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**The Global Financial Crisis**
Where Western Banks went Wrong and Why Asian Banks did not Follow

**Federal Budget**
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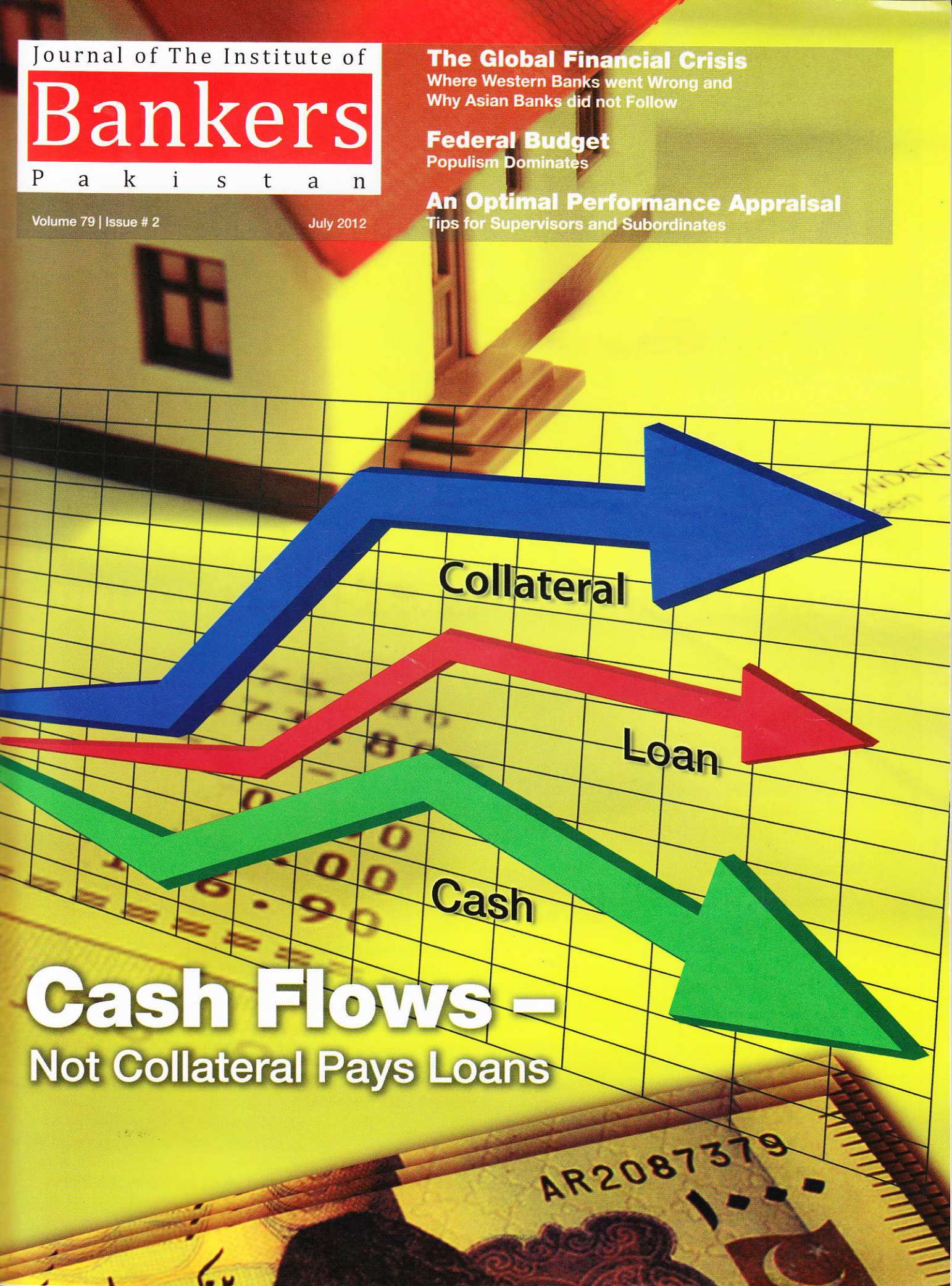
Tips for Supervisors and Subordinates




