Unlike Mark Twain’s cat that once sat on a hot stove lid and would never again sit even on a warm one, bankers should always be careful to get from an experience just the wisdom that is in it—no more, no less. Banks need a sense of caution in a liberal credit environment, but they also need the courage and wisdom to take reasonable risks when credit is tight. Financial institutions succeed as long as the risks they assume are prudent and within defined parameters of portfolio objectives. Policies and procedures should be in place that ensure that exposures are properly identified, monitored, and controlled, and that safeguards against nonperformance or default match the risk levels to which banks commit.

By and large, bank failures are caused by lax credit standards, ineffectual portfolio risk policies, and risks taken in excess of capital constraints. In addition, blame is due to lenders who neglect technological advances in the field. While recent bank failures owe much to the collapse of the housing market, sloppy lending practices contributed to it at least in part—that is, in spite of regulators’ dire warnings of the consequences slack underwriting standards would have in the wake of sharp industry/economic meltdowns.
As it turned out, liberal credit came on the heels of a robust economy, intense competition to turn deals, pursuit of the bottom line, and the misguided notion that good things—capital adequacy in particular—last forever. Credit meltdown can be something of a paradox, given that regulators have always championed sound, diversified credit portfolios and formal credit evaluation and approval processes—procedures whereby approvals are made in accordance with written guidelines and granted by appropriate levels of management. There also should be a clear audit trail confirming that the approval process was complied with, identifying line lenders and/or committee(s) influencing (lending) decisions or actually making the credit decision.  

It turned out that the banks that experienced such failures often lacked adequate credit review processes. Solid, tight credit reviews not only help detect poorly underwritten credits, but they largely prevent weak proposals from being approved since credit officers are likely to be more diligent if they know their work will be subject to review. An effective evaluation process establishes minimum requirements for the information on which the analysis is to be based. There should be policies in place regarding the information and documentation needed to approve new credits, renew existing credits, and/or change the terms and conditions of previously approved credits. The information received will be the basis for any internal evaluation or rating assigned to the credit, and its accuracy and adequacy is critical to management making appropriate judgments about the acceptability of the credit.  

The review process starts with a comprehensive appraisal of the obligor’s creditworthiness, calling for a thorough understanding of the strength and quality of an obligor’s cash flows and capital structure. Credit analysis is multifaceted. It blends traditional core assessment with quantitative processes: incorporating historical-based models, forward-looking models (the theme of this book), and fundamental analysis. Both historical and forward-looking analytics are integral to gaining an understanding of risks but used in isolation, they are weak tools. To improve the credit analysis process and to understand an obligor’s business, we blend historical and projection analyses with qualitative factors brought to the fore by a well-organized and insightful credit analysis covering sustainability and quality of cash flows, debt capacity, asset quality, valuation growth drivers, management, and industry. Management issues such as strategic direction and execution, optimal capital structure, accounting methodologies, aptitude for innovation, labor relations, management changes, and experience go a long way in defining credit quality.

The credit review process lies at the core of PRISM, an acronym for perspective, repayment, intention, safeguards, and management. In this chapter, we begin our examination of the PRISM components with management, which centers on the big picture: what the borrower is all about, including history and prospects. Next we cover intention, or loan purpose, which serves as the basis for repayment. Repayment focuses on internal and external sources of cash. Internal operations and asset sales produce internal cash, whereas new debt and/or equity injections provide external

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2 Ibid.
cash sources. We learn how conversion of balance sheet temporary assets provides the primary payment source of short-term loans, while long-term loans are paid from internally generated cash flow. Safeguards, likewise, have internal and external sources: Internal safeguards originate from the quality and soundness of financial statements, while collateral guarantees and loan covenants provide external safeguards. We consider perspective, which pulls together the deal’s risks and rewards, and the operating and financing strategies that are broad enough to have a positive impact on shareholder value while enabling the borrower to repay loans. Finally, bankers render a decision and price the deal.

Management

Business Operations

Certain business attributes provide bankers with an image of their borrowers. These qualities result from several factors: the number of years a firm has been in business, reputation and performance record, and, of course, willingness and ability to repay debt. Longevity means staying power and is very important to customers, vendors, competitive markets, and financing sources. Long business life also imparts reputation and, for some, that is the most important attribute of all. In this context, past performance is a good indicator of future success. We begin the information flow with gathering company and industry information.

