Top Ten Reasons Loan Applications Fail

Community Economic Development Fund

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In business it often can be instructive to study not only the reasons behind success, but also the circumstances that frequently accompany failure. From this you can draw lessons that will help you learn where to focus emphasis and what particular errors might require your special efforts to avoid.

10. Unwillingness to provide a personal guarantee for the loan

The business press is full of books and articles that relate how famous entrepreneurs avoid signing personal guarantees. Unfortunately, the context is usually missing in these tales. “Nonrecourse financing,” where a borrower provides substantial collateral but has no personal liability for repayment is from the domain of high capital finance, for example in real estate development or shipping. Still, authors dash off advice to avoid personal guarantees as if this were possible in every kind of transaction. It’s not. It’s almost impossible to find nonrecourse financing for a small business loan. It makes no sense from a lender’s point of view to offer it except when the loan is so well secured by other collateral that the borrower’s guarantee is insignificant. But, sadly, applicants misunderstand this reality and resist offering their personal pledges to back the loans.

9. Insufficient collateral for a large loan request

Even with a personal guarantee, a small business lender like CEDF has to have a backup plan in case the borrower can't pay back the loan. For small loan amounts when other streams of income exist, collateral may not be required. Perhaps a borrower or a guarantor has productive full-time employment and the payment could be made even without the projected business profits. But these situations usually don't apply to larger loan requests, so collateral becomes a requirement. And the nature of the collateral is important too. Business accounts receivable are very difficult for a lender to collect. Inventory can disappear from the warehouse or store shelves. Equipment and fixtures are often worth only a small portion of their purchase price when liquidated. This usually leaves real estate, publicly-traded securities or other liquid assets as more useful collateral.

8. Insufficient capital invested by the business owner

To assure a lender that a borrower has a significant interest in seeing that a loan is paid as agreed, there has to be a sufficient amount of owner's capital at stake. The risk can't be all in the column of the lender. But a large loan request with a small owner's capital injection would tilt all of the risk in the wrong direction. The exact percentage a lender like CEDF considers appropriate can vary widely and is influenced by the strength of the business plan, the amount of security offered and the size of the loan. "You have to have skin in the game" is the expression most people use to explain this requirement.

7. No Plan B

Entrepreneurs, as they should be, are very confident in their own ideas and potential for success. But the CEDF lending team has to be more realistic because they have seen marvelous ideas that fail on execution. It's crucial to have a clear plan to deal with the stong possibility that a business won't launch on time, be on budget, or follow the predicted revenue projections. Because so many loan applicants intend to make a living from their businesses, it would be foolish not to consider what could happen if the business becomes an anchor and not an eagle. Is there another source of income that will feed the owner and family? Is there an easy way to pivot the business in a different and more successful direction? If not, the business may be too risky to support with a loan, no matter how confident or determined the applicant feels.

6. Unsatisfactory explanation for low credit score

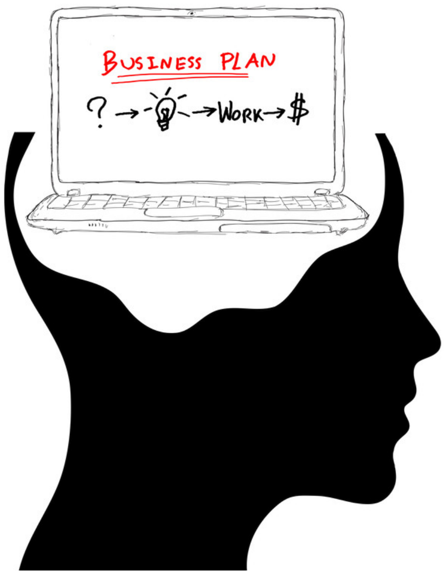
As a stock broker is required to say, “*past performance does not necessarily predict future results*.” But this isn’t quite how it works with credit scores. Good character is one of the fundamentals of lending, but there is no practical way for a lender to assess what’s in the hearts and minds of applicants, so credit scores become an important factor in the overall decision process. CEDF, as a mission-driven lender, is in a position to make allowances for low scores when a verifiable, credible and reasonable explanation can be made. For instance, credit scores can be impacted adversely by medical problems, contentious divorce cases and other misfortunes that don’t paint the same picture as that of someone whose personal financial conduct is simply reckless.

