

Banking and Finance Law Daily Wrap Up, LOANS—OCC issues policy guidance for ‘venture loans’, (Nov. 2, 2023)

Banking and Finance Law Daily Wrap Up

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Venture lending involves commercial lending activities targeting high-risk borrowers in an early-, expansion-, or late-stage of corporate development.

The Office of the Comptroller of the Currency has informed banks about its policy guidance that applies to certain commercial loans to early-, expansion-, and late-stage companies. This bulletin refers to these loans as “venture loans.” The OCC stated that its [bulletin](#) applies to OCC-regulated banks of all sizes that engage in or are considering engaging in venture lending.

What is venture lending? The OCC has observed that some banks have added or are considering adding new commercial lending activities targeting high-risk borrowers in an early-, expansion-, or late-stage of corporate development. The OCC refers to these activities as “venture lending” and borrowers as “venture borrowers” or “venture-backed companies.” Venture lending supports new business formation and can improve access to capital for growth companies, but the OCC warned that new business ventures have a high probability of failure.

“Venture borrowers typically have not reached a mature stage of corporate development and may not exhibit sustainable positive cash flows or collateral to support loan repayment,” according to the bulletin.

This type of lending “often” involves banks accepting high-risk characteristics that banks normally avoid with commercial loans. According to the OCC, it is important for lenders to clearly differentiate between venture loans for which future repayment depends on a borrower’s investments in new products, new markets, higher than historical growth, liquidity coverage of cash burn, or subsequent fundraising from equity investors; and conventional loans to mature companies with structures based on a borrower’s existing sound operating model, internally generated cash flow, and the life of its assets.

Therefore, the OCC stresses that venture borrowers warrant strong underwriting analysis and monitoring commensurate with the level of risk in such loans. Venture lending facilities should include appropriate credit enhancements to mitigate the elevated risk of borrower failure.

The bulletin noted that the OCC “expects banks engaging in venture lending to do so in a safe and sound manner, in compliance with applicable laws and regulations, and with support from sound risk management systems.”

To do this, the OCC states that bank management should identify the purpose of the loan and the source of repayment before making any loans. In addition, bank management should assess the ability of the borrower to repay the loan in a timely manner. “Documentation maintained by the bank should support the decision to grant the credit and allow for follow-up monitoring, as the bank would perform with any loan. OCC examiners will scrutinize loan commitments that are underwritten without an adequate assessment of the borrower’s capacity to repay and will determine whether such loans should be subject to supervisory criticism. Examiners will ask banks to determine the impact that any weak venture loan underwriting standards may have on the assumptions used in calculating loan loss reserves.

Given the inherent risks associated with venture lending, the OCC expects banks undertaking venture lending to establish appropriate operational and managerial standards consistent with the safe and sound practices articulated in the “Interagency Guidelines Establishing Standards for Safety and Soundness.”

The Guidelines describe requirements for controls to safeguard and manage assets and the need for loan documentation practices that provide for appropriate administration and monitoring of loans. Control functions providing independent and objective assessment, reporting, and assurance can help banks identify, measure, monitor, and control risk and reduce the risk of loss.

Early- vs late-stage companies. The OCC divides the broader category of venture borrowers into two segments: early-stage and expansion-stage companies, and late-stage companies with specific guidance directed toward each category.

Early- and expansion-stage borrowers have limited operating histories for lenders to evaluate and underwrite. Instead, lenders often consider the quality of these borrowers' investors or sponsors, the certainty of subsequent capital raises by the borrower, the borrower's recent post-money valuation, and the borrower's projected cash burn relative to cash on hand. Reliance on these factors without appropriate credit enhancements—for example, through controlled cash collateral or other measures—may result in excessive risk taking by lenders.

Borrowers in the late stage of corporate development may be ramping up or may have already reached significant scale. But late-stage companies continue to warrant strong underwriting analysis and monitoring because cash flow may be negative, intermittent, or insufficient to service debt, resulting in dependence on secondary sources of repayment. Secondary sources of repayment for late-stage companies can vary and may include private equity financing, public debt or equity, the sale of assets, or liquidity from earlier fundraising.

Excluded forms of credit. The guidance also detailed which forms of credit are not venture loans:

- loans to businesses that primarily rely on their own internally generated cash flow, rather than equity infusions, to maintain and grow operations;
- loans made under lending support programs when federal, state, or local government guarantees sufficiently mitigate credit risk (e.g., U.S. Small Business Administration guarantees).
- loans made under special purpose credit programs as described in 12 CFR 202.8. Additionally, qualified banks may eliminate unnecessary documentation for certain loans as described in the "Interagency Policy Statement on Documentation for Loans to Small- and Medium-sized Businesses and Farms" conveyed by Banking Bulletin 1993-18.

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