



# Proper Commercial Loan Documentation



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# **Proper Commercial Loan Documentation**

Following the financial crisis of 2007 and 2008, banking institutions have become more cautious about how they lend money and whom to. It was the relatively lax processes and protocols surrounding commercial loans which led – in part – to the global crisis, and in response, banks and the legislature which governs them have tightened controls.

This underlines the need for proper commercial loan documentation in securing an effective loan and realistic terms of repayment for clients. This documentation comes in many forms; some of which must be supplied by the client ahead of the assessment and approval process, while others must be completed by the financial institution during the application and beyond.

All documentation must be appropriately managed and stored, in compliance with data protection laws and with industry standards and best practices. This article is designed to act as a guide, giving banking professionals information on the types of documentation required, and on the dangers which are to be avoided by collecting such documentation.

## **Types of Documentation**

The client should have amassed the relevant paperwork and documentation ahead of time, before negotiations have begun. The onus is on the client to convince the lending institution that they are eligible for a loan product, but it is in the interest of the institution to provide capital for any individual or business which meets the requirements.

This means that – not only does the applicant need to prove that they are currently able to furnish the loan – the lender must be convinced that this state of financial stability will continue in the future.

The lender will assess the documentation, and provide the best credit solution to the applicant, on a mutually beneficial basis. Required documentation is as follows;

## **Financial Statements**

Financial statements provide lenders with a reliable method for assessing the current solvency of the prospective borrower. Regardless of whether the borrower is a business organization or simply an individual, they will need to be able to produce these statements to support their loan application.

If the facility is a personal loan, the recipient must provide personal financial statements which prove their current net worth and also statements which illustrate the financial state in recent years. The lender will need to be convinced of continued financial sustainability before loan terms are agreed, so the prospective borrower should prepare statements which cover at least the last three years.

In the case of personal loans which require a guarantor, this guarantor will also need to provide financial statements. These statements will be used to prove current and consistent financial solvency and ability to fulfill the role of guarantor.

For business loans, complete financial statements will need to be submitted. These statements will also need to prove sustainability and consistent ability to furnish a loan, and should cover at least three years of the company's history.

## **Tax Returns**

Lenders will usually request that the prospective borrower submits copies of tax returns covering the last three years of business or of personal transactions. This is a standard requirement for applicants for both personal and business commercial loans.

In addition, lenders will often require further backup documentation to help them to verify the supplied information. This can include documentation relating to business or personal assets either in the name of the individual or the organization applying for the loan, or it can involve documentary records of profits from past ventures or business initiatives.

The lender may also require that these documents be verified by a qualified third party, creating an extra level of security during the risk assessment procedure.

## **Financial Projections**

Lenders will need to make informed predictions on the future financial performances of the borrower. For an individual, this can be achieved by using the financial statements and tax documents listed above, but for businesses the rules are a little more complex.

Established businesses who have a demonstrable history of strong performance in their respective markets need only supply three years' worth of income statements. These statements can be related either to direct business income or to income derived from real estate assets.

Newer businesses who do not have a history of strong financial performance to draw upon will need to supply further information. These include proformas which outline the projected cash receipts and net profits in the future. The business will also be required to submit descriptions of assumptions to the lender, while also undergoing sensitivity analysis to assess how well the business can stand up to different financial scenarios.

Older businesses may not be exempt from this either. Any business which cannot provide compelling documentary evidence of recent long term stability will also have to submit the above paperwork and undergo the same sensitivity tests.

In some cases, lenders will apply specific rules to organizations, based on the evidence provided. These can relate to the business' cash flow – for example, the cash flow of the business be at least 1.4 times or 1.5 times the amount of the payments due. Alternatively, the rules can involve loan to value ratio – or LVR. For example, the borrower may only be able to acquire a loan with an LVR of 75%.

## **Additional Documentation**

Any loan facility is provided to the applicant at the discretion of the lender. Therefore, the lender retains the right to ask for additional documentation if required, as they assess the capabilities of the borrower. This documentation can be used to decide on whether to accept or deny the application, or to decide on the specific terms of the agreement.

This documentation can include any leases or permits a business or individual currently holds, and proof of sustained payments on other credit facilities. These illustrate the other financial concerns that the applicant currently holds,

and allows the lender to decide whether or not they can bear additional payments.

Other forms of documentation include environmental reports, or verifiable proof that poor financial results or defaults in the past have been reversed. The lender may decide to cancel the agreement, or even bring legal action against the applicant; if it transpires that any requested documents have been withheld.

