Loan commitments and facility fees

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Commercial banks in recent years have begun to reevaluate their policies toward loan commitments—agreements in which banks obligate themselves to lend, upon customer demand, up to specified dollar limits over predetermined future time periods. These reappraisals have been prompted in part by concern on the part of both bankers and the monetary authorities over the high activation rates and large dollar volumes of loans extended under outstanding commitments during periods of tight credit.

The most recent such episode was in 1974 when tight money-market conditions and strong loan demand led major banks to boost the prime rate—the interest rate charged on business loans to banks' most creditworthy customers—to an unprecedented 12 percent. The monetary authorities' concern was that loan commitments made during earlier periods, when banks had easy access to funds, would require large-scale bank lending in 1974, hampering Federal Reserve efforts to restrict the growth of bank credit. Bank regulators were concerned that the high costs attached to honoring these commitments could threaten profitability and capital positions of some commercial banks.

Although bank loan commitments are not new financial instruments, these agreements have grown dramatically in dollar magnitudes and have assumed an increasingly critical position in bank management since World War II. Of special importance has been the growth of fee-based commitments—contracts for which customers pay explicit bank charges called commitment facility fees (or simply facility or commitment fees). These fee-based commitments differ from credit lines, which are the traditional and still prevalent type of bank loan commitment. In place of explicit fees, credit line agreements typically require the customer to maintain compensating balances—minimum average checking account balances.

Growth of fee-based commitments has been spurred by a number of major banking developments since the early 1960s. A primary factor has been the increased reliance of commercial banks on open-market sources of funds to meet loan demands arising from commitments. The greater variability in the costs of these managed liabilities, compared with the relatively stable cost of traditional deposit sources of funds, has introduced additional uncertainties into bank management of loan commitments. At the same time fluctuations in interest rates applied to loans under commitments (i.e., takedowns) have been considerably greater in the post-1965 period. Increased variability of both bank costs and revenues has prompted many banks to analyze in detail the profitability of individual customer accounts and to make greater use of explicit pricing of loan commitments and other bank services.

For a long time loan commitments of commercial banks were viewed as a rather minor service performed as an adjunct to the actual loan contract. Nearly all loan commitments were in the form of credit lines related in a rather mechanical way to the volume of business loans. Largely as a consequence of the greater turbulence of financial markets in recent years, however, loan commitments have gained recognition as a distinct and separable service of commercial banks. This new view of commitments focuses on the financial advantages accruing to a business firm from assurance of future credit availability, a service that commands a price even if the commitment remains unused.

In general terms, loan commitments are

viewed as insurance policies for which firms should be willing to pay a "premium"—either in the form of a facility fee or through compensating balances. Banks maintain some, but not complete, control over policyholder claims by reserving the right to vary interest rates applied on commitment takedowns in most of these contracts. It is extremely unlikely, in normal times, that all holders will decide to draw down their commitments simultaneously. As a result, banks are able to pool risks and forecast loan usage for commitments in much the same way that insurance companies use contingency tables to estimate claims.

Unlike claims under most forms of insurance, however, takedowns under loan commitments are not independent events ruled by accident or nature. Because takedowns occur at the discretion of business firms which are affected by tight credit conditions at about the same time, the possibility exists that a large proportion of commitment holders will turn to their banks for funds simultaneously. During periods of especially tight credit, such as in 1969 and 1974, takedowns were increased sharply enough by a sufficiently large number of commitment holders to engender concern.

Commitment features

Loan commitment is a term loosely applied to a variety of agreements varying from informal understandings to legally binding contracts between commercial banks and their customers. A loan commitment may be negotiated between the parties and tailored to specific operating policies of the bank and particular credit needs of the customer. All major banks and many smaller ones have detailed operating policies regarding commitments. Any one bank frequently uses several standard types of commitments and further customizes these agreements to individual customers.

Even commercial banks are not always in agreement as to what constitutes a loan commitment. Some banks consider all or nearly all short-term business loans to arise from commitments, even if the bank has had no contact with the loan customer prior to the loan application. At the other extreme are banks that view themselves as making no commitments whatever. Fortunately, most banks' commitment policies are better defined and managed than either of these extreme views might suggest. Nevertheless, differences in terminology regarding commitments persist.

