2 The Amount and Type of the Loan

2.a How much should the banks lend?

The decision as to what is a prudent amount to lend to each borrower can only be a subjective one. There are no magic formulae which say that $5 million is safe while $10 million is unsafe, but there are certain criteria which enable sensible judgements to be made on specific proposals.

The question "How much would I be prepared to lend to this company?" is too abstract to be useful; the answer would depend on the nature of the lending, the reason it was needed and the amortisation pattern as well as on the credit of the borrower. The bank is more likely to ask "On the knowledge we have, is the specific amount suggested, on the specific terms and for the specific purpose, prudent?"

The analysis of a borrower is by no means confined to the financial information. The bank is interested in: the quality and depth of management; the nature of the product; diversification by product and geographically; competitive strengths and weaknesses; the possibility of technical obsolescence; labour relations; the quality and modernity of production facilities; and many other aspects which vary with the nature of the business. However, none of these things can be quantified; on the other hand, the relationships between various aspects of the balance sheet and profit and loss give rise to ratios which can be incorporated in the loan agreement as covenants. The rest of this section therefore concentrates on this aspect of the analysis, but the importance of the other factors in the decision whether to lend is no less critical.

Against this background banks look at three broad areas: first, the capital structure of the borrower and the quality and nature of its assets; secondly, the cash flow, defined here to include the possibility of external finance; and
finally, the nature and purpose of the borrowing. All of these must relate to the overall size of the borrower; to do this properly requires a critical analysis of the balance sheet, not merely a statistical review.

The analysis first considers the borrower's net worth. How large is it, both absolutely and in relation to its borrowings and total liabilities? What does it comprise and what is the chance of a significant proportion of it being paid away in dividends? The bank needs a sufficient cushion against fluctuations in the borrower's earnings which might result from obsolescence, pressure on costs, loss of market share or currency risk, to mention only a few of the dangers which banks consider as "equity" risks rather than "debt" risks. Later chapters examine the clauses in the loan agreement with which banks try to protect themselves from these risks; but they must ensure at the outset that they are not excessive.

Most banks use a ratio of either total borrowings or total liabilities to net worth as a first indicator of the size of this cushion. Opinions differ as to which is the better ratio. On the one hand, borrowings carry an interest charge and must be repaid, rather than rolled over in the normal course of business. On the other hand, all liabilities have to be repaid in one way or another, and there is plenty of scope for replacing borrowing by other liabilities; if the bank restricts its analysis too narrowly to borrowing, a deterioration in condition may be concealed by such a replacement. Furthermore, in specialised situations there may well be large liabilities such as advance payments which loom too large to be ignored.

The accountancy conventions of different countries must also be recognised; some countries treat as reserves items which Anglo-American accountants would deduct from assets or add to liabilities; in others, such as Germany for instance, companies show large pension reserves, which, depending on the age and length of service of the work force, may be more or less likely to become a real liability. Off balance sheet items must also be considered. For example, leasing is often an alternative form of borrowing and payment of rental is an obligation which ranks with debt service; however, many countries do not require leases to be shown on the balance sheet and some do not even require them to be disclosed in the associated notes.