PRISM: MANAGEMENT
1. Business Operations
2. Management
3. Bank Relationship
4. Financial Reporting

Company Information

- History of the business, including any predecessor companies, changes in capital structure, present capitalization, and any insolvency proceedings.
- Description of products, markets, principal customers, subsidiaries, and lines of business.
- Recent product changes and technological innovation.
- Customer growth, energy availability, and possible ecological problems.
- List of the company’s principal suppliers, together with approximate annual amounts purchased, noting delinquencies in settlement of suppliers’ accounts.
- Market segmentation by customer type, geographic location, product, distribution channels, pricing policy, and degree of integration.
- Strategic goals and track record meeting or missing goals.
- Number and types of customers broken down by percentage of sales/profit contribution. Note the extent the borrower is overdependent on one or a few customers.
- Government contracts.
- Capital equipment requirements and commitments.
Industry Information

- Industry composition and, in particular, recent changes in that composition.
- Image of the company and its products and services compared to industry leaders.
- Number of firms included in the industry and whether that number has been declining or increasing.
- Borrower’s market share and recent trends.
- Recent industry merger, acquisition, and divestiture activities, along with prices paid for these transactions.
- Recent foreign entrants.
- Suppliers’ versus buyers’ power.
- Bases of competition.
- Industry’s rate of business failure.
- Industry’s average bond rating.
- Degree of operating leverage inherent in the industry.
- Industry reliance on exports and degree of vulnerability.
- Names of the bank industry specialists whom you should contact for help in developing projections and other industry analysis.
- Trade organizations, consultants, economists, and security analysts who can help you with forecasts.
- Adverse conditions reported by financial, investment, or industry analysts.
- Extent that litigation might affect production of or demand for the industry’s products (case in point, Firestone Tires).
- The effects of government regulations and environmental issues on the industry.
- If publicly traded, the exchanges on which the stock is traded, the dealer-making markets for over-the-counter stock, institutional holdings, trading volume, and total market capitalization.

For additional information, the banker typically examines details of company operations. Each type of business has its own idiosyncrasies that set it apart from other industries. How economically sensitive is the business to new products, competitors, interest rates, and disposable income? How has the borrower fared in good markets as well as bad when benchmarked against the rest of the industry? Is the company seasonal?

Management Basics

Banks need to understand to whom they are granting credit. Therefore, prior to entering into any new credit relationship, a bank must become familiar with the borrower or counterparty and be confident that it is dealing with an individual or organization of sound repute and creditworthiness. In particular, strict policies must be in place to avoid association with individuals involved in fraudulent activities and other crimes. This can be achieved through a number of ways, including asking for references from known parties, accessing credit registries, becoming familiar with the individuals responsible for managing a company, and checking their personal references and financial condition. However, a bank should not grant credit simply because the borrower or counterparty is familiar to the bank or is perceived to be highly reputable.3

3 Ibid.
Who are the key players and what contributions are they making? It’s a good idea to prepare a brief biographical summary for each senior manager so you are better able to evaluate overall management philosophy. The human factor in decision making is hugely significant, and because it is, a single error in judgment can mean serious and unpredictable problems.

Integrity deals with communication as well. Since the majority of information comes from management, lenders must have confidence in that information. The amount and quality of information you obtain from management will depend on the deal’s requirements and, of course, information that management is willing to supply. Keep this simple rule in mind: The lower the credit grade, the more information management is asked to supply. Think about the following:

- List of officers and directors, along with affiliations, ages, and number of years in office.
- Names, addresses, and contacts of the company’s professional advisers, including attorneys, auditors, principal bankers at other banks, and investment bankers.
- Number of people employed and major areas of activity.
- Strategies management is using to increase market share and profitability.
- The intelligence demonstrated in taking advantage of changes in the marketplace and environment.
- Overview of management’s problem-solving and decision-making abilities, and whether the right decisions are made at the appropriate level.
- Management’s basic philosophy—for example, is management entrepreneurial?
- The work environment.
- How management and subordinates work as an effective team. Management can be smoothly intergraded or crisis prone.
- Ratio of officer salaries to net revenues (Robert Morris Statement Studies). Is compensation reasonable when compared to results?
- Determine if executives prevent problems from arising or use valuable time to work out the same problems over and over.
- The reputation of present owners, directors, management, and professional advisers gathered from industry journals, periodicals, and a good Internet browsing.
- Adequacy of quantitative and statistical information, including strategic and tactical plans, effective policies and procedures, adequate management information systems, budgetary control and responsibility accounting, standards of performance and control, and management and manpower development.
- Obtain an organization chart and business plans, both short-term and long-range.
- Evaluate if business objectives and strategies are well thought out and represent genuine management tools or if they have been presented for show.