Loan commitments typically include four major elements—disclosure of the commitment to the customer, the dollar limit on loans under the agreement, interest rates on takedowns, and the time period during which the agreement is effective. While some banks have adopted internal guidelines for use in screening customer loan requests, these guidelines typically are not considered loan commitments unless they have been communicated to customers. Thus, terms such as "disclosed credit lines" or "confirmed lines" often are used to distinguish commitments from internal guidelines. Although all credit commitments involve disclosure to the customer, either orally or in writing, their treatment of the other major elements varies widely. Confirmed credit lines include lending limits but do not detail other terms and conditions of usage. Credit lines sometimes are open indefinitely or until further notice from the bank, but most often are on an annually renewable basis.

On the other hand, formal loan commitments, sometimes called "firm" commitments, include all four major elements of commitment agreements. Not only dollar loan limits, but also lending rates and the period for which the agreement is in force, are stated in writing. The lending rate is usually specified to bear a fixed relationship to the prime rate. The period during which formal commitments are in force is normally one to three years, depending on the purpose of the borrowing. There is usually a clause requiring a bank to show cause for not honoring a formal commitment, and proviso clauses stipulating that the customer must maintain minimum adequate working capital, limiting the customer's reliance on nonbank external financing, or imposing other controls on the

firm's operations sometimes detail the conditions under which the bank may be released from its obligation to lend.

Two of the most important types of formal commitments are revolving credits and term loan commitments. A revolving credit entitles the customer to take down and repay loans repeatedly during the time the agreement is in effect, so long as the total loans outstanding at any time do not exceed the dollar limits of the commitment. Banks may require that a revolving credit be repaid in full for some part of each year. Term loan commitments are for bank loans having original maturities exceeding one year. Some commitments apply directly to term loans, whereas other commitments begin as revolving credits and allow conversion to term lending during the life or upon expiration of the revolving credit agreement. Revolving credits and term loan commitments are two principal types of commitments on which banks often charge explicit fees.

Another major category of formal commitments is the standby commitment, which is used to back an issuance of commercial paper—promissory notes issued by large corporations and used as a close substitute for bank loans. Although collateral is not required on commercial paper, investors typically require some assurance that issuers will be able to repay or refinance the debt upon maturity. Under standby commitments banks promise to provide refinancing through bank loans when the commercial paper matures. Corporations sometimes find bank refinancing less expensive than commercial paper, and take down large amounts of standby commitments. At other times, when commercial paper is relatively less expensive, standby commitments remain unused and serve only as credit assurance. In many instances a large corporation will have loan commitments outstanding from dozens of banks to cover its commercial paper. The fees charged for these commitments are referred to as standby fees.

Credit lines traditionally have been a major component of "customer relationships"—longstanding cooperative arrangements by which a bank provides total packages of bank services to business customers. Standing ready to provide loans, especially in times of tight credit, is vital to maintaining the loyalty of the customer and the long-run profitability of his account to the bank.

Advance commitment of funds also may serve as an important part of the loan approval mechanism used in major banks. So long as total loans to a given borrower remain within the dollar limits of the commitment, pre-approved lending reduces administrative costs for a bank loan department by eliminating the need to review and approve each loan separately.

Knowing both the overall dollar volume of commitments and the totals for separate commitment categories, senior bank management is better able to forecast loan demand. However, knowledge of the usage rates of various types of commitments is also necessary.

Usage rates

Usage rates (i.e., the percentages of commitments taken down at any given time) vary significantly among credit lines, revolving credits, term loan commitments, and other types of commitments. Usage rates tend to be highest for formalized agreements, especially for fee-based commitments. Thus, term loan commitments and revolving credits have higher usage rates on average than confirmed credit lines.

Usage rates also display more cyclical variability for some categories of commitments than for others. Credit lines and revolving credits are designed to meet both foreseen and unforeseen short-term borrowing needs and so have more cyclical and seasonal usage than term loan commitments.

