5 KEYS

To Exploring Risk Mitigation Techniques in AR Based Financing

EBIZMORE
Accountants and Advisors

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Key #1 – A Strong Initial Credit Decision:

Credit policy and credit officer training –
Beacons to guide your lenders

“Begin with the end in mind.”

That was a catch phrase made famous by Stephen Covey in 1990 and it would also qualify as one of the seven habits of highly effective lenders. When preparing to initiate any financing relationship, it is critical to begin with the end in mind. *According to the SBA, approximately six hundred thousand new businesses will start operations each year in the US and about 51% of these will survive more than five years. Many of these businesses will seek funding for short term capital during the first five years of operation, whether they fall into the 51% group that succeed or the other group that ceases operations or sells. It is, therefore, imperative that the bank have a plan for money going out and how it will come back even if things don’t go so well. When planning any sort of revolving credit relationship, the process begins with a formal internal credit policy, continues with credit officer training, and continues through ongoing credit review functions. Everyone touching the relationship needs to know what is expected of them. ProfitStars Lending Solutions has provided lender training and sample credit policy addendums to its client banks since 1994. With Business Manager as with any other credit risk initiative in the bank, it is important to fine tune your approach and ensure that lending and credit personnel are comfortable with its deployment.

While much of our resource material addresses best fits and business characteristics, it is equally important for bank policy to define which receivables are not eligible for the program. Whether due to the age of specific invoices or the nature of the accounts, lenders should be aware of bank policy in this regard. For example, ProfitStars does not recommend contractor relationships for its AR funding programs due to the inherent risk associated with that form of receivable – including progress billing, performance risk, supplier lien rights and more. The company also discourages produce related transactions due to PACA and similar legislation. In addition, brokerage firms such as Trucking Brokerage are discouraged. Any credit policy relating to revolving credit transactions should address subject matter such as this and much more. The sample BusinessManager credit policy and credit officer training initiatives include the following key components. Whether you are using BusinessManager or designing policy for other bank AR solutions, these should be addressed. Please keep in mind that this policy is designed as an addendum to the bank’s general credit policy, so items such as loan officer limits, approval rights and loss provisions are only covered to the extent that they vary from that overall bank policy. The addendum and others like it attempt to address the specific nature of the product being covered.

The key elements of the Business Manager credit policy addendum include:

Product description:

The product description should include a good working definition of the product or service as well as its overall scope in your organization. It should also reference any third party firms the bank uses to deliver the product to the market. The description may include information relating to the targeted size of relationships and the anticipated pricing metrics.

Approval process (proposal and analysis):

This section should clearly define the internal protocol for obtaining credit approval under the described program. Any special approval or limits should be spelled out as well as any special underwriting requirements that may go beyond the banks general credit policy for facilities of equal size.

Financial information requirements:

It is important to communicate any special financial statements requirements that may not be described in the bank's general credit policy. For example, in some cases the bank may want to require historical accounts payable aging reports or specific examples of invoices and purchase orders to help understand the nature of each transaction.

Documentation requirements (including specific lien filing and perfection guidelines):

While the bank's standard lien filing instructions will typically apply in revolving relationships, the bank may also add additional requirements to address issues such as IRS Code 6323 (tax liens). In revolving credit relationships, the bank will typically either require that IRS Form 8821 be signed and executed at closing, or that a third party monitoring firm be assigned to monitor the banks lien position in relation to other liens on business assets. This section may also describe what is acceptable bank policy for obtaining lien release and/or subordinations from other financing institutions. Finally, the section would include a list of documents that would typically be utilized in the proposed funding transaction

Monitoring methods used:

This section should clearly define the daily, monthly and annual monitoring responsibilities of the lender, the program director and the program administrator. Checklist and job descriptions (as Exhibits) may also be used to further detail this section.

Businesses eligible (best fits and those that are not eligible):

This section would typically describe the bank's target market for a particular product or service. Which industries tend to exhibit the needs addressed with the product? Which business characteristic cause a particular business to be a good fit as a marketing target? This section is abbreviated and the reader can be referred to the bank's marketing plan for greater detail.

