Comprehensive Assessment Circular No. 2

Approach to estimating sustainable debtor cash flows

15 March 2016

The purpose of this circular is to provide guidance related to the use of the going-concern approach as part of the individual provisioning and impairment under work-block 4 "Credit File Review" (CFR) of the Manual. The guidance is issued with the intention to provide a robust and consistent approach to examining debtors in the CFR such that the process can be made as efficient as possible whilst maintaining the integrity of the Comprehensive Assessment (CA).

Estimating sustainable cash flows under the steady-state cash flow approach

This guidance relates to section 4.6.4.1 of the Manual *"Estimation of the present value of the cash flows of the debtor"* and introduces a modification to the use of Capex[1] for the calculation of the Cash Flow Adjustment[2].

The guidance reflects the following understanding and local market specifics:

- Limited information on Capex in bank files;
- Unreliable industry proxies for Capex as a result of conglomerate businesses operating in different industries with little commonality of financial structure;
- Limited support of depreciation figures to be used as a proxy for required capital expenditures in industries where investments are cyclical or in specific cases where businesses have discretionally over or underinvested.

Therefore, the AQR Provider team should put to scrutiny the extent to which depreciation charges historically relate to capital outlays made in order to assess the level of required capital expenditures to support debtors' sustainable cash flows.

In estimating the Cash Flow Adjustment, the AQR Provider team should consider any significant above normal Capex which may be a result of underinvestment in prior years or due to existing commitments for significant expansion.

For the avoidance of doubt, the approach to the calculation of the present value of cash flows to the debtor is unchanged:

[1] Required capital expenditures as per the Manual for the calculation of the Cash Flow Adjustment
[2] Manual reference "4.6.4.1 Estimation of the present value of cash flows of the debtor"

PV Operating Cash Flows (Debtor) =
(EBITDA + Cash Flow Adjustment + Sustainability Adjustment) * M

AQR Provider teams should follow the Manual in the guidance to the estimation of the components of the debtors' sustainable cash flows taking into account the amended herein approach to Capex. The assessment of the sustainable level of EBITDA should take into account significant one-off revenue and cost positions, and any resulting impact on EBITDA should be justified and evidenced to support the conclusion.

In the quality assurance process strict scrutiny shall be applied in the review of assumptions which result in positive changes to cash flows, therefore AQR Provider teams should ensure that justification is clear and supporting evidence is properly documented.

AQR Provider teams should apply the multiples on sustainable steady-state one-period operating cash flows as per the Manual to arrive at the sustainable level of debt for the bank:

The multiples are in line with standard good banking practices and reflect a level of leverage that allows debtors to repay loans from internally generated cash flows over a period appropriate to the structural nature of the industry in which it operates.

Where AQR Provider teams deem the multiples provided to be inappropriate for an individual case, they will draw on market practices and team experience to derive a debt capacity multiple reflecting the most likely outcome.