RISKS IN LENDING TO GROUPS OF COMPANIES

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Lending to a member of a group of companies or affiliated firms is more complex than lending to single entity corporate borrowers. Moreover, additional credit risks are usually involved. These risks arise because a number of affiliated firms may be involved in the loan repayment of an individual group member. Consequently, the nature of financial analyses performed and the subsequent structuring of loan terms and conditions necessarily differ in order to minimize these risks.

Because of the limitations of conventional methods of accounting for groups of companies and because of the many ways in which group structures can be organized and financed and business affairs conducted, assessment of credit risk primarily through analysis of financial statements is limited. For example, whereas some of the group members involved in a "group" loan repayment are incorporated and hence included in consolidated reports, other unincorporated entities are excluded from the conventional "area" or scope of consolidation. Indeed, in some circumstances relevant incorporated as well as unincorporated firms of concern for credit risk assessment of an applicant group member may be outside this conventionally-defined group. Further, because of the substantial degree of discretion allowed in the organizing of group structures and financial arrangements, possibilities for "window dressing" of applicant group member financial statements as well as consolidated statements are enhanced. As more group managements are apparently becoming increasingly aware of the widened range of sophisticated organizational arrangements and financing techniques which consciously exclude (or partition) financial results, in particular debt, from group financial results, this limitation is now being recognized as an increasingly severe problem in group financial analysis and credit evaluation.

The purpose of this paper is to outline briefly some of the principal risks involved in lending to a member of a group of affiliated companies. Some possible ways to minimize these risks will also be suggested, and some of the limitations and inadequacies of consolidated reports will be pinpointed. The information for this analysis was obtained from (a) a review of relevant published professional banking literature, internal bank training materials, credit policy manuals and internal bank documentation; (b) survey and empirical findings; and (c) informal, unstructured interviews with corporate lending officers.

Group Lending Risks

The above-mentioned information sources unanimously stress that the principal group lending risk is lending to a group member which does not have sufficient internal cash-generating ability to meet loan repayments. This is because the "group" represents only a notional integration that has no legal existence; whereas a lender has to be concerned with the ability of the individual applicant to repay a loan. Further, in situations of default and in the absence of guarantees, a lender only has recourse to the assets of the particular borrowing company. In this respect, the information sources frequently caution both trainees and experienced lenders that consolidated statements do not provide information as to the "factual" position of a holding company or its separate subsidiaries. Further, when one considers that firms are increasingly organising their business through myriads of subsidiaries and unincorporated enterprises such as partnerships, trusts and joint ventures, and are increasingly entering into more sophisticated off-balance sheet financing arrangements and techniques such as debt defeasance which are directly resulting in even more complex "group" structures, the limitations and inadequacies of traditional consolidated statements for
depicting pertinent group relationships and arrangements for credit evaluation purposes become particularly significant.

A related major risk is concerned with the operating and financial interdependencies between the borrowing company and other group members. This interdependence factor is important for four reasons. First, it indicates the extent of diversification of the group, the closeness of trading links and operating dependencies, and any concentration in a weak industry which may adversely affect the entire group. Second, besides indicating the relative importance of the affiliate to the overall group, analysis of group operating interdependencies may indicate the extent of likely parent company support for an affiliated borrower which may become financially distressed. For example, a parent corporation would probably support a financially troubled subsidiary if that subsidiary needed to be kept viable because it provided a critical link in the production of goods further manufactured by the parent. However, in the absence of formal support a parent company may allow a financially distressed subsidiary to be liquidated if it was considered economically advantageous (as was the case with IEL failing to honour the debts of its insolvent subsidiary (Colmax Electric) which were not guaranteed). An assessment of the probable management support for a subsidiary is thus important to assessing the financial risk of lending either to the parent or to the subsidiary.

The third risk related to this interdependence factor is concerned with the possibility of a parent company “siphoning” out (or “upstreaming”) operating and loan funds from a subsidiary (through such means as transfer pricing, royalties and management fees) for its own uses or for subsequent transfer to other group members. Closely related to this is the fourth risk which is concerned with the possibility of loan funds, which have been granted for a specific purpose and according to specific requirements of a borrower, being transferred and used in more risky ventures by other group members without the knowledge of the lender concerned. The information sources for this paper revealed a number of examples of such situations. A common situation is where a borrowing parent company, which in substance is essentially an investment company holding a variety of interests in a number of operating subsidiaries which, in turn, also hold further downstream investments in risky property development and real estate subsidiaries and joint ventures, uses both bank term loan and overdraft facilities to make further downstream investments of this character without the lender’s knowledge or consent. In such a situation the lender is essentially committed to a risky long-term loan which has no immediate dividend cash flow and no relatively certain future cash flows available to service the loan granted to the parent. Indeed, there are also similar situations which may be even more risky because management agreements or restrictive covenants in downstream enterprise loan agreements prohibit dividends being paid upstream to parent companies.

