Reconstruction Finance Corporation in making direct term loans to business.

The change was marked. A Federal Reserve survey in 1939 showed term loans accounted for a fourth of the dollar volume of business loans at the banks sampled—39 percent at the banks sampled in New York. More than a third of the banks, however, showed no more than five term loans on their books. A 1946 survey of member banks showed term lending accounting for more than a third of the dollar volume of business loans.

As many banks have relaxed the clean-up rule, however, allowing continuous indebtedness, revolving credits often qualify now as an intermediate form of term lending. Some contracts, in fact, include conversion clauses that allow credits to continue as term loans when the revolving credit agreement expires. Under such contracts, the period of revolving credit is often viewed as the first years of a term loan.

Short-term and term loans as substitutes

Distinctions between term and short-term loans have sometimes been misleading. The most detailed survey of continuous indebtedness through renewal of short-term loans was conducted nearly 25 years ago in the Cleveland Federal Reserve District. The survey showed that half of the dollar holdings of short-term business loans outstanding at member banks in the district were obligations of borrowers continuously in debt to the same bank for at least two years. A fourth of the short-term credit was owed by businesses in debt to the same bank continuously for at least five years. Only 8 percent of this credit was to customers in debt to the same bank no longer than three months.

As long as loans are renewable, some borrowers with long-term financing needs might actually prefer short-term loans. Initiation costs are lower. And as the contracts are less detailed, they are less likely to put operating constraints on the borrower.

Continuous indebtedness of this kind may not be to the bank's advantage, however, especially if it has to renew credit to prevent a loan default or bolster future demand for loans or other bank services. The prospects of renewal requests increase uncertainties for the bank. A borrower may feel that the loan can be renewed. But the bank cannot be sure renewal will be requested. Even if a bank has done very well in predicting renewal requests and sorting out the loans it feels obligated to renew, this ability is a poor second for certain knowledge of the length of indebtedness agreed on when the credit was first made.

Short-term loan renewals can, of course, be appropriate at times, as for example, when the need for longer-term credit was not anticipated. But the flexibility of term loans nowadays reduces the need for renewals. The term loan itself can be written to capture one of the main advantages of short-term loan renewal—periodic adjustment in the interest rate. Floating rates substitute directly for the

Floating loan rates . . .

Banks have been devising alternatives to fixed-rate pricing of business loans for decades. Graduated rates on some term loans appeared in the late 1930s. This scheme, applying progressively higher rates to later years of maturity, did not provide floating rates, of course. Term premiums to be added to the loan rate for later years were set when the loan was originated. The loan rate did not move with market rates, and the bank had no influence on it over the life of the loan.

Floating rates came into use in the late 1940s, with the introduction of formulas involving the addition of a quarter of a percentage point or more to the Federal Reserve discount rate. Floating rates were not widely used, however, as long as the discount rate and other rates remained fairly stable.

When the discount rate began changing more often in the early 1950s—and lagging hikes in the prime rate—banks switched the floating-rate base to the prime, a rate more closely reflecting market forces. Floating rate provisions, limited almost entirely to term loans, were not nearly as common as today.

The big change came in the mid-1960s, with the advent of modern bank liability management, growth of money-market funds, and more changes in short-term rates. Floating rates gave banks a way of making sure returns on outstanding loans—both long and short-term—moved with the costs of funds.

. . . and the formulas for computing them

Essentially two types of prime-based formulas are used in calculating floating rates:

- Prime-plus. The more conventional of the two, this method calls for an add-on factor to adjust for default risk and provide a term premium for long-term credit. An example is the prime rate plus 2 percentage points—"prime *plus* 2."
- Times-prime. Becoming more common, this method calls for multiplication of the prime by a factor to adjust for credit risk and a term premium. An example is the prime multiplied by 1.2—"1.2 *times* prime."

With either example, a prime rate set initially at 10 percent results in a floating loan rate of 12 percent.

Differences follow, however, if the prime rate is any rate other than 10 percent. With reductions in the prime rate, floating rates based on times-prime pricing decline faster than plus-prime rates. And increments in the prime result in faster increases in times-prime rates than in plus-prime rates.