As stated earlier, the policy should communicate those industries that are excluded from the product's market due to special risk characteristics. In the case of Business Manager, this would include general and sub contractors, general contractors, trucking brokers, PACA related transactions (as well as transactions effected by the Meatpackers and Stockyard Act and the Poultry Producer's Act). If the banks elect to fund such relationships, they should do so only in cases where there is ample outside collateral to cover exposure. Finally, there should be a clear method of approving any exceptions to bank policy in this regard.

Receivables eligible:

In addition to defining industry types, the bank will describe the nature of the receivable it is targeting under any revolving relationship. This may include a description of aging characteristics, invoice size limits, sales terms, etc. The bank would typically exclude certain invoices from funding as well – including pre-billings, invoices aged beyond 60 or 90 days at the time of funding, and invoice size limits. In some cases, the policy may require additional documentation before funding a specific invoice. This could be determined by a size threshold.

Reserve requirements:

In the case of Business Manager, the bank is maintaining a cash collateral reserve account to accommodate the repurchase of past due invoices or invoices that have fallen out of the normal funding parameters established by the bank. The credit policy should clearly state how the reserve account is to be structured, what percentage of each invoice is to be deposited into the reserve before funding, and the tiering of the reserve that will take place as invoices age. This section should also define the lender's ability to require additional reserve as circumstances dictate. In the case of Business Manager, the bank's right to adjust reserves is arguably the most important credit risk function of the Agreement.

Repurchase requirements:

Just as the previous section of the policy determined new reserve structure, this section should clearly communicate what is expected of the lender when enforcing the repurchase requirements of the Business Manager Agreement. In the case of traditional revolving lines, this section would provide detailed instruction regarding actions taken when invoices were no longer eligible for funding, and the resulting impact on borrowing base calculations.

Monitoring practices:

The policy should serve as a guide to lenders regarding regular monitoring requirements for the product. This may include standard reporting requirements, reserve management, repurchase management and ongoing financial reviews of the business. It may also include guidelines regarding office visits and other ongoing communication with each client to discuss business status and needs.

Bank bookkeeping practices (loss provision, etc.):

To the extent that bookkeeping for a product varies from traditional loan products in the bank, the credit policy can include specific information or instruction regarding the accounting treatment, loss reserve provisions, income recognition and any other specific guidelines. I regards to Business Manager, bank clients can refer to the Bank and Business Implementation sections of the training guides to see typical bank accounting practices as well as Call report guidelines.

Once the stage has been set with a formal written credit policy, the next step is to help communicate that policy and assure its longer term effectiveness through training and ongoing review functions.

The key elements of credit officer training would include:

Roles and responsibilities (Program Director or product owner, Processor, Lender of record):

The primary goal of this training is to define roles and responsibilities for the positions that manage the program. In the case of Business Manager, the training also includes specific daily and monthly tasks completed by the individuals as well as examples of how these can best be accomplished.

Sales process and understanding of cost/benefit analysis:

For any bank product or service, it is important that the employees involved can see beyond just the technical issues. The training should address how the product benefits both the bank and its clients. This includes general business benefits as well as a complete understanding of cost benefit analysis for both parties.

Best practices in underwriting AR supported lines (including liens and perfection issues):

Any training geared toward revolving credit facilities should include best practices for underwriting, sample underwriting cases and 'spilled milk' type stories. Especially for new lenders, reviewing what key area to emphasize in a write-up and committee presentation is the key.

Monitoring AR:

This segment of training should include an understanding of verification practices, reserve management, repurchase enforcement and insurance structure. It should also utilize workflow checklist to communicate monitoring responsibility and task management. Within Business Manager, we use tools such as the job descriptions and the "Twenty Minute Drill" to discuss these tasks.

System use and reporting capabilities:

With any tools, it is important to both know their intended function and how to use them effectively. Lenders and program administrators in the bank should be trained on all the capabilities of the tools they will be using. Ideally, much of this training will include hands on case reviews and examples.

How to recognize signs of a problem with the business or a debtor:

A lot of new product training only goes so far as to discuss how things should work in optimum conditions. An effective training should also include some cases and discussions of what to do when conditions merit corrective action to mitigate the risk of loss. Every effort should be made to discuss warning signs and red flags – how to recognize them and how to address them.