The fact that intra-group loans, advances and leases can be readily made between group members at management discretion is another significant risk. Such cash outflows and commitments from a group member can undermine its individual ability to repay a loan, either as a borrower or as a guarantor of another group member. Even though overall group cash flows may be sufficient to repay a loan, the individual borrower’s repayment ability could be seriously diminished as a result of cash transfers and commitments made to other group members. The applicant’s contingent liabilities and consequent credit risk can also be increased as a direct result of such discretionary intra-group contracts and transactions which are not “arms length”.

The risk of claim dilution is also higher in group situations. Because it is easier to raise additional debt of the same or higher priority through a group member who is not already a borrower, the existing lender’s possibility of loan repayment and/or claim to security from the first borrower may be diluted.

Minimizing Group Lending Risks

In order to minimize inherent group lending risks of the type mentioned above, financial analysis should focus on the following two primary interrelated purposes:

1. assessing the ability of the individual group member applicant to independently repay the loan applied for in the ordinary course of business; and
2. analysing the relationships and interdependence of the applicant borrower with the rest of the group.

Identification and detailed analysis of group affilia-
ations, operating and financial interdependencies, management and control, shareholding and ownership, as well as group financial structure and cash flows, provides essential information for an assessment of credit risk and group member repayment ability. The analysis should focus on the individual borrower's self-sufficient operating profitability, cash flow generation, financial position and loan repayment ability, as well as its relationships with other group members. Other group members may comprise the parent company and subsidiary companies, as well as director-controlled companies, unincorporated partnerships, joint venture arrangements and related family interests which are "outside" the conventionally-defined group.

Consolidated financial statements which are restricted in their area or scope to an aggregation of parent and subsidiary company financial results, are considered to be inadequate for the above purposes. This is primarily because of their failure to depict either pertinent aggregate group financial results or to provide information on relevant group financial structures and cash flows. In some circumstances consolidated statements may also be misleading. The discretionary ability to exclude pertinent financial results, especially debt from consolidated statements has already been mentioned. In other circumstances consolidated statements may provide a favourable overall impression of solvency or liquidity which may be misleading when some firms are in a strong position while others are in a weak financial condition. Further, combined leverage ratios and other measures of credit risk prepared from consolidated statements may be distorted. In addition to the above limitations, consolidated statements often fail to provide the relevant information on intra-group operating and financial flows and indebtedness which is necessary for credit evaluation in situations where substantial interdependencies are involved.

In circumstances where repayment ability depends upon the applicant's borrowers interdependent relationships with other group members, risk assessment necessitates an analysis of the overall group's profitability and financial position, as well as its interdependent financial flows. In order to assess the likelihood of repayment from the entire group of entities in such situations, further information and analyses may be undertaken by lenders in order to (a) ensure that the necessary resources for loan repayment are available, (b) determine the allocation of the particular loan, or (c) establish the loan terms and conditions. In some circumstances, for example, the lender may prefer to negotiate term loans with a number of the various group members in accordance with their own individual repayment abilities. In other circumstances a guarantee(s) may be obtained. An excerpt from an internal credit manual made available by an American-based international bank illustrates these various strategies in such circumstances:

Because of the inherent risks and control problem in group lending, the essential loan decision should be to lend only to the strongest, self-sufficient members of the group, based on the individual borrowers needs and its self-sufficient cash flow. Where possible such facilities should be supported by the assets and earning power of the whole group.

If it is not possible to lend to the strongest members or is the financial position of the strongest is dependent upon other group members, the terms of the facilities should be designed to embrace the other interdependent segments by means of inter-company guarantees or by allocating the total facility into separate facilities for each company according to their respective needs, assets and strengths.