5. Poor understanding of business cash flow

Much of a business plan's persuasive power relies on the credibility and realism of the financial projections. A good business plan can demonstrate on spreadsheets that the loan proceeds will be sufficient to acquire the equipment or inventory that the business requires, and, when combined with reasonable and realistic revenue expectations, that sufficient working capital will be generated to lubricate all of the wheels that the business turns on. But a poor plan makes assumptions that ignore the time that it often takes to accomplish even the most basic business objectives, such as launching operations, building a customer base, getting a product to market, or collecting receivables from customers. By ignoring the impact of these kinds of inherently uncertain factors, a poorly prepared applicant attempts to make the projections work as if by magic and loses the confidence of the lender.

4. Unrealistic revenue or expense projections

It is obvious to a lender that a loan applicant has gotten overly enthusiastic about sales and profitability potential if the numbers for Year 2, 3 or later projections show geometric growth. It doesn't take a wild exaggeration to make a loan officer and underwriter skeptical if productivity claims are unexplainably out of the norm for an industry when compared to standard data sources and reports. Even if the revenue assumptions are reasonable, some prospective borrowers try to inflate profitability expectations by ignoring or minimizing likely or even inevitable expenses. It's never a good idea to strike a pose with unrealistically low expenses in hopes of persuading a lender that you're an exceptionally talented manager.



3. Applicants don’t understand their own business plans

Not everyone gets an “A” in composition. So there’s no shame in getting help to write a business plan so that it communicates your intentions clearly and concisely. Development of the financial reports and projections can require more than a beginner’s knowledge of accounting. But what can quickly destroy a lender’s confidence and interest is when the conversation reveals that the applicant doesn’t really understand what’s in the plan. At CEDF, there’s not an expectation that every applicant has command of accounting knowledge and would be capable of reconstructing the cash flow projections from scratch. However, it’s very important that a business owner has a working knowledge of the strategies and can at least explain the basic financial assumptions. It is your business plan and your financial projections.

2. Nonexistent or poorly-written business plan

It's very disappointing when an applicant doesn't understand their own business plan, but there's no hope when the lender can't understand the plan because it is poorly-written, vaguely-explained or lacking essential elements such as projections. And obviously, a loan application can't be processed on the basis of a verbal presentation. There has to be a written plan. In academic and entrepreneurial circles, full narrative business plans are often criticized because it is felt that they are poorly read, infrequently updated by business owners once in operation and take too much time to prepare. Lenders like CEDF want to read your busienss plan and look forward to it.

1. Little or no experience in an industry

Business ownership is an honored American dream. But those responsible for making business loans have a duty to only support proposals that have a good chance of success. Not only does this help preserve the loan capital of the lender to ensure future applicants can be funded, but it would not be fair to the applicant to support a plan that has little chance of success. Managing a small business requires a wide variety of skills that not everyone is equipped with at the outset. When applicants approach CEDF for help entering an industry which is known to be particularly competitive, operationally complex or fraught with failures, special qualifications are required. A common example is the restaurant business. Those who have never so much as washed a dish and whose only qualification is having eaten dinner out frequently won't pass the experience test. But solid inside knowledge of an industry and progressive experience in management is always a big plus in support of a loan application.

Meet the Community Economic Development Fund

Nonprofit community lender organizations, just like banks and credit unions, provide responsible, affordable small business lending.

CEDF is an independent, nonprofit, mission-driven Connecticut economic development organization. We provide loans primarily in low-to-moderate income communities and predominantly to low-to-moderate income small business owners who are not able to obtain bank financing. We focus on the 53 towns and cities designated by the State of Connecticut. (See our website.) In other CT towns we lend to borrowers who meet a family income ceiling. Our rates are typically a little higher than a bank and quite reasonable. There may be modest fees for document preparation, commitment and line of credit renewals. While banks are highly regulated and have lots of restrictions on credit scores, time in business and collateral, CEDF can be more flexible and creative to look at the big picture for an applicant.

We assign Business Advisors, who are seasoned, successful, former small business owners to each of our borrowers. They serve as relationship managers and coaches in management, marketing and finance to encourage business growth and reduce risk, typically in monthly meetings. The CEDF Business Education Center offers learning in a variety of formats: Seminars, webinars and workshops, online courses, podcasts and published content at WeTeachSuccess.org.

Ready to apply?
Questions for a loan officer?
Visit CEDF.com/inquiry

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