Once these are in place, success becomes a matter of execution. Credit functions within the bank, including any central underwriting teams, must work to assure that policies are maintained and that exceptions are approved and monitored. Internal credit review functions inspect the results of the lender's monitoring efforts to help assure ongoing performance and profitability. No lending initiative can be successful in the bank without both a sound marketing strategy and a strong credit implementation strategy. Working to structure and monitor results in both of these areas will help to create long term profitability for your program.

**Source: According to the Small Business Administration (SBA), approximately 600,000 new businesses are started in the United States each year. The SBA provides free training to entrepreneurs to help them succeed with their new businesses. Source: SBTN Podcast: Is Entrepreneurship For You?*

Key #2 – Accurate and Timely Information:

Exploring the types of information that are critical to success in all forms of asset based financing

"Information is the currency of democracy." Thomas Jefferson

"My sources are unreliable, but their information is fascinating." Ashleigh Brilliant

These two quotes sum up both the benefits and challenges of the information age. As our ability to communicate has increased at an incredible rate during the last 20 years of banking, so has the risk of falling prey to inaccurate information. During the course of any debtor/creditor relationship, both parties will rely on the use of information. Creditors depend on accurate and timely data in order to make reliable decisions regarding everything from initial approval to terms and structure, to daily credit management and even pricing. As we explore the world of asset based lending, the questions becomes; How much information do we need, and what types of data will most improve our ability to manage the relationship?

Through the use of electronic transfer, more and more bankers are now depending on information that comes directly from their client's accounting system via extracted reports. Whether it involves accounts receivable, accounts payable or inventory, this is typically the most reliable source and also reduces the risk of human transcript error – but it is not foolproof. In this article, we will explore the types of information most asset based lenders require and methods they use to validate that information after receiving it.

Before initiating any revolving credit relationship secured by receivables and/or inventory, it is critical to understand the nature of the business and the life cycle of every sale. It is recommended that the lender obtain sample transactional documents from purchase orders to invoices and any others that support the sales and payment cycle. It is also important to understand whether every business sale is similar or whether they vary widely, with different debtor terms, conditions etc. Once you understand the nature of the sale for any given business, you are more prepared to determine which pieces of data you will want to see when monitoring the relationship.

When accepting data in electronic form, such as when using it to populate a borrowing base, it is also important that your documentation reflect that method of invoice transfer. In other words, does your existing documentation define invoices whether in "written or electronic form?" Also, do your lending practices require a business owner to electronically validate the accuracy of their data – at least to their knowledge – before they hit the "send" key? Even though your processes will call for you to verify invoice and inventory data either before or after funding, it still helps to have the customer make this statement of validity prior to sending information. With that foundation explored, here are the types of information you would typically request:

Information to obtain prior to funding (in addition to normal financial data):

Accounts receivable aging:

In most cases, the financing institution will want to review a detailed aging report rather than a summary aging. This report will be reviewed with an eye toward potential contra accounts or affiliate company receivables. The report will also be studied to review concentrations, past dues and potential charge offs, accounts that enjoy special terms of sale, and accounts that may potentially involve foreign debtor relationships.

Accounts payable aging (to study the possibility of contra accounts or affiliate relationships):

In addition to studying A/P for contras and affiliates, this report helps generate a discussion regarding use of proceeds. If payables have been stretched, chances are your client is missing discount opportunities or not getting the best prices for materials. One goal of any asset based relationship is to reduce payables turn and open up these opportunities for your business client.

Customer lists (w/ explanation of any that may enjoy special terms of sale):

When establishing any revolving credit relationship, it is important to understand the terms of sale associated with your collateral. Some debtors may enjoy special terms, discounted terms, etc. All of these can impact you're A/R turn cycles and your advance rate structure.

Sample purchase order or sales agreement:

Not all sales are created equal. Without understanding of the sales transactions, you could inadvertently fund specialized sales transactions where your client does not in fact own the receivable. These may include consignment sales, broker arrangements (as with transportation brokers) and dated purchase order contracts (as with some agricultural and apparel business). Many of these special sales arrangements are outlined by detailed purchase orders, sales contracts, service contracts or sales agreements. It is important to review these, if they are used, prior to beginning your funding relationship.