For group financial analysis, risk assessment and lending decision purposes, information on intra-group operating and non-operating financial flows is regarded as being necessary in order to:

(a) ascertain the "real" (independent) operating profitability and cash flows of an applicant and the extent to which there may have been disguised or "window dressed" by group cost allocation and transfer prices; ("real" intra-group sales, purchases, receivables and payables figures are necessarily required to be eliminated in credit evaluation in order to ascertain a particular borrower's requirements and repayment ability);
(b) ascertain the extent of intra-group operating dependence and the extent to which operating funds may have been transferred amongst group members; and
(c) assess whether loan funds are likely to be retained in the applicant firm for financing in accordance with specifically stated purposes and in accordance with the particular firm's requirements and capabilities.

Such information may be useful for financial analyses and for minimizing perceived lending risks in a number of ways. For example, substantial intra-group financial flows are a signal of a possible concentration of part of the group in a weak industry. It may also be a guide to the allocation of loan funds
to various group members, or to the establishment of loan terms and conditions. For example, while term loan covenants which attempt to establish each loan for a particular purpose by a particular company reduce the possibility of group management using a loan established for one member company used by other members without their knowledge, more effective control may be obtained by carefully considering the specific purpose of the loan and "tailoring" it to the specific requirements of the applicant. For example, a term loan could be "tied" to specific capital expenditures and other expansion plans of the applicant borrower, a credit line required to finance sales would exclude intra-group sales, and (similarly) a credit line established to finance receivables would exclude amounts owing by subsidiary and affiliated firms.

Intra-group guarantees (parent, subsidiary or cross-guarantee), and less formal support such as letters of comfort, assurance, knowledge and concern, are commonly used in different circumstances to minimize group lending risks. Guarantees are essentially designed to help bring together all the cash flows of the guarantors within the group to repay a particular member's commitment in the event of default. Sometimes security is insisted upon either as an additional or a substitute method of further reducing risk. However, in all situations the two previously-mentioned specific purposes of financial analysis are equally applicable in assessing repayment ability. In situations of (a) the giving of guarantees of repayment by subsidiaries (or related entities) of the parent company's debts; (b) parent companies guaranteeing subsidiary company's (or related entity) debts; (c) cross-guarantees from all or a number of group members; and (d) lending accompanied by tangible security, the dominant concern when lending to a group member(s) should be the same concern when lending to a "non-group" corporation - the assessment of that particular applicant's ability to repay in the normal course of business, with no reliance for payment placed on sale of collateral or call upon endorsers or guarantors.

The arrangement of guarantees in a group loan decision has a number of implications for the nature and extent of financial analysis. They also effect the relative utility and significance of consolidated and other group member financial statements, and are interrelated with a number of other factors in the group loan risk assessment and decision process. Such factors as the nature of the activities of the parent company, the relative interdependence of the group members and their interrelated support for each other, guarantee commitments already given by a potential guarantor, and the reputation of management affect which sets of financial statements should be analysed, which group members the lender actually lends to, the arrangement of guarantees, the nature of the covenants in any subsequent loan agreements and the computation of accounting based ratios which are to be used in these covenants.

A guarantee factor may also interact with other non-accounting factors, such as the quality and reputation of group management and their degree of ultimate financial control, in a lender's risk assessment and credit judgment process. It may also affect the degree of reliance placed on financial statement and accounting information. For example, a lender would prefer to contract with a group member who is under the control of a "strong" group management which has been assessed as reputable and trustworthy. A guarantee from such a "quality" management would also reduce a lender's concerns for additional information and further financial analysis of an individual group member applicant.

Conclusion
This paper has illustrated some of the principal risks in group lending, and suggested some possible ways in which they may be minimized. Some of the limitations and inadequacies of conventionally-prepared consolidated statements for group credit evaluation purposes have also been briefly pinpointed. It should be recognised that there is no standard approach to group financial analysis and credit evaluation. The approach is situational and contingent upon the specific circumstances. The nature of the group structure, its degree of complexity, existing operating and financing arrangements, the management of the group and of its individual members, the degree of operating and financial interdependence, guarantees, the extent of risk of firms linked with an applicant by guarantees and a host of other factors may enter into a group risk assessment and lending decision. The nature and extent of financial analyses performed, the relative significance of, and reliance placed on, consolidated, parent and other (incorporated and unincorporated) firm financial statements, the adjustments made to these statements prior to analysis and the particular group members which a lender eventually contracts with, are all contingent upon the particular group lending situation and circumstances.