Term Loans

* What is a term loan?

Term loans are most commonly used by businesses to purchase equipment or provide working capital. In addition, some student loans (ex: Stafford loans) are also considered a term loan. Term loans typically have a variable or “floating” interest rate, but this will depend on the agreement. The interest rates are typically 2.5-3 points over the prime rate. The prime rate is an index of the 30 largest banks daily rate for corporate loans. The Wall Street Journal’s prime rate index is the industry standard for the prime rate. In addition, term loans may have monthly or quarterly repayments, and a fixed maturity date (when the loan becomes due).

* Interest Rates & Fees:

Interest rates and fees associated with term loans vary greatly among financial institutions and are highly dependent on risk, length of the loan, and loan use. When considering a term loan, it is very important to shop around for institutions that charge the lowest fees and interest rates. However, it should be noted that term loans tend to have lower interest rates and fees than other loans.

Is the interest rate fixed or floating? A fixed interest rate remains constant through the life of the loan. In contrast, a floating or variable interest rate fluctuates based on the market. In addition, it is important to know whether the interest is compounded. The typical fee for a term loan is 1%.

* Short & Long-term Loans:

Short-term loans:

Short or intermediate-term loans typically have a term of 1-3 years. These loans are most commonly utilized by new businesses and may be in the form of a line of credit or tied to a specific purchase. New businesses tend to seek these short-term loans/lines of credit because they need working capital and make immediate equipment purchases in order to start generating revenue. Interest rates are typically fixed and 2.5 points over prime and can have a monthly or quarterly payment schedule. The lender’s goal is to limit their risk, so the application process and financial review of the applicant’s personal and/or business credit history is very thorough. New businesses will also likely need to produce a personal credit history because they lack a business credit history.

Long-term loans:

Long-term loans typically have a term of 1-7 years, but they can be longer. These loans are most commonly used by established businesses to make larger capital purchases, for equipment, and large projects. Lenders may also require applicants to put up collateral for the loan. Interest rates may be floating or fixed at approximately 3 points over the prime rate, with a monthly or quarterly payment schedule. Like short-term loans, the application process is very thorough, but will most likely focus on the business’ credit history and business plan.

* Penalties:

Some of the penalties that are most commonly associated with term loans are prepayment fees and acceleration. A prepayment penalty or defeasance fee is assessed by the lender against the borrower for full payment of the loan before the date of maturity. A prepayment penalty is meant as a deterrent, because the lender is unable to realize the anticipated interest on the loan. An acceleration clause in a term loan causes the full balance of the loan to become due immediately upon violation of a loan’s term or condition.

* Terms & Conditions:

There are several terms and conditions typically associated with term loans. For instance, the lender may place limitations on the financial liabilities that the borrower may assume, such as additional debts, dividend payments, and salaries. Lenders may require the borrower to earmark or set aside a percentage of profits for repayment of the loan. A personal guarantee on the loan may also be required. Finally, some term loans have a “balloon” payment that becomes due when the loan matures (becomes due).

* Suggestions:

When shopping for the term loan that is right for you, start with the lending institution(s) with which you have a financial history or relationship with. Term loans are not uncommon and the terms and conditions vary widely, so shop around for the term loan that is right for you. In addition to shopping around, you should take advantage of the resources around you. Friends, family, colleagues, the newspaper, the internet, and the Small Business Administration [www.sba.gov](http://www.sba.gov) may be an excellent source of information and guidance.

Finally, when applying for a term loan, it is important to know that lenders will be assessing your credit worthiness. In other words, the lender is trying to determine how risky it would be to lend money to you (risk of default). Improving your standing in five categories, commonly know as the 5 C’s will likely get you better a better interest rate and terms. Lenders look assess your: character, capacity, capital, collateral, and confidence. Character is your personal and or business reputation. Capacity is your ability to repay the loan (income, debt, credit score). Capital is your own portion of the investment in the business, project, or item for which you need the loan. Collateral are your available assets. And the lender’s confidence in making the loan will depend on the size of the loan, interest rate, and loan use.