Further financial projections may also be requested, or financial statements from further back in the history of the business or individual.

## **The Components of a Loan Agreement**

Once the terms and conditions of a loan are agreed upon, these must be drafted into a binding document and signed by both parties. This document will include detailed and specific conditions relating to the loan. The different components of a loan agreement are outlined below.

### **Amount**

Both the borrower and the lender will already be well aware of the amount to be borrowed, but this is still a vital part of any loan agreement. This section will detail the total agreed amount under the terms of the loan agreement, which will be delivered to the applicant once the terms are met and the agreement is actioned.

As well as the total amount, this section should detail the interest to be paid and include information on how this interest is calculated. The total amount repayable by the loan applicant will be greater than the total borrowed, so this must be clearly defined in the loan agreement.

### **Schedule and Options for Repayment**

The terms of the loan repayment will have been agreed beforehand, but must be defined within the loan agreement. This will include details on how much is to be paid back in each installment, and over how long.

Longer repayment plans result in cheaper monthly repayments for the borrower, but will see them paying much more money in the long term. Interest calculations should be included in this component of the loan agreement, to clearly demonstrate this to the applicant.

### **Collateral or Security**

In most cases, a loan agreement will include an element of collateral or security. This is something which the applicant 'risks' when they enter into the agreement. If they are unable to keep up with payments, the lender takes possession of the collateral or security.

Typically, collateral or security is provided in the form of a property or other high value asset. The lender will have the collateral privately assessed and valued before the agreement is finalized. Other forms of collateral could include high-value jewelry, vehicles, or corporate stakes. The aim is to enable the lender to provide the borrower with the cash they need, while minimizing the risk.

### **Consigner and Guarantor Details**

Another way in which a lender can provide themselves additional security is to request a consigner or guarantor. This is a third party individual or business entity that vouches for the capability of the borrower, and also agrees to take financial responsibility in the event of default or failure to repay.

This is not required for all loan agreements, and it is up to the lender to decide whether they require one or not on a case by case basis. Usually, less established businesses or younger private borrowers will require a consigner or guarantor, as they will not be able to provide adequate documentation for themselves.

### **Fees and Charges**

Hopefully, fees will not need to be applied to a loan agreement. However, they are something which needs to be outlined ahead of time. Loan delinquency – the action of defaulting on a loan or missing payments – is a major problem for lenders and affects their ability to provide good quality loan products to clients.

Late fees and other charges provide a useful incentive to the borrower as they aim to keep their repayments on schedule. They also help to recoup any administrative fees incurred by the lender as a result of any missed payments.

All fees and charges are imposed at the discretion of the lender. The lender reserves the right to waive fees as they see fit, although this will usually require proof of extenuating circumstances on the part of the borrower.

### **Additional Provisions**

Each loan agreement is different, and so some loan agreement contracts may require additional provisions to be made. This may include permission for the lender to sell the loan to a third party at a reduced rate in the event that payments are being missed. Such sales help the lender to recoup some of their losses in the event of a default.

Other additional provisions may be added after negotiations on the loan have been completed. It is up to both parties to agree on the conditions and ratify them by signing the document.

### **Worst Case Scenarios**

It is important for the lender to know which documents are required for the loan application, and to communicate this clearly to the applicant. Without such knowledge and high levels of clarity, the loan agreement can go off track and one or both parties may end up out of pocket.

Read on for details of the worst case scenarios, which illustrate why proper documentation is so vital for a commercial loan agreement.

### **Client Receives Wrong Advice, is Denied Loan**

Understanding the documentation required is vital if a lender is to provide the borrower with the right loan facility to them. As it is in their interest to provide credit to all qualified borrowers, lenders must ensure that the applicant knows which documents are required to secure funding.



Advising the applicant wrongly can result in the loan being automatically denied, delaying the process. This is an inconvenience for all parties, and the borrower may simply head elsewhere.

### **Loan Breaches Legal Requirements**

In the wake of the global financial crisis, banks have an increased legal responsibility to ensure that they lend only to qualified business and individuals. This means exercising due diligence and an appropriate level of care when assessing loan criteria.

Failure to uphold this standard can result in legal action being taken against the lender.

### **Lender Falls Victim to Loophole, Ends Up Disadvantaged**

Checking all the relevant documentation is vital is the lender is to ensure that the terms of the agreement benefit them. Failing to include a late payment fee, for example, means that the borrower can default on the loan without penalty. This can put the lender at a major disadvantage as they try to recoup their expenses.

