

## **Why do banks require loan covenants?**

With today's challenging economic times and an ever changing environment, banks are increasing the level of financial monitoring requirements needed by borrowers. Having current financial information is essential and will help banks understand how a company is performing and more importantly will keep a bank apprised of any challenges a client may be facing.

### **What is a loan covenant?**

A loan covenant is simply a clause in the lending contract that requires the borrower to do or perform in a specific way. There are typically two types of covenants; restrictive and protective. A restrictive covenant may include a condition that the borrower must comply with in order to adhere to the terms of a loan agreement. These would include things such as limitations on dividend distributions, cash flow coverage benchmarks and perhaps limits on additional borrowings. Protective covenants may include things such as maintaining a minimum level of working capital, carrying adequate life and property insurance, and supplying the bank with monthly or quarterly financial statements.

Depending on the industry and business covenants can be tested monthly, quarterly or annually. Again Banks typically require covenants as a way to monitor the borrower's financial performance and condition throughout the year and are particularly important for loan commitments longer than one year.

### **Common Loan Covenants**

Typically banks will have loan covenants associated with both the income statement and the balance sheet. Following are some examples of common loan covenants:

- Debt Service Coverage Ratio: This is a cash flow (income statement) measure that reflects a company's ability to repay the debt. For example. A cash flow covenant of 1.2: 1 would indicate that a business has \$1.20 of cash to service every \$1 of debt. Banks typically like to see this coverage at 1.2 or greater.
- Debt-to-Worth Ratio: This ratio (balance sheet) is a measure of total liabilities divided by its total shareholder or equity value. For example. A ratio of 2:1 would indicate that for every \$1 of equity there is \$2 of debt. In many cases banks typically like to see this ratio at less than 3:1.
- Working Capital: Working capital is defined as those funds invested in a company's cash, accounts receivable, inventory and other current assets. This is calculated by subtracting current assets less current liabilities. Working capital essentially finances a company's cash conversion cycle. This is the conversion of raw materials into finished goods, finished goods into sales, sales into accounts receivable, and finally accounts receivable to cash.

Loan covenants are important tools that help banks monitor the risk profile of a company and sets realistic expectations with the borrower on financial performance. Clients should have honest and open discussions with their bankers should any issues arise.

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