# Cash Flows –
## Not Collateral Pays Loans

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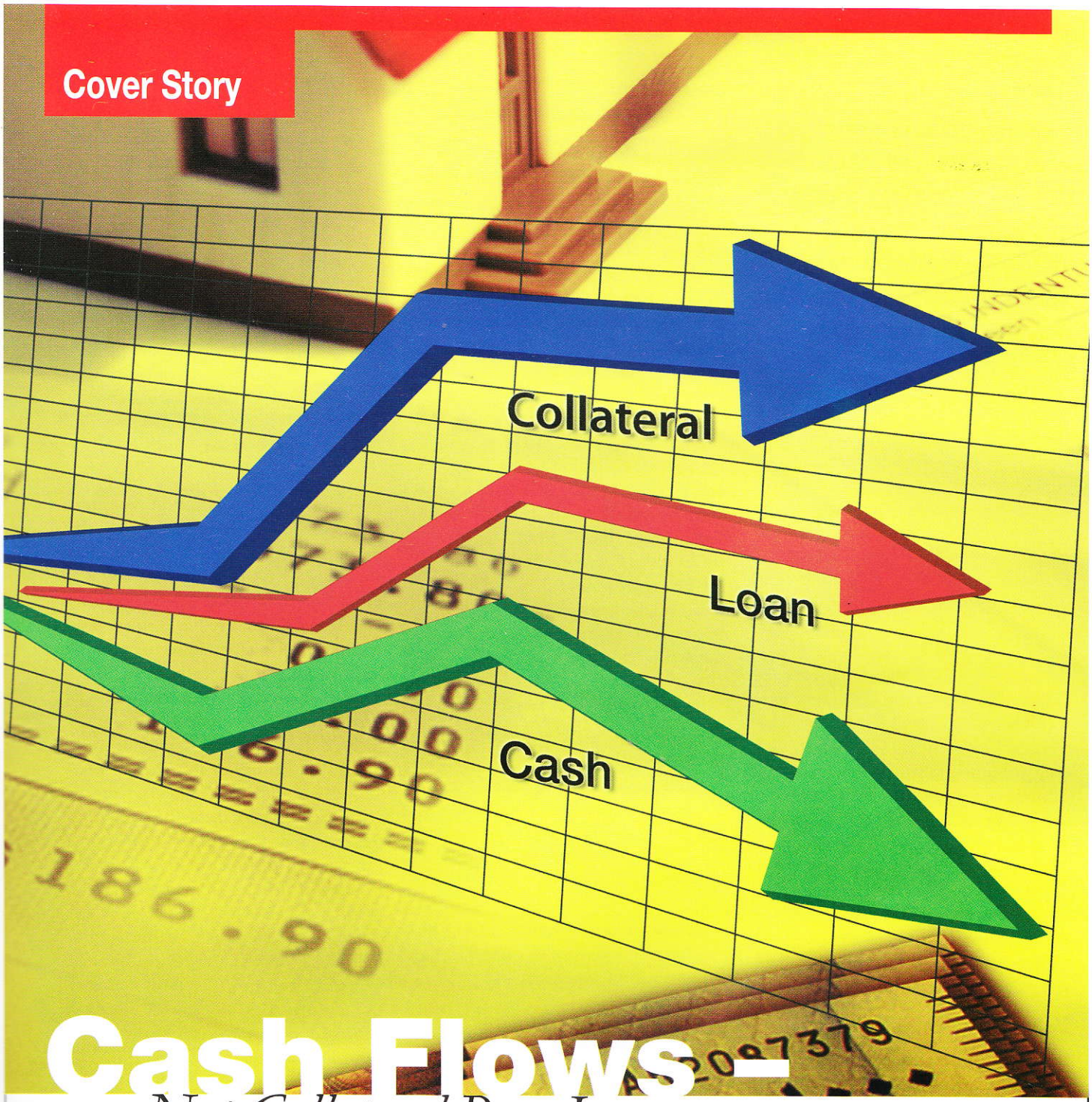



# Cash Flows – *Not Collateral Pays Loans*

By: Rana Muhammad Nadeem

**The importance of cash flows in credit analysis is much higher as compared to simply looking at the collateral. Recent crises have also pressed the need for renewed emphasis on loan repayment capacity vis-à-vis relying mainly on collateral values.**

Financial sector, particularly commercial banks, remains the key source of funding capital needs for all segments of the economy. Given that the government has been the single major borrower in the recent past coupled with an all-time high

**"While mainly focusing on self-liquidating asset financing, the financial institutions started becoming choosy in corporate lending and gradually changed their focus towards low risk government lending."**

non-performing loans (NPLs) portfolio faced by the local financial institutions, majority of the banks have become more risk conscious. While mainly focusing on self-liquidating asset financing, the financial institutions started becoming choosy in corporate lending and gradually changed their focus towards low risk government lending. Figure 1 also captures this trend in the banks' lending book.

Historically, the banks, while assessing credit risk for corporate borrowers, tend to be more influenced by the collateral. This is partly owing to relatively low confidence on information provided by borrowers, including their financial accounting records and partly due to the banks' own lack of capability in effectively measuring the cash flow generation ability of the borrower. The reason is not necessarily the inability of the banks to assess the risk, but perhaps their reluctance in strengthening their risk management framework.

We have seen in the recent past the subsequent to the financial crises; how every bank started to focus on improving their risk management systems and how the risk managers are empowered in the whole lending process. The importance of understanding borrowers' business and its ability to generate sufficient cash was only highlighted when the banks encountered problems in realizing collaterals. This, in my view should be the utmost important basis for moving from collateral-based lending to cash flow based loans.

What is the difference between cash flow lending and collateral lending? Let's have a look at both, one by one:

## Cash Flows

Lending, in financial dictionaries is defined as, "to grant the use of money with the understanding to get it returned on a future date". Therefore, it may be called a business of giving loans and getting it repaid from the borrower through cash and not collateral. Cash flow assessment is as much critical in a collateral based loan as it is in case of unsecured loans and green field project financing.

