This PDF is a selection from an out-of-print volume from the National Bureau of Economic Research

Volume Title: Term Lending to Business

Volume Author/Editor: Neil H. Jacoby and Raymond J. Saulnier

Volume Publisher: NBER

Volume ISBN: 0-870-14129-5

Volume URL: http://www.nber.org/books/jaco42-1

Publication Date: 1942

Chapter Title: Definition of a Term Loan

Chapter Author: Neil H. Jacoby, Raymond J. Saulnier

Chapter URL: http://www.nber.org/chapters/c5750

Chapter pages in book: (p. 9 - 14)

1

Definition of a Term Loan

An understanding of the several essential elements of a term loan is necessary in order to appreciate fully the important and unique position that such loans have come to occupy in the business credit market of the United States. The basic elements that define a term loan are: (1) credit extended to a *business* concern; (2) a direct relationship between borrower and lender; (3) provision at time of making the loan that some part of the principal is repayable *after* the passage of one year.[1] While particular types of collateral security, repayment provisions, uses of funds by borrowers or loan agreements may be associated with term loans, none of these are essential characteristics.

Term Loans Are a Form of Business Credit

The fact that term loans are credits extended to business concerns serves to differentiate them from many other types of loans, also having terms of more than one year, that are made by commercial banks, insurance companies and other financial institutions. The salient factor is that the term lender usually appraises the probabilities of financial success of a *business enterprise* in judging the likelihood of repayment of the loan at maturity. Thus the definition of term loans excludes consumer loans, where attention is focused on the moral and financial worth of an individual—who is not necessarily an entrepreneur. Also excluded are loans to individuals secured by mortgages on residential property. In making loans

[1] Some writers would add that a "term loan" is amortized out according to a prescribed plan. Although the majority of term loans are repaid in instalments, it appears unwise to limit the definition in this way for reasons stated subsequently.

of this type the lender customarily looks to the value of the pledged property. In contrast, even where term loans to businesses are collaterally secured by real estate or other property, the lender generally looks mainly (or exclusively) to the earning power of the business rather than to the value of pledged property to protect himself against loss. The collateral security given by a business concern is usually of a specialized type that cannot be liquidated by the lender to realize any certain amount in case of default.

Term Loans Involve a Direct Relation Between Borrower and Lender

The circumstance that term loans involve a direct relationship between borrower and lender serves to distinguish them from corporate bonds and debentures sold to investment bankers for public distribution. Although such securities generally mature more than one year after date of issuance, and are like term loans in this respect, there is no direct relationship between the borowing enterprise and its creditors. Almost invariably these bonds or debentures are accompanied by trust indentures requiring the appointment of trustees to act for all security holders. In all likelihood individual security holders are unknown to the borrower. The term loan is unique in being a medium-term credit, usually accompanied by a formal loan agreement between borrower and lender, but retaining that direct and intimate connection between business concern and financing agency that has always been associated with the busiess loan activities of commercial banks.

"Private placements" of corporate securities with insurance companies and other institutional investors resemble term loans more closely than they resemble publicly marketed debt securities. Private placements may involve use of the same legal forms as those employed in the traditional investment banking operation but they dispense with registration under the Securities Act of 1933, and short-circuit underwriters and security dealers who perform the function of breaking up

large loans into small units for wide distribution. The steady trend toward institutionalization of savings, together with the application of stricter controls (reflected in higher costs) of public distribution of securities, have led many concerns to "wholesale" their debt securities directly to the large investing agencies. While securities privately placed by business corporations generally mature after longer periods than do term loans, and in fact "straddle" the medium-term and long-term business credit markets, it would be illogical to differentiate medium-term private placements from term loans. Both media compete in the same credit market.

Term loans are closely related to, but are to be differentiated from, purchases by banks of instalment contracts arising from the sale of commercial and industrial equipment. The bulk of such instalment paper pays out over periods exceeding a year, and in a sense reflects the extension of term credit to the buyer of the equipment as well as to the seller who transfers the contract to the bank. There are a number of reasons why it is inadvisable to regard the acquisition of such instalment contracts by a bank as term lending. First, the majority of these credits are secured not only by the particular income-producing equipment involved and by the name of the buyer, but also by the name of the seller, thus producing a credit appraisal problem different from that usually encountered in term lending.[2] Second, instalment financing of income-producing equipment often involves use of financing plans under which many buyers purchase equipment from a single seller upon identical terms—a feature not characteristic of term loans. Third, bankers have extreme practical difficulties, in the records of their personal loan or time sales financing depart-

