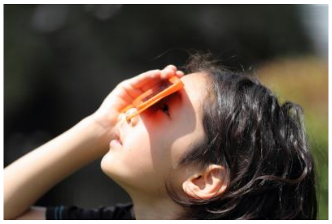

Eclipsed Asset-Based Lending

by Steve Brown

The much anticipated total solar eclipse will happen today. However, only a select few get to experience a total eclipse. It starts at 10:16 a.m. PST in Oregon and will continue through 8 states - for the first coast-to-coast solar eclipse in almost 100 years - before it ends in South Carolina. It is a lucrative event to be sure. Airbnb apartments are going for as high as $7500/night in Salem, OR, and there is a plethora of eclipse-branded swag priced at a premium. This makes us realize that there could be eclipsed opportunities in banking.

Some of you may have looked at asset-based lending at one time. Certainly, lending against assets is tricky business, but it can also be profitable for some, when risks are properly controlled. In fact, loss ratios can be comparable to those of commercial loans, while providing a reasonable net interest margin (NIM) and fees.

As you most certainly know, the main difference between asset-based lending and commercial lending is that a commercial loan relies on collateral and covenants, while an asset-based loan relies on the quality of receivables.

To make smart asset-based loans, bankers cannot use conventional underwriting procedures. Instead, you'll need to know a lot more about the borrowers' assets. These can be receivables as we mentioned above, as well as inventory or equipment. The key here is that these assets can move, so you will have to have tight controls to monitor and control the collateral through its entire life cycle. That means finding out whether there are actually washing machines in the boxes at the warehouse (vs. empty boxes) and whether those washing machines actually turn on when someone plugs them in. It also means you need to understand how likely it is that a borrower's invoices will be paid on time so they can pay you on time.

What assets should be considered?

If you're considering asset-based lending, you'll first need to decide what types of inventory or receivables you'll accept. Will you lend on finished goods or also work in progress? Receivables typically get a higher advance rate than inventory. Will you exclude foreign receivables, or buy credit insurance on them? Will you track government receivables in a separate category from other receivables, because they generally take longer to pay?

Also, remember that insurance companies typically pay a fraction of what is owed. So, if your client is in the healthcare industry, its actual receivables are less than the amounts it has billed. For instance, $40k in billed services might actually be worth somewhere around $10k to $25k.

You'll also need to think about the type of inventory you'll write a loan against. If the borrower builds things, inventory needs to be a finished product and not parts. Remember that some inventory also has a sell-by date. If the borrower sells fruits and vegetables, for instance, the product is only good for a limited amount of time.

Guard against fraud

Monitoring for fraud might be the toughest part of asset-based lending. Here, one of the best safeguards involves having asset-based borrowers use a bank established lockbox. This way their clients' payments come directly into your bank's control.

Field audits and random customer calls can also help ensure that the client has accurately reported the invoiced amounts in its accounts receivable for each loan advance. Personal guarantees from asset-backed borrowers are another possible protection.

Finally, you will also need employees with the expertise to understand each customer's payment patterns and who are detail oriented to an extreme. You are tracking everything, so you need to know about sudden drops in collections or anything else about a borrower's cash flow that doesn't seem quite right or could cause problems.

Manage your risk well and you may earn a higher yield than you would with commercial loans. However, manage it poorly and you could run into big problems. Our advice is to start small, have lots of controls, ensure staff is trained really well, educate customers thoroughly and control the cashflow no matter what because that is how you ultimately get paid. These steps and others can help you avoid being blinded if you look into asset-based lending.

BANK NEWS

Policies

Regulators indicate policies are: statements of actions that the bank adopts to pursue certain objectives. Policies guide decisions and often set standards (on risk limits, for example) and should be consistent with the bank's underlying mission, risk appetite, and core values.

Tech Impact

A Deloitte survey of global CIOs finds the technology areas indicated that will have the most impact on the business in the next 2Ys are: digital (67%), analytics (59%), cloud (46%), cybersecurity (45%), legacy or core modernization (42%) and emerging technologies (17%).

Executive Age

Korn Ferry research finds the average age by title for the top 1,000 US companies by revenue is: CEO (58Ys old), CFO (53), CIO (51), CMO (52) and C-Suite (54).

Global Cost

Research by Marsh & McLennan on cyber risks finds the estimated annual cost of cybercrime to the global economy is a whopping $445B.

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