BASIC MINISTRY FINANCE

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The Art of Lending

Understanding 3 key financial ratios behind most loan decisions

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Sometimes, looking at a painting from 10 feet away — and again, from 10 inches away — can provide two very different perspectives.

When applying for a loan, an organization is usually seeing the "big picture" from 10 feet away. However, a lender is charged with the responsibility of looking at the loan from 10 inches; it's studying the detailed paint strokes to determine whether a loan is prudent.

The individual paint strokes, in lending terms, are called financial ratios. These ratios vary between fairly straightforward and very complex.

#1: Loan-to-value ratio.

A common ratio commercial lenders use — which most home owners are familiar with — is the loan-to-value ratio, or LTV. To calculate your LTV, the loan amount is divided by the value of the organization's property that's being used to support the loan. Generally, lenders will obtain a current appraisal or other valuation on the collateral to determine its value. The lower the LTV, the more equity you have, and the more comfortable the lender will be with your loan request.

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#2: Debt coverage ratio.

As with any loan, cash repays the debt, and your lender will be focused on determining if the organization can afford the loan. Most lenders will use a debt coverage ratio to determine this.

There are many ways to calculate this ratio; but, in principle, a lender adds up the organization's annual expenses and compares those to the annual income to determine whether the organization has enough money left over to make its debt payment.

A quick way to determine your debt coverage is to add up annual expenses, and then subtract that total from annual income. Certain expenses will not need to be included, such as depreciation and interest paid on your current debt. The lender's expectation is that what is remaining is slightly more than the proposed new payment. Put another way, the lender would be hoping you net $1.25 for every $1 in debt payment being considered.

#3: Debt service ratio.

Another key ratio that your lender will use to determine the debt capacity of the organization is the debt service ratio. The purpose of this ratio is to make sure that an organization is not dedicating too much of its income to debt payments. Most lenders want the monthly debt payment to represent about one-third of the organization's income, so that the organization will have plenty of money to support ministry, staff salaries and property maintenance.

Admittedly, there are many other ratios a lender will look at other than the three noted here. Hopefully, however, these provide an idea of how a lender determines whether an organization qualifies for a loan. When a close look at an organization's financials demonstrate strong ratios, and the leadership has a great overall picture for where the organization is going, a loan relationship can be a work of art.

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