Chapter 3

BANKS

INTRODUCTION

Although banks are essential to the economic health of the nation, they only deal with companies that lie within a narrow range of parameters. Fortunately, there are a number of alternatives to banks. Our discussion of banks in this chapter will provide a basis for contrasting the strengths and weaknesses of banks to the strengths and weaknesses of other financing sources.

This chapter views the world as banks do. By understanding the forces that drive banks, the entrepreneur should be able to make them more responsive to his or her needs. This chapter discusses the main types of credit services (facilities) banks provide; underwriting, the process banks use to determine who will get credit; and it explores some of the misconceptions about banks.

THE BANKER STAKE OF MIND

Banks aggregate money by accepting deposits from the public and make money available to businesses and individuals at interest. They also provide other services such as checking accounts and cash management. Most U.S. banks are federal banks chartered by the Comptroller of the Currency of the United States. A few banks are chartered by states. Banks

with Federal Charters must join the Federal Reserve and are subject to examination by the Comptroller of the Currency. Banks with state charters are regulated by the state that issued their charter, and under the Monetary Control Act of 1980, are subject to regulation by the Federal Reserve. The Federal Deposit Insurance Corporation (FDIC) also regulates banks and has the power to examine bank records.[1]

The founders of our country recognized the importance of banks to the economy and history has confirmed their judgment. Countries with strong banking systems have tended to prosper (i.e. Germany and the U.S. after World War II) and those with weak banking systems have less robust economies (i.e. Russia and Japan from 1990 to 2004.)

A high degree of regulation has been placed on banks because of their importance to the economy and because they hold the deposits of millions of ordinary citizens. One of the consequences of this regulation is that bankers have limited credit granting discretion. Fifty years ago, credit was largely granted based on a banker's personal knowledge of an individual borrower, but regulators cannot test or evaluate personal relationships. They can only evaluate facts on the record. This has made banks very conservative in the range of risks they are willing to tolerate. The implication is that banks will only provide capital to firms that fit within a narrow range of documented financial performance. Companies that fall outside that range, for any reason, are wasting their time trying to get a bank loan and are better off considering other sources of capital discussed in this book.

BANK FACILITIES

Banks call the credit services they offer facilities. The three main facilities offered by banks are term loans, lines of credit and letters of credit. Similar criteria are used to decide on extending each of these facilities.

Term Loans

Term loans are loans that must be paid off with regular monthly payments. Term loans are used for things like plant expansion, equipment and working capital for installation, training, raw materials, finished goods inventory, and accounts receivable related to expansion. These loans are typically for three to seven years. Repayment terms can vary, for example, there can be even payments of principal and interest, similar to a car loan. With even payments, the portion of the payment that is allocated to interest