Sample invoices:

For any given relationship, are all invoices going to be identical, or are they going to vary widely based on which debtor is being invoiced? If all invoices are similar and you are funding a cookie cutter type of sale, it obviously is much easier to understand the business/debtor relationship. If however, invoices vary based on the sales agreement between the business and debtor, you will want to understand the terms and conditions of those invoices.

Physical inventory reports:

It is very possible that the inventory system your client uses could be independent from their accounting system. For example, they might use QuickBooks, Peachtree or MAS90 for their general bookkeeping and use a custom built or proprietary software for inventory management. It is important to understand how the inventory reports are created and to agree on the level of detail you want to see when funding inventory. Based on your advance rate and your dependence on the inventory as a repayment source, you may also want to plan on-site visits periodically to do an inventory site check. The scope of this article excludes floor planning and other similar forms of inventory finance, but refers to a more general type of inventory advance structure. Still, the 'Inspect What You Expect' rule applies to any situation where you find yourself advancing against inventory. As a side note to the inventory discussion, it is also critical to understand the nature of any prior inventory liens. If, for example, you are simply advancing against accounts receivable, you would obviously want to assure that no receivable or inventory liens exist ahead of your position, unless you have a written agreement with the financing party that is ahead of you.

Information obtained daily, weekly or monthly depending on the funding relationship:

Newly generated invoices:

Most A/R financing or factoring software allows the user to see and study invoice level detail. Some may even provide invoice scans containing signatures, approvals, etc. Strong software products also allow a mechanism for exception management, so newly generated invoices that may fall out of the average parameters are initially excluded from any automated advances until a credit officer can review them. Either way, it is important to study the type of invoice level data you and your lending staff will be seeing prior to signing off on advance requests.

Credit memos:

It is important that your business client post credit memos promptly and that your system receive those updates so that adjustments to your collateral values are made. Allowing open credits to reside in either system for any period of time should be discouraged.

Back up documentation for larger invoices (as determined during initial underwriting):

In most situations, it makes sense to set a limit on invoices that would automatically be incorporated into a borrowing base calculation. Invoices larger than the assigned threshold would require additional documentation. For example, your client's average sale is $750 and a large invoice any given month might be $1,200. It would make sense to require a hard copy of the invoice and perhaps some light verification efforts if an invoice exceeded $1,200 or perhaps $1,500. Most good funding systems can automatically trigger such a request when the parameters are established by your bank.

Any information specific to the industry (ex. Transport – Bill of Lading, Medical – Claim reconciliation reports):

From time to time, your organization may develop a relationship within an industry that involves more complex documentation. It is important to consider the circumstances where you would require copies of such documentation. Examples might include periodic request for EOB data in the medical arena, or Bills of Lading in the transportation sector. Some request may depend on the size of the invoices or claims, while other determinations may be based on the credit quality of the business you are banking. One word of caution – If you are funding any medical accounts receivable, a specialty system is recommended and documentation requirements necessary to comply with HIPAA (Health Insurance Portability and Accountability Act) would be necessary.

New customer information (especially in cases where verifications are being performed):

It is always important to recognize new account debtors and to understand the terms associated with those sales of your business client. In most cases, an automated system for funding would catch a new debtor and prompt your client to enter contact information regarding that debtor. The contact information may then be used for either notifications or verifications initiated by your organization when appropriate.

Regular physical inventory reports or summaries:

Depending on your reliance in inventory as a primary or secondary source of repayment, you will request inventory summary or detail information as appropriate. This may be weekly, monthly or some other schedule. It is also important to understand the nature of the inventory you are seeing in the report, and not just an assigned dollar volume. Is the inventory value stable based on market conditions, technology, shifts in demand or other business trends?

Special Note: Importance of periodic information obtained by direct visual verification: One word of caution – Never get too comfortable with information coming across your desk from a client. Once a month, once a quarter or at least semi-annually, pay a visit to their offices and see firsthand how things are going. Take the tour and get to know their key employees. Take the client to lunch and talk about their goals for the business. Transactional data can help to guide your daily funding relationship, but it is not a replacement for active face-to-face discussions. Engage the business owners and have them tell you about conditions in their industry, goals for the next quarter, and general trends they feel are impacting their business.