**Bank Relationship**

If the relationship is an existing one, how solid has it been? Obviously, a loyal customer with a strong history receives better treatment than someone who walks through the door for the first time.
Financial Reporting

Naturally, banks evaluate the accounting firms that are preparing the financial statements. Reputation is important. Are the financials liberal or conservative? Do they provide an accurate picture of the borrower’s condition? Here are a few good pointers:

- Obtain audited financial statements, including registration statements (if they exist) and comparative financial results by major division.
- Procure recent unaudited quarterly statements, including sales backlog information and a description of accounting practices.
- If you can obtain them, secure tax returns for the last five years, IRS reports, and schedules of unused loss and investment credit carryforwards.
- Ask the client to submit projected operating and financial statements.
- Obtain any SEC filings and a shareholder list, if available.
- Form an opinion about the overall credibility and reliability of financial reporting. Check if an independent accounting firm audited the books, and investigate the accountant’s reputation.
- Check bank records. Auditors who submitted falsified reports on other deals will end up in the database.
- Review the adequacy and sophistication of the client’s internal auditing systems.
- Find out what the auditor’s major recent findings were and the company’s disposition of those findings. Determine to whom the internal auditing department reports.
- Assess the adequacy of internal accounting controls along with the company’s attitude toward strong controls, making sure of the extent earnings were managed.
- Assess the strength of the financial management and controllership function.
- Determine how often internal reports are issued, how soon after the end of the period the reports are available and if they are used, and whether the internal reporting timetable and content are consistent with the auditor’s monthly closing requirements.
- Find out whether subsidiaries have autonomous accounting departments that may not be functioning uniformly and, if so, how overall control is exercised.
- Check to see if long-range plans reflect competitive reactions and include alternative strategies.
- Check if objectives are described so achievement can be monitored.

Intention (Purpose)

“Banks must operate under sound, well-defined credit-granting criteria. These criteria should include a thorough understanding of the borrower or counterparty, as well as the purpose and structure of the credit, and its source of repayment.”

First, pin down what the loan’s real intention is—whether it is real as opposed to fanciful. “Fanciful” is what troubled clients offer as the reason they would like the bank to believe, and such intentions may be flat-out fabrications. Second, be aware that behind intention are three reasons why firms borrow. The first deals with asset purchases—short term, to support seasonality, and long term, to support growth. Loans to acquire seasonal assets are repaid once inventory is worked down and

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4 Ibid.
receivables collected. Long-term loans support fixed-asset purchases along with nonseasonal current assets.

The second reason is that firms borrow to replace other creditors. For example, management usually anticipates suppliers’ 2/10 net 30-day terms to take advantage of trade discounts. On the one hand, short-term loans approved to replace creditors may be symptomatic of problems if (agency) reports, such as Dun and Bradstreet, reveal tardiness. Late payments to suppliers often point to slow-moving inventory or receivable problems. On the other hand, loan requests to replace creditors (recycling debt) may, perhaps, simply mean that another financial institution is offering better rates or service.

Finally, the third reason is that firms borrow to replace equity—stock buybacks (e.g., buying up a partner’s share in the business, acquisitions, leveraged buyouts, employ stock option plans, and so on. Equity replaced with debt can easily dislodge the debt-to-equity ratio and cash flow coverage, putting the remaining equity at risk. One reason lenders prepare pro forma (what if) financial statements is to ensure that the equity is not impaired.

**Repayment**

Firms can raise cash primarily in two ways: internally, through business activities, and externally, via new monies from debt and equity sources. Asset liquidations bring in cash as well, but normally as a secondhand source.

**Internal Repayment Sources: Short-Term Loans**

The conversion/contraction process influences short-term internal repayment sources. Say a company borrows to support its seasonal manufacturing operations. Assets and liabilities increase spontaneously. The seasonal high point begins as inventory is sold, creating receivables. When receivables convert to cash, the balance sheet contracts and the company retires its debt. As a result, the seasonal conversion process becomes the primary source of repayment.

