

READING**WHY IS GLOBAL CASH FLOW NEEDED?**

In many business lending situations, it is difficult to separate the business and its owners on a financial basis. Assets may be used both personally and for the business. The owner may be a co-borrower with the business on many of its loans. From year to year, as tax rules and incentives change, an owner may elect to recognize income or take out cash out of the business in a variety of ways.

To remedy the intermingled nature of the owner and the business, most business bankers attempt to go beyond simply analyzing the business and the owners separately. Instead the business banker takes the analysis to the next level and combines business and personal cash flow into a global cash flow for comparison to both business and personal tax debt service capacity. When analyzing the “big picture” in this fashion, how much or how little salary the business owner pays him or herself is not material. Whether the business owner is a full guarantor or co-borrower is not critical. What matters is that total business and personal cash flow, combined with no double-counting, is sufficient to cover combined business and personal debt service.

Beyond this underwriting approach used by most business bankers, bank regulators have developed an expectation of a full, global analysis in business and commercial lending situations. This was spelled out in the interagency Policy Statement on Prudent Commercial Real Estate Loan Workouts issued on October 2009. Within the context of loan workouts, this document cites the need for “An analysis of the borrower’s global debt service,” where “global debt represents the aggregate of a borrower’s or guarantor’s financial obligations, including contingent obligations.” This is one of the few interagency statements that discuss the concept of global analysis. The following appears later in the document, when it extends the discussion to guarantors:

The institution should have sufficient information on the guarantor’s global financial condition, income liquidity, cash flow, contingent liabilities, and other relevant factors (including credit ratings, when available to demonstrate the guarantor’s financial capacity to fulfill the obligation. This assessment includes consideration of the total number and amount of guarantees currently extended by a guarantor in order to assess whether the guarantor has the financial capacity to fulfill the contingent claims that exist.

Again, while the context is loan workouts, the regulatory definitions and discussion of GCF are important to understand and should be applied to all lending situations for two reasons. First, developing the GCF is part of a broader, global analysis of financial condition. Second, it is important to understand the following differences between contingent claims and contingent liabilities:

- Contingent liability (Level 3 Course 1) Contingent liabilities are amounts the borrower is not directly liable for but may need to pay some time in the future based on events that may or may not be within the borrower’s control. Contingent liabilities include guarantees of loans and leases, outstanding letters of credit, legal actions pending, and past due tax obligations
- Contingent claims, while not specifically defined by the policy statement, go beyond the face amount of a loan or lease guarantee, letter of credit, etc. and attempt to identify a contingency that is likely to become a direct liability in the short-term

For example, a person may have a 50 percent limited guarantee on a \$1,000,000 loan secured by a business or real estate project. If in a global analysis it is determined that the business or project has very strong debt service coverage (DSC) ratios and a very strong financial condition overall, this contingent liability is not likely to be a contingent claim in the short-term. For purposes of a GCF, there is no immediate contingent claim to include in the business and personal debt service calculation.

If, on the other hand, the business or project has weak or insufficient DSC ratios, or has a very weak financial condition overall, a contingent claim should be developed, based on the guarantee percentage, the loan amount, any collateral or reserves pledged, and any knowledge of the relative financial strength of any other guarantors. This estimated contingent claim should be included in the business and personal debt service calculation within the global analysis.