All of the information listed above will arm you and your lending staff with the tools necessary to understand the business and to comply with internal bank policy. It will also help your lenders to anticipate upcoming changes in business cycles and new business opportunities. When asset based lending is performed properly, these clients become some of the closest relationships in the bank. By using electronic exchange of data, you will be able to efficiently monitor that relationship without overwhelming your own staff. You and your clients will both have used the "Information Age" to assure future business success.

Key #3 – Controlling the Cash:

Controlling the repayment stream in asset-based lending relationships

“In every chain of reasoning, the evidence of the last conclusion can be no greater than that of the weakest link of the chain, whatever may be the strength of the rest.”

In 1786, an Englishman by the name of Thomas Reid forever altered the way we look at chains when he wrote, “In every chain of reasoning, the evidence of the last conclusion can be no greater than that of the weakest link of the chain, whatever may be the strength of the rest.” The concept of the weakest link was born. We all have seen evidence of the weakest link during our careers, whether referring to business processes, team cooperation or other areas. As we continue this series on asset based lending, it makes sense to address what is often the weakest link in the receivable financing process – payment from the account debtor.

This article will explore the following areas:

- Debtor notification of lien
- Documentation between bank and business client
- Contras and affiliate relationships
- The three V’s of asset based lending
- Monitoring dilution trends
- Addressing diversion of funds

With unmonitored lines of credit, there is no attempt to regulate the stream on payments between the account debtor and the business owner. In theory, the business owner is supposed to post payments and use the proceeds to pay down the line of credit, thus creating new availability. In reality, this is where the evergreen line is often created. Granted, many of these relationships are secured by an abundance of collateral assets and the bank sees no need to closely regulate. When accounts receivable is your primary source of collateral, however, there is a greater need to assure that lines revolve as they should.

Debtor notification

Depending on the nature of your financing agreement, you may or may not be notifying account debtors of your collateral position. In some agreements, you may be depending on your business client to re-direct payments to your lock box through a blind billing arrangement, where the debtor is simply told to remit to the new address. In these cases, where the terms are more relaxed, the bank must stay diligent in assuring the proper address notifications are sent and that future verifications do not point to diversion of funds. In cases where invoices are being submitted electronically, the bank should also check the physical invoices on occasion to make sure the proper lock box address is clearly indicated. If payments themselves are being sent electronically, the bank should provide clear instruction as to the location and account numbers for proper ACH resolution.

It is also important, in the case of default, that debtors are notified of the bank's security interest as soon as possible. Businesses in default have been known to contact debtors and ask that payment be sent directly to them rather than to the lock box. It is in your best interest to clearly communicate your position to the debtor and to remind them of their obligation to pay you directly once they have been notified of your lien. Your legal counsel can assist at this level of communication, and can review debtor 'double liability' obligations within your state.

Your decision whether to notify debtors at the beginning of the funding relationship will be determined by the nature of your funding process, the strength of the business client and several other factors. No matter how and under what circumstances debtors are notified, your attention to detail in this area can be critical to the overall success of the relationship.

Documentation

Clarifications made by the banker or bank attorney at the closing table can go a long way toward heading off future problems. If you are employing a lock box process, it is critical to point out the standard "remittances in trust" language in your funding agreement. This language points out that any payments received by your client will be held as remittances in trust for the bank and spells out how such payments are to be delivered to you. The business owner, and any employees who handle correspondence, need to understand that any payments are to be directed to the bank.

Your banking staff should also be on the lookout for unusual payments, such as payments drawn of your own client's checking accounts to satisfy one of their customer's obligations. The business owner should be made aware of representations and warranties made within the agreement that address validity of invoices, including the fact they have not previously received payment for any invoices they present for funding. Bottom line – the business owner and key employees need to understand that diversion of funds would result in default of your agreement.

Contras and affiliates

In most cases, banks would not knowingly fund contra accounts or affiliate company receivables. A periodic scan of both the receivables and payables aging reports can often uncover such accounts, but in many cases a more active search is required, possibly through a field exam. These accounts simply carry too great a risk of direct offset between your client and the other related company, especially if your client is past due on their own obligation with that company. This may or may not technically be considered diversion of funds, but it merits mentioning in this article.