Nonbank financial institutions, especially finance companies, are major users of commitments, either directly or as backing for commercial paper, and are often treated as a separate commitment category. These commitments are most similar in form and usage to the revolving credits issued to commercial and industrial borrowers.

Banks also issue construction-loan and

mortgage-loan commitments for loans secured by real estate, collectively called real estate commitments. Ultimate usage rates are near 100 percent for real estate commitments. A construction commitment is tied directly and formally to a specific construction project and includes a date for total takedown or a timetable for periodic takedowns increasing to 100 percent usage during the construction period. Similarly, a mortgage commitment is tied to a particular commercial or residential property as of a closing date. Real estate commitments are a totally separate entity and normally are not discussed along with "regular" commitments because the bank's uncertainty about usage rates, which is substantial for credit lines, revolving credits, and term commitments, is not as important for real estate commitments.

Lending under commitments

Estimates from the latest available Federal Reserve survey of bank lending, covering loans contracted in the first full week of November 1977, indicate that slightly over 40 percent of the dollar amounts of short-term business loans (i.e., loans with maturities less than one year) and over 48 percent of long-term business loans were contracted through commitments. In general, the largest banks originate a larger proportion of their business lending through commitments than smaller banks. For example, 54 percent of the dollar volume of short-term business loans of the 48 largest banks in the November 1977 survey were made under commitments, compared to 33 percent of the same category of lending by other banks. Over 62 percent of the long-term business lending by the 48 largest banks was under commitments, compared to about 32 percent for other banks.

Generally, large loans are more likely to originate from commitments than are smaller loans. In the November 1977 survey, for example, only 19 percent of the dollar amount of short-term business loans in the $1-99 thousand size category arose from commitments, compared with 50 percent of short-term lending in the $100 thousand and over size category. Similarly, about 37 percent of the dollar amount of long-term loans in the $1-99 thousand category were made under commitments, compared to over 53 percent for the loans of $100 thousand and over. The prevalence of commitments for large loans is explained in part by the lead time for advance planning afforded by a loan commitment, which is especially critical when the loan represents a sizable portion of the bank's total lending and is to be outstanding for a long time.

Pricing commitments

Facility fees, like interest rates, are quoted as annual percentage rates and are paid either in full when the commitment begins or at regular intervals during the life of the contract. Some banks use a base fee to which are added, depending on the customer, supplementary facility fees or compensating balance requirements related to the dollar amounts of the commitments or the takedowns.

During the 1950s and most of the 1960s, the basic facility fee was ¼ percent per annum on the unused dollar amount of the commitment but at times was increased by some banks to ½ percent on the unused amount.

The major purpose of the facility fee on commitments is to pay for the credit-assurance services provided by the bank. Like prices of other goods and services, facility fees serve as an economic rationing device. They can be varied by the bank as a means of controlling the dollar volume of loan commitments. Increases in facility fees, other factors unchanged, will result in a reduction in dollar amounts of commitments demanded by new and existing customers.

Commercial banks change their basic facility fees very infrequently. One reason for the "stickiness" of these fees is that banks have other methods available for influencing the volume of commitments. Commercial banks can change the availability of the funds borrowed under commitments by altering compensating-balance requirements when applicable or can vary other elements of the

commitment agreement. Interest and non-interest terms on the loans assured by the agreements also can be modified in lieu of changing the facility fee. For example, a business firm previously qualifying for loans at the prime rate might terminate the agreement or carry a smaller commitment when faced with a higher loan rate—say, prime plus one percent.

Inflexibility of facility fees also results from the manner in which fee charges influence loan demand, especially when the fee is applied to unused portions of commitments. The effects on loan demand are illustrated best by looking at changes in facility fees during two recent episodes of tight credit and strong loan demand.

- In the spring of 1969 several large New York City banks raised their facility fees from ¼ percent to ½ percent per annum on unused portions of new commitments and renewals of existing ones.
- In the fall of 1974 several major money-center banks imposed a ¼ percent fee on total dollar amounts of new and renewed commitments in addition to the ½ percent fee already levied against unused segments of their commitments.