**Short-Term Loans Facilities**

*Own paper borrowing:* This implies that lenders evaluate each request on its own merit and includes short-term, unsecured borrowings not falling under a line of credit. *Lines of credit:* Unlike own paper borrowings, credit lines are usually established with a bank letter stating the approved advances and maximum amount allowed. The amount borrowed may be repaid and reborrowed up to the line limit. While banks are not legally obligated to honor loan requests against lines of credit, arbitrarily canceling lines is the fastest way to alienate customers and lose business. Hence, lines are generally limited to high-quality customers with little chance of failing.
Seasonal loans provide for the short-term working capital needs of eligible small businesses by financing the seasonal increases in the trading assets (receivables and inventory), the liquidation of which repays the loan at the end of each season. A seasonal loan is taken out only for seasonal needs and is repaid when inventory and receivables are partially converted into cash at the end of the seasonal upsurge. It is,
then, a self-liquidating loan, with its repayment dependent on the conversion of other current assets into cash.

For many small and medium-size firms, the true essence of seasonal lending emerges as an infusion of working capital to support operating activities stimulated by demand. Companies classified as seasonal in nature are traditionally undercapitalized, requiring short-term financing to support temporary current assets. In a broader sense, however, any short-term loan supporting temporary levels of accounts receivable or inventory is referred to as a seasonal loan if it is satisfied through the conversion of these assets.

Commercial banks grant short-term loans with the understanding that loans are retired at the low point of the season or the end of the cash conversion cycle. During the fiscal year, a seasonal company’s balance sheet goes through expansion and contraction. At the high point, or most active part of the period, debt and assets increase to support seasonal activity, thus expanding the balance sheet. During this phase, sales emulate the manufacturing cycle; the result of which is the conversion of inventory into accounts receivables. At the low point, or least active part of the period, the manufacturing cycle has ebbed, leaving the firm with the responsibility to “clean up” outstanding short-term debt. This is accomplished through the conversion of accounts receivables to cash or deposits. Once all short-term debt has been satisfied, the firm’s balance sheet will contract back to its normal level. Any excess cash on hand is usually designated for temporary current asset investments in the next season.

External Repayment Sources: Short-Term Loans

If the balance sheet fails to fully convert, a company may seek external sources to cover exposures in the form of new outside debt or equity injections. Thus bankers evaluate a borrower’s debt capacity. The key attributes to acquiring new monies are the borrower’s reputation, existing capital structure, asset quality, profit-generating abilities, and economic value.

Intermediate-Term Loans

Unlike confirmed lines of credit, revolving commitments/credits (R/Cs) and term loans (T/Ls) involve a legal commitment on the part of the issuing bank. The loans (commitments) are made under a written loan agreement that sets down the terms and conditions of advances. Commitment fees are computed on the average daily unused portion of line, generally ¼% to ½%. Commitments require a loan agreement containing restrictive covenants.

R/Cs authorize discretionary borrowing up to a specific amount for periods of at least one year. R/Cs typically convert into term loans at the end of a specific period, as specified in the agreement. R/Cs are useful financing vehicles for new projects not expecting to produce immediate cash flows. The expiration of R/Cs (and conversion to a T/L) can be timed to coincide with the project’s expected cash flow, matching cash inflows and outflows.
T/Ls are nonrevolving commitments with maturities beyond one year. These loans generally contain periodic (annual, semiannual, or quarterly) amortization provisions. T/Ls involve greater risk than do short-term advances, because of the length of time the credit is outstanding. Because of the greater risk factor, T/Ls are sometimes secured loan agreements on such credits and normally contain restrictive covenants during the life of the loan. These loans have assumed increasing importance in recent years. T/Ls generally finance capital expenditures needed by the firm to maintain low production costs and improve its competitive superiority. T/Ls also finance new ventures and acquisitions, such as new product procurement or vertical/horizontal mergers.

Internal Repayment Sources: Long-Term Loans

The main question to be answered is: Does the company have the cash flow to support fixed asset investment(s)? Internal repayment of long-term loans is directly related to historical and projected cash flow quality, magnitude, and trend. Historical cash flow analysis provides a track record of the company’s past performance.

The quality of historical cash flow is analyzed by looking at the firm’s gross operating cash flow (net income plus noncash charges less noncash credits). If the gross operating cash flows are comprised of primarily noncash items, such as depreciation, deferred taxes, or asset write-downs, with a relatively small amount of cash being generated on the income statement, the quality of the operating cash flow may not be sufficient to repay credit. As stated earlier, profits and the sale of assets play a major role in retiring debt requirements, so it is imperative that the bank analysts identify what accounts for the firm’s cash flow.

The magnitude of historical cash flow relative to growth plans will help to identify the external financing requirements facing the firm. The smaller the cash flow, the greater the debt load required to support long-term growth plans. If, for example, the income statement is not producing enough cash flow to service its loans year after year, the firm is in jeopardy of defaulting on its loans and going bankrupt. Astute loan officers should question why funds are being funneled into a company in the first place if it can’t buy assets to produce a decent level of profits to pay back debt.