The Three V's of Asset Based Lending (Verify, Verify, Verify)

Undiscovered diversion of funds from the lock box will show up in one of two areas – either the dilution trends or the verification responses. Verifications, whether they are in writing or by phone, become critical in the effort to regulate the payment stream. Debtor responses during these communications can reveal whether payment has been sent, and in many cases, can provide further insight into the current business/debtor relationship.

Monitoring trends in dilution

We will cover dilution more thoroughly in the next article, but it should be stated that any spikes in dilution could be the result of diversion. There are several reasons why an invoice could age beyond the bank's eligibility for funding. Whether dilution results from aging criteria or credit memo activity, both scenarios should be researched to determine whether payment has been received by your business client.

Addressing diversion

As one of the most significant areas of risk in accounts receivable financing, diversion of funds should not be tolerated and would typically be considered a condition of default by the bank. There are certainly cases where accidental diversion may have taken place, perhaps through an employee of the company who was unaware of the financing arrangement. In those cases, it will be up to your best judgment how to address the default. In most other instances, diversion would result in termination of your funding relationship. As a commercial lender, you rely on being able to trust your client. Once that trust is broken, it is usually in everyone's best interest to unwind the relationship.

Control of the cash in any asset based arrangement is critical. While it can become the weakest length, it also has the potential to be the strongest. As with any of the Five Keys, the tools utilized by the bank to track lock box compliance can make all the difference. It is also one of those areas where a little knowledge and a little effort can go a long way toward establishing a strong and profitable bank/business relationship.

*Ref: Essays on the Intellectual Powers of Man, Pub. 1786, Thomas Reid

Key #4 – Establishing Sound Monitoring Procedures:

Maximizing both effectiveness and efficiency when attempting to monitor asset-based financing relationships

An effective commercial lender is someone who knows how to draw a line in the sand, communicate the location of the line to clients, and enforce that boundary over the course of a long term business relationship.

It also helps to be able to do so in a manner that creates client satisfaction while meeting the financial needs of their business. If done correctly, the needs of both the bank and the business are met and both sustain growth and profitability.

Effective monitoring of commercial transactions begins long before the money leaves the bank. It begins during the initial phases of underwriting, credit approval, documentation and loan closing. Actions you take as a lender during these pre-funding steps will help to establish your communication with each client, your expectations of their performance as a borrower and your expectations of your own employees in managing the creditor/debtor relationship. So much of the success of an asset based lending relationship is pre-determined with the establishment of this initial foundation. You could say, in fact, that it is every bit as important as what happens after funding begins to take place. The purpose of this fourth installment in the Five Keys series is to outline steps taken before, during and after initial financing takes place and to discuss how you can develop an effective and consistent approach to monitoring asset based facilities in your organization.

Underwriting & Credit Approval

While discussed as Key #1 in an earlier article, it bears mentioning again that the credit approval process is critical to your long term success. This is where you set the expectation for your lending staff and where you determine the specific information needed to monitor the relationship once it is established. This is where you initially set parameters such as documentation requirements, rules for approving draws, loan covenants and informational reporting requests. As mentioned in the first article, this is all established through your asset based lending policy and through communication of that policy to your lenders. It fosters consistency across lending units and individual lending officers.

Documentation & Loan Closing

Previous articles in this series have also included a discussion of effective documentation and closing procedures. Your documentation communicates to your business client the expectations you have set in order to have a successful funding relationship. The discussion that take place at the closing table helps to breathe life into those documents as you communicate the terms of the agreement and the representations that both you and your client are making to each other as you sign it. It is also a good idea to communicate these to key employees of your client's business. In asset based lending, anyone who creates and invoice, opens the mail or posts payments needs to understand the promises the business has made to the bank in order to obtain financing.

At any loan closing, it is a good idea to have a written meeting outline so that you know you have communicated all important details to your client. This would include two areas. The first would be your internal checklist of documentation and closing procedures. The second would be a document that outlines your closing table discussion and helps to guide you in that discussion.

Answer these questions:

1. Based on your prior experience, do you feel that your borrowing clients always read the loan agreements they have signed at your organization?
2. Do you have a formal closing procedure whereby you communicate the major legal provisions of the Loan and Security Agreement to your client?
3. Do you have a summary document that outlines these major legal provisions to help guide your discussion?