Levying facility fees against the unused portions of commitments has significantly different implications for loan demand than placing fees on total commitments. The fee increase in 1969 was aimed at reducing the amount of outstanding commitments and thereby stemming the growth of business lending. However, increasing the fee only against unused commitments provided an offsetting incentive to commitment holders to *increase* the usage of the commitments that remained in force.

Given the size of the commitment, an increase in the fee on the unused portion amounts to a decrease in the effective loan rate on takedowns. Consider a commitment carrying a ¼ percent fee on the unused portion in early 1969 and obligating the bank to lend at the 7½ percent prime rate quoted from mid-March to early June 1969. The effective, or marginal, interest rate on loans under this commitment is 7¼ percent rather than 7½ percent because of the ¼ percent facility fee on unused commitment amounts. The borrower pays only 7¼ percent more by taking down the commitment since the ¼ percent fee is "saved" on each dollar of commitments used.

Now suppose that after the facility fee increase in 1969 from ¼ percent to ½ percent, the commitment holder chose to renew his commitment. With the prime rate still at 7½ percent, the new effective rate on takedowns would be 7 percent—the 7½ percent prime minus the ½ percent fee on unused commitment amounts. Thus, an increase in the commitment fee would result in a reduction in the effective cost of takedowns and probably would have the undesired effect of encouraging greater usage of commitments during a tight money situation.

It is noteworthy that the prime rate was increased in June 1969 from 7½ percent to 8½ percent—the largest single movement in the prime in modern history. This prime rate increase occurred soon after the ¼ percentage point increase in facility fees on unused commitments by some major banks. Some part of this hike in the prime rate may be explained by the need to adjust the loan rate to the new facility fee schedules.

Indirect evidence that banks learned a lesson in facility fee policy from the 1969 episode is provided by the experience of 1974. Banks that increased fees in 1974 avoided simultaneously decreasing effective loan rates on takedowns. Since the additional ¼ percent fee (or more in some cases) was placed on the total amount of new and renewed commitments, the commitment holder could not reduce the fee charge by simply taking down the commitment. From the banks' viewpoint the additional fee on total commitments had the advantage of reducing the dollar volume of commitments without stimulating an offsetting increase in takedowns.

Even when applied to total commitments, higher fees tend to increase observed usage rates because these agreements become a higher-cost financial resource. This is because the higher commitment fees lead holders to

economize on the volume of unused commitments, resulting in higher observed usage rates.

Regulation

It has been suggested on occasion that bank loan commitments should be subject to public regulation, either by placing reserve requirements on commitments or by limiting overall dollar volumes. Each of these alternatives, however, presents serious problems owing to the rather special nature of commitments—namely, that these contracts are contingent claims on the banking system. Because no transaction involving the actual transfer of funds is made until the commitment is taken down, commitments do not appear on bank balance sheets. Thus, regulation of commitments would not operate directly on an item appearing on the balance sheets of commercial banks.

If reserve requirements were placed on loan commitments, however, banks would need to alter accounts which do appear on their balance sheets—liquidating loans and investments or attracting additional deposits—in order to obtain funds to meet these requirements. By absorbing loanable funds, reserve requirements against loan commitments could prove a heavy burden on banks. The probable result would be that some banks would eliminate loan commitments (formal commitments at least) from the list of bank services provided. Many banks probably would impose additional compensating balance requirements, facility fees, and higher loan rates on commitment takedowns. In this way, the implied costs of reserve requirements against commitments would be shifted onto banks' credit customers.

The establishment of ceilings on dollar volumes of outstanding loan commitments would cause serious regulatory problems. Restrictions on loan commitments would have to be extended to entire business loan portfolios of commercial banks. Otherwise, banks simply could shift large volumes of lending from formal commitment status to lending without prior commitment or to agreements sufficiently informal as to avoid, at least technically, the official definition of a commitment. Unless all business lending and commitments were regulated in the same way, a reversal in the trend toward formal commitments would enable banks to circumvent quantitative controls on commitments.

If different quantitative restrictions (or reserve requirements) were imposed on different categories of business loans and loan commitments, the consequence would be bank credit allocation with its multitude of regulatory costs and inequities.