Cash flows provide first level shield to the lending institution before the collateral comes into play. While looking at various aspects of overall cash flows, Free Cash Flow from Operations (FCFO) and Free Cash Flow to the Firm (FCFF) are considered as key tools to measure the repayment ability of the borrower from internal generation. A number of ratios are in use in this regard.

Few important ones are:

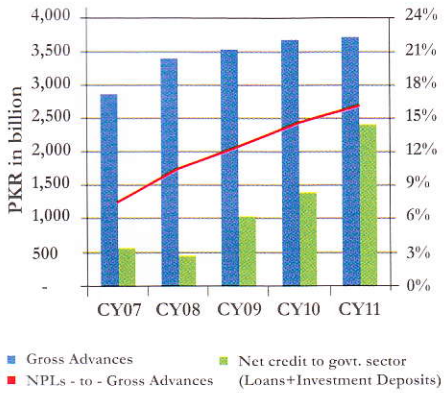
i, **Interest coverage:** FCFO vis-à-vis Interest expense as against established convention of comparing interest cost with pre-interest earnings [commonly called as EBITDA] only,

ii, **Debt service coverage:** FCFO vs Interest expense plus current maturity of long-term loan.

iii, **Long-term debt payback:** This is measured in number of years of debt payback i.e. Total long-term debt/FCFO.

The analysis, based on past years' financial statements of the borrower,

Figure 1: Selected trends in last 5 years




Data source: State Bank of Pakistan

typically shows the historical repayment capacity of the borrower. This means that the impact of additional cash flows which are likely to be generated by investing newly borrowed funds is yet to be taken into account. However, as a risk analyst, one may run numerous scenarios while incorporating future cash flows in the evaluation process. As forecasts usually based on various assumptions, the possibility of their remaining applicable sometime in future may be less likely. Moreover, the attitude and risk appetite of company's management preparing the forecast and their biases towards the prospects of their businesses may impact the way cash flows are prepared. Therefore, it is always suggested to look into the impact of important variables, either individually or in a combination, by building stress scenarios. The most conservative one may be to measure the impact of increased borrowings on existing cash flows of the firm.

There are various important factors which need to be taken into account while assessing overall cash flows of a borrower including:

**"This is partly owing to relatively low confidence on information provided by borrowers, including their financial accounting records and partly due to the banks' own lack of capability in effectively measuring the cash flow generation ability of the borrower. The reason is not necessarily the inability of the banks to assess the risk, but perhaps their reluctance in strengthening their risk management framework."**

i, Type of the industry the borrower operates in.

ii, Quality and diversification in revenue stream from core business operations of the company.

iii, Length of cash conversion cycle; here separate analysis of gross and net cash cycle is important.

iv, Cash conversion efficiency.

v, Discretionary vs non-discretionary Opex and Capex.

vi, Sustainability of cash flows, if any, from non-core operations of the company.

vii, Dividend payout policy of the company.

In addition to cash flows from operations, while the borrower is running a viable business, added cushion on the balance sheet lies in the form of any liquid asset, which can immediately be converted into cash such as marketable investments.

## Collateral

Collateral is considered as a secondary source of repayment of loan as it comes into play only when the borrower defaults on its obligation. The obvious reason may be the deterioration in cash generation ability from its business – the first shield as discussed earlier.

Collaterals are of many types; these may be fixed assets [property, plant and equipment, land, or buildings], current asset [inventories, or trade receivables, or tradable/marketable investments], or just the personal guarantees of the owners. Therefore, collaterals analysis is important. The lender has to consider the value of collateral, the availability of active market to sell the collateral in case of need and existing charge, if any, on the asset being offered as collateral. The type of charge the lender is going to have on the collateral is a critical consideration as there are different types with varying degrees of risks attached to these.

**"Cash flows provide first level shield to the lending institution before the collateral comes into play."**

**"The importance of understanding borrowers' business and its ability to generate sufficient cash was only highlighted when the banks encountered problems in realizing collaterals."**


More liquid collaterals such as current assets or in few cases certain other movable assets like vehicles etc. give more comfort to the lender as against charge on fixed assets of the company. These assets usually have an active market and their conversion into cash is relatively easy. On the other hand, fixed assets carry higher values; their valuation can be manipulated, as identifying readily available market with an adequate number of buyers becomes difficult in these scenarios. Mostly, in case of default, the lender, while trying to recover its amount from disposal of such assets, would end up in lengthy legal proceedings. At times, this ultimately results into much investment of time and effort on top of legal fees.

Nonetheless, collateral may prevent borrowers from consuming the loans for the purpose other than for which it was obtained and the right to repossess collateral gives comfort to the lenders in such cases.

**"Good collateral without the cash flows is a guaranteed lending pitfall!"**

The financial institutions can look positively towards those corporate borrowers who critically monitor and maintain their financial profile at acceptable levels by giving due importance to their cash flow management. This does not mean that collateral should be ignored but cash generation ability of the borrower should lead the analytical process. Good collateral without the cash flows is a guaranteed lending pitfall!