In the world of asset based lending, where new money is going out every day, this closing table discussion is a necessity. You want your client to understand their obligations to provide information, to communicate to their own clients (ex. lock box address for payments) and to communicate to their employees. Covering your bases at closing will help you to establish a rewarding and successful long term relationship for you and your business clients.

Some important items to include in your discussion are:

a. The fact that you are only financing valid receivables where goods have been shipped or services have been rendered. You are not funding purchase orders or to-be-performed contracts. Similar statements can be made regarding the validity of inventory reports if that is part of your collateral base.
b. All payments should be directed to the bank lock box or a pre-defined ACH address. Payments received at their place of business should be presented to you in their original form no later than the next business day.
c. Credit memos, if necessary, should be completed and posted properly so that you can see the most current value of each receivable.

There are more, but you get the point. While all of these items would be a part of your Loan and Security Agreement, they need to be discussed separately at closing.

Ongoing Monitoring and Relationship Management

With a standard equipment, real estate or vehicle loan, you put it in place and then manage the repayment process. With asset based lending or other revolving credits, you may be making new funding decisions every day. This increases the need for ongoing communication with your business clients in the form of new sales, credit memo and payment data, updated financial summaries and data relating to new customer relationships. To guide this process, it is beneficial for you to utilize daily, monthly and annual workflow processes to guide your lending staff in the process.

In addition to fielding requests for line draws and reviewing daily or weekly transactional reports, each lender of record for an account should initiate a monthly review process that consists of the following three tasks:

1. Review key reports from your asset based lending system
    a. Aging reports
    b. Trends data analysis
    c. Inventory reports (if applicable to your facility)
    d. Bank profitability tracking
2. Review overall line usage and service history from the prior month
3. Initiate a five to ten minute phone conversation with the business to discuss general business trends, line utilization, possible future financing needs, etc. At least once a quarter, you may consider turning this into a live business visit.

By utilizing this three step approach to monthly line management, your lenders can keep up with the progress of their commercial clients while also providing the highest possible level of customer service. With this 20 – 30 minute commitment of time each month, you will learn more about these business clients than any other clients in the bank. After all, one benefit of asset based lending is that you get to see the active business cycles of your clients and you have a front row view of their successes as well as their business challenges. This view, by the way, also opens the door to virtually any other form of financing, depository service or cash management service that your client might need.

Internal Support from Line Administration Functions

Any discussion of asset based line monitoring technique would be incomplete without mentioning your back-room administrative functions. Whether using a third party monitoring system or a system developed internally, you are likely to have a commercial loan administrative function as part of the process. The person executing this function will see the daily workflow and help to administer daily draw requests, payment applications, etc. This person becomes an integral part of your monitoring strategy. They become your front line for both customer service and monitoring. In a very short time, they get to know your clients as well as anyone else in your organization. As a result, it is important to involve them in any monitoring discussions regarding the client and to ask their opinion on how the relationship is progressing. While they may not have credit authority, they quickly develop a sense of credit health and should be given a voice to communicate their thoughts on that subject.

Monitoring of asset based lending relationships does not have to be time consuming or labor intensive. While it will take more commitment than term financing or unmonitored lines, the potential for return is much greater and the relationships developed can lead to significant cross selling opportunities. In short, these can become some of the most rewarding relationships in your organization.

Key #5 – Protection Against Changing Circumstances:

Developing solutions that adapt well to a changing financing environment.

Commercial lenders do not make bad loans – right?

Loans typically go into default because of changing circumstances. The conditions of the credit change during the life of the loan, thus causing the borrower to suffer financial stress and subsequently default on their payment obligations. The question becomes: Is there any way to avoid these changing circumstances? Unfortunately, the answer is no. After all, stuff happens. Markets change, tsunamis impact delivery channels, product concepts fail, people get sick, etc. The challenge for commercial lenders is to structure facilities that will pay out even in the face of these changing circumstances. In the field of asset based lending, here are five ways to help assure that your line gets paid off even when the business itself falls on hard times.

1. Utilize collateral tracking systems that allow you to adjust advance rates very quickly.
2. Consider tools that will enable you to monitor your "real" primary repayment source, the account debtor.
3. Consider the use of accounts receivable insurance.
4. Put checks and measures in place that will tell you if your client fails to pay their taxes, or has a suit/lien/judgment placed against their business.
5. If you see smoke, assume it's a fire and act quickly.

