

Jump Start Micro-Enterprise Credential: How Small Businesses Credit Applications are Evaluated

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Banks and online finance companies approve small businesses for lines of credit if they believe that these companies will have the cash necessary to pay them back.

This document describes the dissimilar ways that banks and online finance companies evaluate the credit applications they receive from small businesses.

How Banks Evaluate Credit Applications from Small Businesses

Banks want to make sure that if they lend money to a small business there will be multiple ways for them to get repaid. Therefore banks look for:

- “credit-worthiness,” company owners with strong credit scores and a track record of repaying loans;
- “liquidity,” which means the company has sufficient cash and “liquid assets” to repay all loans;
- “guarantors,” credit-worthy individuals who make a legal commitment to step up and pay the loan payments of a small business that doesn’t have sufficient cash to make their payments; and
- “collateral,” or assets owned by the business or by guarantors that the bank can seize and sell in the event that payments aren’t forthcoming.

Credit-Worthiness – a person is credit-worthy if he/she has a strong credit score. There are three main credit bureaus in 2016 (Equifax, Experian, TransUnion), all of which provide credit scores between 300 and 850. A score in the low 700s is good. A score in the high 700s or 800s is excellent. Individuals with these credit scores are likely to find it easy to get approved for credit and to serve as guarantors for loans.

Liquidity – “liquid assets” are cash or “cash instruments” (like stocks and bonds that can immediately be turned into cash). Individuals (or companies) are “liquid” (or have “liquidity”) if they have lots of liquid assets. Banks check the liquid assets that companies and individual guarantors claim in their loan applications – not only that these liquid assets exist as claimed, but also that the liquid assets are not already pledged as a guarantee for another loan. If these liquid assets exist and are “unencumbered” then the bank is likely to approve an application.

Liquidity Concepts

Liquid Assets – cash or securities that can be immediately turned into cash, which can then repay any loan amount outstanding. A company or individual “has liquidity” if they have lots of liquid assets.

Cash Instruments – cash, publicly traded stocks, government bonds or corporate bonds. All can be turned into cash quickly.

Guarantor – a person or company with sufficient liquidity who guarantees to repay a loan if a company cannot.

Unencumbered – assets that are not already pledged as a guarantee to repay another loan.

Collateral – equipment, inventory or other goods that are pledged to the bank in the case the company can’t make a loan payment.

Lien – the right to take possession of collateral until a debt is repaid.

Extra Credit: Liquidity Ratios

Banks analyze a company's financial statements to confirm liquidity and make sure the company has not over-committed themselves with debt. Some of these ratios are:

Ratio	Formula	Acceptable Range
Debt Ratio	Total Liabilities / Total Assets	50% or less
Debt Coverage Ratio	Annual Profit Before Taxes / Total Liabilities	Greater than 1.0
Debt-to-Income Ratio	Total Annual Debt Payments Due / Annual Profit Before Taxes	38% or less
Mortgage-to-Income Ratio	Total Mortgage Payments Due / Individual Monthly Earnings	33% or less
Current Ratio	Current Assets (Cash, Liquid Assets, Inventory) / Total Current Liabilities	Greater than 2.0

Guarantors – company officers are often asked to provide personal guarantees to a bank. This means they will personally make any debt payments the company is unable to make. If company officers are not credit-worthy then outside investors can serve as guarantors. Guarantors often require some type of compensation from the company to provide their guarantees – because, after all, if the company needs them to make debt payments they're legally required to do exactly that.

Banks check guarantors carefully. They also make sure that guarantors haven't over-extended themselves by making too many guarantees.

Collateral – banks prefer that companies repay their loans with cash, or that guarantors step up to pay the loan amounts companies cannot. But there are times when banks ask companies to pledge inventory, equipment (like cars) or other assets as collateral. That way, if all else fails, the bank can seize the collateral, sell it and repay part or all of the loan.

Banks ask entrepreneurs to complete highly-detailed applications that help them understand all of these issues. After they complete their thorough review of the company, the entrepreneur and all guarantors, banks then offer successful applicants lines of credits or long-term loans. Because they have so thoroughly analyzed so many factors, banks are confident they will be repaid . . . so they can offer their funds at a lower cost to the entrepreneur and his/her new business.

Banks hope to develop long-term relationships with entrepreneurs. The goal of every bank is to develop relationship with successful businesspeople, providing them with loans over the years that help their companies succeed and grow.

How Online Finance Companies Evaluate Credit Applications from Small Businesses

Online finance companies advertise their ability to make quick loan decisions and get cash to small businesses very quickly. They require less information about entrepreneurs . . . but, as we’ve seen, charge a great deal more for the funds they loan a small business.

The credit decisions online finance companies make are based on the factors indicated in the table below.

Factors Considered by Online Finance Companies When Evaluating Credit Applications from Small Businesses		
Factor	Why Important	Acceptable Range
How long in business	Most companies go out of business within a year – the longer a company has been in operation, the more likely it will stay in business.	Over 1 year
Size of the business	The more revenues a company generates the more likely the company can repay any loan.	More than \$60,000, prefer more than \$250,000
Entrepreneur credit score	Entrepreneurs are almost always required to act as guarantors for an online business loan.	570 or more
Past cash management	Companies that have not had any negative account balances (also called overdrafts or bounced checks or) are more likely to repay loans.	Fewer than 3 days with a negative bank balance
Multiple transactions	The more frequent a company has cash transactions with its customers, the more likely it will have the cash to replay their loans.	More than 10 transactions each month

As you can tell, these factors are much less demanding than the ratios and multiple levels of analysis that a bank completes in evaluating a small business loan applicant.

That's why online finance companies can approve a loan application more quickly than a bank . . . and why online loan companies charge so much more for the money they lend.