Despite the monetary authorities' occasional concern over the pro-cyclical effects of loan commitment usage, the need for regulatory control over loan commitments has not been clearly demonstrated. The fee revisions in 1969 and 1974 have shown that banks' control over outstanding formal commitments can be maintained during tight credit periods. Some firms holding bank credit lines in 1974 sought to convert them to fee-based commitments. While assuring customers that confirmed lines would be honored as readily as formal commitments, banks balked at converting these informal lines.

It should be remembered that commitment agreements expire and must be renegotiated. Even if many large, unused commitments accumulate during a period of slack loan demand, many of them expire as business credit demand recovers. After that occurs, and before credit pressures of the recovery have mounted, banks have several options. They can reduce the sizes of commitments, raise facility fees and compensating balance requirements, or alter other interest and noninterest terms on loans. Moreover, commitment holders have little incentive to accumulate commitments in anticipation of a credit crunch if the agreements are expected to expire before credit stringency appears.

Indeed, the othewise minor difficulties that some banks encountered from loan pressures in 1974, as well as the resulting concern on the part of the monetary authorities, were exacerbated by efforts of public officials to hold bank lending rates—particularly the prime

Information on commitments

Mellon Bank NA, headquartered in Pittsburgh, has been a leader in developing specific procedures for managing commitments and has been collecting detailed data on dollar amounts of formal commitments and credit lines since 1959. The Board of Governors of the Federal Reserve System has gathered data on loan commitments since the late 1960s and since January 1975 has compiled a Monthly Survey of Loan Commitments showing amounts of unused commitments and loans made under commitments by 136 large banks. Some information on commercial banks' commitment policies is available also from Changes in Bank Lending Practices and the Survey of Terms of Bank Lending, both published by the Federal Reserve System.

This information provides a useful starting point for developing generally accepted terminology regarding loan commitments and refining bank commitment policies.

Federal Reserve survey*

	Monthly survey of loan commitments	Terms of lending at commercial banks	Changes in bank lending practices
Banks included	136 weekly reporting banks, accounting for about 85 percent of commercial and industrial loans, 95 percent of nonbank financial loans, and 75 percent of real estate loans of all weekly reporting banks	About 340 banks selected to represent all sizes of banks	About 120 selected large banks
Reporting period	End of each month beginning with January 1975	Quarterly sample for the first full business week of each February, May, August, and November—beginning with February 1977	Quarterly sample for mid-month of each February, May, August, and November—beginning with February 1967
Source	Federal Reserve Statistical Release G. 21	*Federal Reserve Bulletin* and Federal Reserve Release G.14	*Federal Reserve Bulletin*
Description	*Federal Reserve Bulletin*, April 1975	*Federal Reserve Bulletin*, May 1977	*Federal Reserve Bulletin*, April 1968
Information on commitments	Outstanding amounts of unused commitments and loans made under commitments. Major commitment categories include formal commitments, disclosed credit lines, and commitments to nonbank financial firms.	Percentages of amounts of loans made under commitments for various size classes of loans. The sample contains separate strata for 48 large banks and the other banks in the sample. The data are classified as short-term business loans, long-term business loans, construction and land development loans, and loans to farmers.	Essentially qualitative information from senior bank lending officers about changes in their lending practices since the previous reporting period. Information concerns changes in review procedures for credit lines of nonfinancial business customers and establishment of new or larger credit lines by finance companies.

* Statistical releases mentioned in this table can be obtained from Publication Services, Division of Administrative Services, Board of Governors of the Federal Reserve System, Washington, D.C. 20551.

rate—below the level dictated by market forces. To the extent that banks yielded to pressures to restrain rate increases, they denied themselves the use of a major method for controlling commitment usage—raising the price of borrowings.

Though formal controls appear unwarranted, commitments nevertheless pose problems that merit the attention of bank management and supervisory authorities. Some banks still have fairly informal commitment policies and could benefit from specific guidelines and better internal data on loan commitments. Consideration should be given to uniform disclosure of dollar amounts of loan commitments, at least formal agreements, as addenda items on all bank balance sheets. Disclosure would enable investors to evaluate the impact of loan commitments on individual banks' risk positions, and also could contribute to more consistent and effective bank examination procedures.