Suppose, for instance, that an initial 10 percent prime is hiked to 12 percent. The prime-plus-2 loan rate moves from 12 percent to 14. The 1.2-times-prime rate moves from 12 percent to 14.4. If the prime is lowered from 10 percent to 8, the plus-prime rate falls from 12 percent to 10, but the times-prime rate drops to 9.6 percent.

Banks sometimes combine the two methods. An example is 1.09 times the *sum* of prime plus 1 percentage point—a floating rate equal to 1.09 *times* the prime plus 1.09 percentage points. Again, if the prime rate is set initially at 10 percent, the combination method leads to about the same floating rate as the basic methods—for example, 1.09 times 10 percent plus 1.09 percentage points, or roughly 12 percent. Effects for the combination method at any other prime, however, are the same as times-prime pricing, given the same multiplicative factors in the formulas.

As times-prime rates vary more than plus-prime rates over the interest-rate cycle, they have greater implications for changing bank loan revenue and, therefore, total profits.

One of the main reasons for times-prime pricing is that when the prime rate is raised, bank costs of funding outstanding loans in interest-sensitive markets may go up faster than the prime. The greater-than-proportional increase in the loan rate from times-prime pricing helps compensate banks for lagged upward responses of the prime rate.

The drift away from compensating balances also helps explain the growing use of times-prime pricing. The trend toward higher loan rates and lower required demand-deposit balances has, in fact, been a major factor in the use of more complicated floating-rate formulas.

The idea is to raise the loan rate enough to offset the loss of loanable funds when compensating balance requirements are eased. But the cost to a bank of foregoing these balances varies over interest-rate and credit cycles. When credit demand rises and banks scramble for ever more costly money-market funds, earlier reductions in compensating balances become increasingly costly. If rates are adjusted by the times-prime formula, explicit reimbursement to the bank increases as the prime rate rises. That is, an escalating rate premium replaces the supporting deposit balances.

Against these advantages of floating rates must be set the main disadvantage—the greater variation in loan revenue over the credit cycle. The disadvantage of floating rates becomes most apparent when market rates are falling. If formula loan rates are geared to fall as fast as money market rates, or even faster, bank profit margins on outstanding loans can be squeezed. Banks can immunize part of their business-loan portfolios from movements in money-market rates and the prime by continuing to make fixed-rate loans to customers interested primarily in loan-rate certainty.

privilege of banks to change the interest rate when a short-term loan is renegotiated at maturity.

Both bank and borrower find advantages in negotiating the *effective* maturity at the outset instead of a *nominal* maturity that can be renewed. Sure of the maturity of a loan, a bank can absorb some of the other risks elsewhere in a loan agreement or lower the average loan rate. Assured of credit for the full term, a borrower is spared the real (albeit sometimes small) risk that a renewal request might be denied.

Loan commitments

Loan commitments, once informal credit lines available to customers that kept adequate balances at a bank, are now more apt to be firm agreements laying out a bank's obligation to provide credit in the future (including the amount of the credit and the rate to be charged) and often the customer's obligation to pay fees on the credit availability. The change has come with the growth of both term loans and revolving credits and the greater use made of formal commitments for short-term lending.

The Federal Reserve Survey of Loan Commitments at Selected Large Banks for April 1979 showed $68 billion outstanding in unused formal agreements. Of these unused formal commitments, 16 percent was for term loans, 71 percent was for revolving credits, and the remaining 13 percent was mostly for short-term credits. Loans that had been made under formal commitments totaled $76 billion.

Despite the trend toward formalization of loan commitments, informal but confirmed lines of credit still accounted for much of the unused commitments. A total of $95 billion in unused credit was available to business borrowers under informal but confirmed lines, compared with the $68 billion in formal commitments. Use of informal lines was much less, however. Loans outstanding under confirmed lines amounted to $29 billion, compared with the $76 billion in loans that had been made under formal commitments.

Compensating balances

Although many banks still require compensating (or supporting) balances, with the trend toward explicit pricing of bank services, less emphasis is put on these balances than in the past. As a result, required balances are being replaced in many cases by explicit fees and increases in lending rates.