Historical cash flow trends enable the creditor to determine if the firm’s cash flows support the decision to go for growth. This is decided by evaluating the company’s viability. A healthy company is able to fund a good part its expansion internally. On the other hand, a company suffering from declining cash flows requires the helping hand of debt to expand.

Projections are not intended to predict the future perfectly but to see how the borrower will perform under a variety of situations. It is up to the lender to ascribe an expected probability to each set of projections and to determine a most likely scenario on which to evaluate the borrower’s repayment ability. Projections quantify expectations but can never replace a banker’s judgment and experience; the mental ability to perceive and distinguish relationships is naturally a PRISM hallmark.
External Repayment Sources: Long-Term Loans

Let’s look at *external* repayment of long-term (e.g., cash flow) loans. Repayment often depends on whether funding sources are readily available. Consider these questions: What will be the company’s comfort level of debt? To what degree will operating cash flow protect debt service? Will the borrower continue to generate good asset quality to attract debt? Will the company sustain its overall reputation?

Some credit wells run dry during downturns. If the bank’s approval depends solely on an external takeout, beware. Consider what Federal Reserve examiners have to say:

> Overreliance on continued ready access to financial markets on favorable terms can come in many ways, including:

1. Explicit reliance on future public market debt or equity offerings, or on other sources of refinancing, as the ultimate source of principal repayment, which presumes that market liquidity and appetite for such instruments will be favorable at the time that the facility is to be repaid;
2. Ambiguous or poorly supported analysis of the sources of repayment of the loan’s principal, together with implicit reliance for repayment on some realization of the implied market valuation of the borrower (e.g., through refinancing, asset sales, or some form of equity infusion), which also assumes that markets will be receptive to such transactions at the time that the facility is to be repaid;
3. Measuring a borrower’s leverage and cash coverage ratios based solely on the market capitalization of the firm without regard to "book" equity, and thereby implicitly assuming that currently unrealized appreciation in the value of the firm can be readily realized if needed; or
4. More generally, extending bank loans with a risk profile that more closely resembles that of an equity investment and under circumstances that leave additional bank credit or default as the borrower’s only resort should favorable expectations not be met.

Safeguards

What *safeguards* or protection does the bank have against default? If a bank is to extend credit to a firm, the level of risk influences the degree of protection lenders generally require. Safeguards can be internal, external, or a combination of both. Internal safeguards refer to financial analysis, while collateral, personal guarantees, and loan covenants provide external protection. Although external safeguards are popular, they usually are not considered before internal protection. Internal protection relates to the borrower’s cash power depending on whether the intention of the loan is short term or long term.

Recall that the primary source of internal repayment of short-term loans is balance sheet liquidity, the result of the season’s cash conversion cycle. Internal safeguards of
seasonal loans relate to the quality magnitude and trend of cash flows/income statements. The bank just wants to make sure that a seasonal temporary problem does not become a structural cash flow problem in the years ahead. External safeguards can come from a variety of sources: collateral, guarantees, covenants, and syndications and participations.

**Collateral**

Collateral is defined as property pledged as security for the satisfaction of a debt or other obligation. Credit grades assigned to secured loans depend on, among other things, the degree of coverage, the economic life cycle of the collateral versus the term of the loan, possible constraints of liquidating the collateral, and the bank’s ability to skillfully and economically monitor and liquidate collateral. What is its value compared to credit exposure? What is its liquidity, or how quickly may its value be realized and with what certainty? What presumed legal right does the borrower have to the collateral?

**Guarantees**

A guaranty is a written contract, agreement, or undertaking involving three parties. The first party, the guarantor, agrees to see that the performance of the second party, the guarantee, is fulfilled according to the terms of the contract, agreement, or undertaking. The third party is the creditor, or the party to benefit from the performance.

**Covenants**

Covenants of a loan agreement lay the framework for the financial plan jointly agreed on by the borrower and the lender. The number and detail of the covenants will largely
depend on the financial strength of the enterprise, management’s aptitude, and the length of the proposed loan.

**Perspective**

What is the deal’s perspective or “conclusion(s)”? The perspective section considers the following:

1. Risk/reward analysis.
2. Operating and financing strategies that the banker believes might improve performance and go a long way toward adding to shareholder value and, from the banker’s perspective, preserve credit quality.
3. Finally, we render a decision and recommend pricing.