Adjusting advance rates as circumstances change

In almost every commercial loan, your repayment source comes from collection of an account receivable. A product or service is sold, your client receives payment and that payment completes the cash flow cycle of their business. If that invoice was serving as collateral for a line of credit, hopefully the payment is used to pay down the line to create new availability. In the world of asset based lock-box lending, it would be required. With technology that exists today, there is no excuse for failing to track the value of that invoice throughout its life cycle.

As you evaluate any asset based lending system, be sure to study the 'time lag' within the process. The time lag is defined as the period of time that passes between the moment your client enters information into their accounting or inventory system and the moment you see it in your line monitoring system. For simple borrowing base lending, that time lag can be as long as 30 days or more. For the highest quality systems today, that lag can be a day or less – giving you more time to respond by adjusting your advance rate on the asset in question.

You might ask, how do we adjust advance rates when we have already funded against the asset? The answer lies in the technology, and your ability to manage your advance against new invoices being financed today, as well as your ability to maintain and adjust cash reserve cushions. By investing in technology of this type, you can significantly improve your ability to track collateral asset and manage your exposure. You will also have more real time information relating to any accounting activity that impacts the value of your collateral, such as a partial payment or a credit memo.

Consider tools that will enable you to monitor account debtors

In the old days, two or three years ago, bankers relied solely on D&B reports and Paydex scores when they chose to underwrite large account debtors. That world is changing. Now it is becoming possible to cost effectively track the payment performance of all key debtors. When you place a new line of credit, you underwrite your business client's ability repay, yet the true question becomes; can their clients pay? I am not recommending that you stop underwriting your clients; only that you begin to track the performance of your true repayment source.

You will always need to study the financial strength of your client over time. After all, in order to create quality receivables and inventory, they have to be financially sound. But by taking advantage of today's technology, you can go one step further. You can study the chances that their clients will have the financial strength to make good on their obligations as well.

Consider the use of accounts receivable insurance

The practice of insuring the risk of debtor default and insolvency is more than 100 years old in this country. It is even older in Europe, where banks typically do not finance accounts receivable without insurance. In the US today, there are a few key players in this market. With some receivable financing programs, the use of insurance is routine. For others, the bank's decision to insure an account will depend on the size of the debtor/creditor relationship. It may also involve insurance of foreign receivables. For your larger lines of credit, consider looking into this resource as a method of reducing concentration risk. Who knows, your client may already be insuring the risk themselves, since much of this insurance is written for the business, with the bank named as collateral beneficiary.

Track your client's tax payment history and court records

When I first started as a lender, one of my responsibilities was to review the Journal of Record in counties where we did business. I had to make sure that none of our clients had suits, liens or judgments registered against them. I called it the 'prayer journal' since we prayed that none of our client's showed up on it. Today the risk of these occurrences is just as great, but the methods of tracking have improved significantly. You can, for very little money, hire a third party to track these records and let you know if and when something comes up. This can provide you with more advance notice of problems on the horizon. When you have that advance notice, your reaction time improves and your risk of loss goes down significantly.

If you see smoke, assume it's a fire and act quickly

Besides cash, nothing moves as swiftly on a balance sheet as an account receivable. For those of you financing inventory, that value can change quickly as well. If you see something that does not look right, it is important to act quickly. Let's say that while calling to verify a large invoice, the payables clerk at the account debtor's office tells you that it was paid forty five days ago. Let's also assume that your financing system does not reflect the payment. In the best case scenario, there was simply an error at the debtor's office and they were referring to the wrong invoice number. Worst case, your client received the payment directly and deposited the funds into their own account, thus violating the terms of your agreement. Knowing what you know about accounts receivable, what action would you take? Would you just assume it was an error, or would you assume that it could be diversion and follow up with your business client? Even if it was diversion, it could have been an honest mistake made by an employee of the company – but your swift action to investigate could save you thousands.

We have the good fortune of living in the information age. The sheer volume of that information, though, can be overwhelming. The trick is to utilize risk mitigation tools that allow you to monitor the ever changing business environment. By deploying these time saving tools and acting decisively when the siren goes off, you can increase your efficiency, reduce your risk, and leave yourself with more time to do the parts of your job that you enjoy the most.