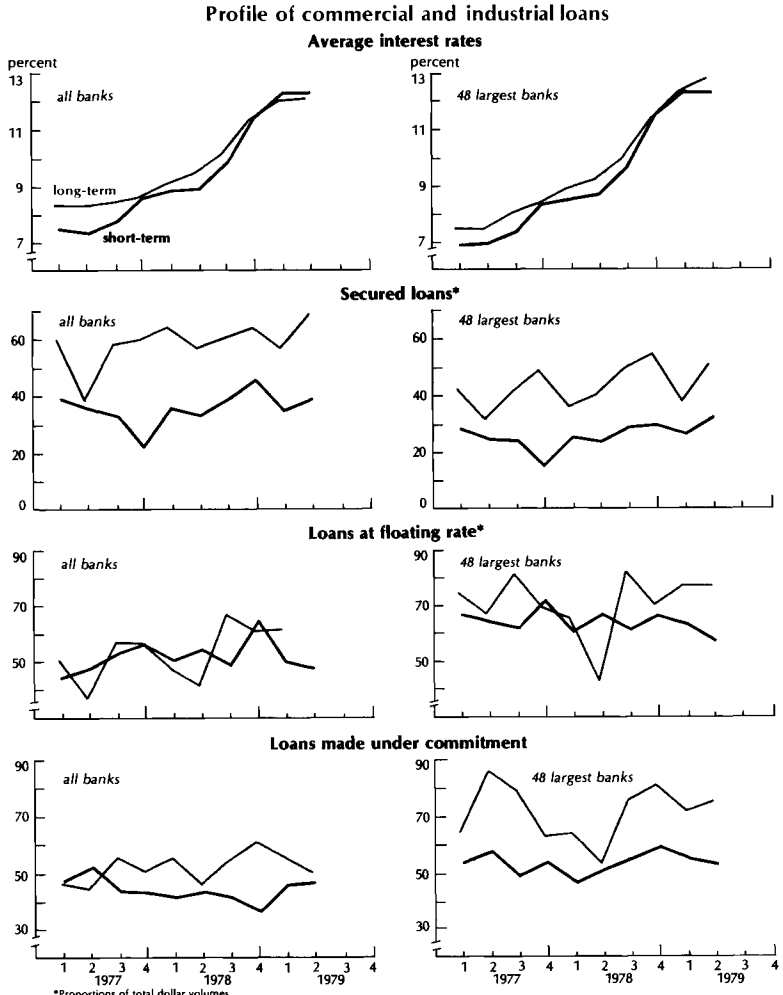
Where demand-deposit balances are still used, the requirement is usually stated as an average deposit balance equal to a percentage of the loan or commitment. A typical requirement is an average balance of 15 percent of the loan. Another is 10 percent of the loan, plus 10 percent of the unused commitment—10 percent of the total commitment.

Negotiations sometimes result in higher requirements on the loan commitments than on the loans themselves. In other cases, balance requirements are set higher on loans than on commitments.

Pressure from a credit customer to shift the balance requirement one way or the other gives a bank some indication of how the commitment is to be used. If the borrower wants the balance requirement on the commitment reduced enough to have the loan requirement raised an equal amount, he clearly expects to make little use of the loan commitment—less than half of it on average. If he expected to use most of the commitment, he would want the opposite, with more of the balance requirement on the unused commitment.

Loan prepayments

Prepayment provisions in loan contracts spell out the penalty costs (premiums) charged for paying a loan before it matures. Until the 1960s, banks usually did not charge premiums when loans were paid off (or paid down) before maturity, provided the funds came from operating earnings or other internal sources. Although substantial premiums were often imposed on prepayments financed from other borrowing, especially from other banks, many banks in the 1950s actually encouraged prepayments from a firm's retained earnings.



*Proportions of total dollar volumes.

SOURCE: Federal Reserve Survey of Terms of Bank Lending. The survey data are taken from about 340 banks selected to represent all sizes of banks. The data are collected from one business week in the middle month of each calendar quarter. Short-term loans have original maturities of less than one year, and term loans have maturities of one year or more.

Banks today often impose substantial penalties on the prepayment of fixed-rate loans, the intentions being to hold borrowers to the full terms of their contracts in return for the banks' having to risk a rise in interest rates.

If term borrowers could prepay their loans at will, with no direct or implied costs, they would in effect control maturities. As banks could not be sure of the repayment dates, prime-setting decisions would have to be based on probable prepayments, with banks undoubtedly charging more to compensate for the uncertainty.

Prepayment of floating-rate loans is seldom a problem. Borrowers have little incentive to prepay loans when the rates move with the costs of credit generally. Even if other interest rates fall a little faster than the floating rate, or rise a little slower, the substantial costs of originating other credit are apt to lock a customer into the existing loan.