[2] A minor fraction of instalment paper arising from the sale of commercial and industrial equipment is sold to banks and finance companies by the manufacturers or distributors *without* recourse. In such cases the lender is protected only by the promise of the buyer to pay the debt and the right to repossess the equipment in case of default. It must be conceded that there is no real distinction between the credit problem posed for a bank purchasing such a contract and the credit problem raised when a bank makes a term loan to a buyer of equipment, repayable in instalments and secured by title to the equipment purchased with the proceeds of the loan.

ments, in separating contracts pertaining to consumer goods from those relating to commercial and industrial equipment, only the latter of which constitute business credits. Finally, and most important, even in the case of nonrecourse paper the credit relationship between the ultimate borrower—the purchaser of the equipment—and the lender is not usually established directly, as is true of term lending, but is established through the seller as an intermediary. For all of these reasons it is inadvisable to classify purchases of contracts as term loans.[3]

Term Loans Are Credits Extended for More Than One Year

The force of defining term loans to include only credits with maturities at time of making *more* than a year distant is obviously to exclude loans the proceeds of which may be used by the borrower to finance *only* short-period expansions in his operations. The traditional theory of American commercial banking has sanctioned certain relationships of banks to business enterprises which exclude extension of term loans. This traditional theory, largely evolved out of the experience of British banking during the nineteenth century, held that commercial bank credit would be extended in the form of short-term notes, given by borrowers to procure funds for manufacturing or holding commodities for sale during temporary peaks in activity, such as seasonal expansions. Equity capital or funds borrowed on long term were expected to satisfy all the fixed capital requirements of a business concern, as well as to provide minimum working capital needs at seasonal low points in inventory holding or productive operations.

The early regulations of the Federal Reserve Board concerning the kinds of loans upon which member banks could get Reserve bank credit reflected this philosophy. It was a

[3] For further treatment of this type of business financing, see forthcoming publication of the National Bureau of Economic Research (Financial Research Program), *Instalment Financing of Commercial and Industrial Equipment*, by Raymond J. Saulnier and Neil H. Jacoby.

natural concomitant of this theory that the banker expected an annual "clean-up" or extinction of indebtedness during the seasonal nadir in the borrower's operations. This, in theory, provided an annual test of the borrower's ability to achieve financial independence of the bank, and gave assurance that the bank was, in fact, financing only temporary expansions and was not permitting its funds to become part of the "permanent" capital of the business.

While it is generally recognized that the breach between this theory and American banking practice has steadily widened, the theory has usually been honored *in form* in the business loan activities of commercial banks. Bankers continued to take demand, 90-day, or six-month notes from borrowers, with a full expectation on the part of both parties that these obligations could not be discharged at maturity (without great inconvenience or embarrassment to the borrower) and would be renewed at their due dates.[4] Business concerns faithfully continued to extinguish their indebtedness during a short period each year at one bank by borrowing on short term at other institutions, thus preserving the fiction of the annual "clean-up." This had at least the limited value of showing that the borower could get credit from another institution.

Only with the advent of the term loan during the 1930's was there a definite break with the orthodox theory of commercial banking relationships with business enterprise. For the first time there was a frank recognition by both debtors and creditors that, *de facto*, many business debts would not terminate within a year, that the proceeds of loans would not be used wholly to finance short-lived expansions but would be devoted to the acquisition of fixed assets, the long-term

[4] Tangible evidence of this well-recognized practice is presented in a study entitled *Long Term Loans of Iowa Banks*, by Fred L. Garlock, pp. 296-99. (Research Bulletin No. 129, Agricultural Experiment Station, Iowa State College, Ames, Iowa, 1930.) The prevailing practice of a sample of Iowa banks was to date notes with six-month maturities but the actual average terms of their credits ranged from ten to thirty-two months during the years 1914-24. There was a tendency for the actual average maturity of loans to increase during this period.

expansion of working capital or the refunding of long-term debt. Since a loan to be repaid more than one year after date of creation could not be considered to provide merely seasonal working capital, a one-year term establishes the line of demarcation between term loans and the traditional short-term business loans.[5] Although there is difference in opinion concerning the appropriate distinction between medium-term and long-term business credit, for purposes of the present study fifteen years will be considered as the outer margin of medium-term loans. Loans and private placements of debt securities having terms of more than one and not more than fifteen years are the "medium-term" business credits with which we are concerned.[6]

[5] This limitation also applies to loans contracted in order to finance business transactions consummated in less than a year although not necessarily of a seasonal nature.

[6] Strictly speaking, any loan maturing on a definite date possesses a term and might be called a "term" loan, in distinction from a demand loan or a perpetual obligation. But the phrase "term loan" has acquired a well-accepted connotation in the financial community as an intermediate-term business credit, and this common usage is followed herein.