Whether the rates are fixed or floating, then, most term loans run to maturity. And as a result, outstanding term loans are essentially immune to changes in the prime rate.

There are limits, of course, to the changes that can be made in prime rates. If floating rates went up too much or did not respond to drastic reductions in market rates, borrowers would stand the prepayment penalties and term loans outstanding would fall.

Secured loans

Although large corporations with top credit ratings routinely receive unsecured bank loans, many business borrowers have to post collateral. The amount of collateral and the type depend on the customer's credit rating, the size and maturity of the loan, and the purpose of the credit. Because of risk factors involved in some types of term credit, term loans are more apt to be secured than are short-term loans.

The most recent trend in secured bank lending is the kind of asset-based lending long handled by commercial finance companies. Large banks and their holding companies have become active in this specialized

form of secured lending by acquiring existing finance companies, establishing new commercial-finance affiliates, and restructuring their own lending policies for closer management and monitoring of the collateral behind secured loans. The inroads large banks have made into asset-based lending represent a competitive response—especially to attract small business borrowers—and awareness of the need for adequate collateralization as an adjunct to the risk-bearing business of modern bank lending.

Recent pricing tactics

When loan demand eases and money-market rates fall, large money-center banks come under pressure to lower their prime-rate quotations in an effort to attract more new business loan customers. This was the situation in 1976 and 1977. Because of floating-rate provisions in outstanding business loans, however, reductions in the prime rate aimed at bolstering new loans call for forfeitures of revenue on floating-rate loans already on the books. Bank concern over loss of this revenue can slow the lowering of the prime.

When two large banks in a money-center have significantly different proportions of their loan portfolios in floating-rate loans—especially if the loans are priced by different formulas (see box)—the one with the larger proportion may well be at a disadvantage in lowering its prime. These interbank differences in floating-rate loans help to explain split-rate primes—different prime rates at various money-center banks.

Large banks have tried several loan pricing policies aimed at bolstering loan demand and at the same time protecting profit margins on outstanding loans. One policy, dating from the 1950s, specifies ranges in which floating rates can be revised, as for example, an initial loan rate of 6 percent with the rate floating from 4 percent to 8 percent.

Some banks redesigned the cap-rate feature a few years ago by offering floating rates that would not average more than an agreed-on rate over the life of the loan. Because these cap rates combined the borrowing advantages of both fixed rates and floating rates, they gained some customer acceptance in 1971 and 1972.

When open-market rates rose, in 1973 and 1974, however, pushing up funding costs, profit margins on outstanding cap-rate loans dwindled. The upper limit on average interest costs became a ceiling that made further rate increases impossible. Banks have paid little attention to this type loan since. They have also shown few inclinations to adopt minimum-rate features that would limit the decline in loan rates when the prime was lowered.

Another technique for bolstering loan demand while protecting bank loan income has been floating rates tied to base rates other than the prime. This pricing feature is often tailored to the needs (and competitive environment) of large multinational corporations with access to credit markets abroad.

One of the rates that moves somewhat independently of the regular prime rate quotations governing other floating rates is the London Interbank Offering Rate (LIBOR), a short-term European money-market rate. Although this is the most common formula rate for these loans, such U.S. money-market rates as the commercial paper rate and secondary certificate of deposit rate are also used. In some cases, large banks have revised their overseas lending policies to provide credit in the European market at rates tied either to their U.S. prime rate or to LIBOR, depending on the expected changes in the prime-LIBOR rate spread.

Business lending strategies refined at large banks during a time of rising interest rates will be tested when demand for loans eases and interest rates fall. As pressures build for banks to lower their prime rates from the above-15 percent levels of recent months, a large part of their current loan portfolios will still be on the books.

Banks have been preparing for an eventual downturn by diversifying their business loans, interspersing fixed-rate loans with loans written to various formula rates based

on prime and other rates. Their success in pursuing this diversification strategy will be reflected in how well their prime rates follow declines in market rates.

Since revisions in prime rates usually lag behind changes in market rates, the tendency is for the spread to widen when rates fall rapidly. If, after adjustment for the lag, the prime rate still responds sluggishly to easing market conditions, banks may have to rethink some of their explicit pricing methods for business lending.

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