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## PART 3: AIMING FOR A BETTER 2010

Ed wraps up a three-blog series by building goals for lenders on the foundation of lessons learned from 2009

Conclusion of the series: Share your views now!

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An article in The Wall Street Journal the other day talked about the difficulty of keeping New Year's resolutions. Less than 20% of all the resolutions seem to have "sticking power." We'd probably do better by concentrating on building and reinforcing new habits. Rather than making resolutions, let's talk about building better habits.

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To me, a remake of our credit-related habits fall into three important segments:

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• Due diligence

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• Loan structuring

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• Self-improvement

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Each of these, practiced in the earlier part of this credit cycle, could have prevented some of the problems we suffer today. And each of them, practiced now and in the future, can't help but lead to better future results. Let's examine them one by one.

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Due diligence: A necessity that's growing in scope and importance

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Due diligence means finding out all that we reasonably can about the borrower. It's much more than credit analysis, though that certainly is part of it. It's more than inspecting the collateral, although we need to do that too.

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What I'm talking about is a more comprehensive way of conducting "stress testing." Stress testing has traditionally meant analyzing a credit with a view to the business's fixed and variable cost structure. Interest paid on borrowed money is one of the principal components of a company's cost structure, and we, as lenders, should have a healthy curiosity about its impact on the bottom line.

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If interest rates go up, what's the impact on the business? It might be negligible, or it might be substantial. We need to know in relative terms.

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To me, this is the original meaning of stress testing.

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But what about other assumptions that we routinely consider when extending credit? Do we ever stress test those? What about projections on sales volume and mix across the product lines? What about weather? What about competition? What are the factors that influence collateral values?

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Think about any credit that you have underwritten in the last few months. How much time and effort did you expend, or ask the borrower to expend, in figuring out how vulnerable the business might be to a series of "ifs?" Assumptions are, after all, just "ifs."

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A business's historical track record is important. That should be examined closely for clues. However, in a dynamic business environment where change is more certain than not, it's probably critical.

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Just look at how badly we and our customers misjudged the overall health of our local and national economies recently. This will give you a sense of what I'm talking about.

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This is not an exercise to convince you not to make the loan. Rather, it should be a reasonable assessment of the borrower's operating environment. Assume that things change-most everything in business does these days. Some of the changes may be beneficial, but that's an assumption.

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Two stories illustrate my points:

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The case of the "burned-out" borrower. At The Bank of New York in the 1960s, we routinely did credit checks on our customers. Most of us in the training program figured that these were dreamed up as busy work by our bosses. Occasionally, though, they turned up important information.

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I'll never forget doing a check on a customer and calling one of his suppliers, who was located in a state south of the Mason Dixon line.

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Our customer had suffered a serious fire in one of his factories, and that recent event was of concern to us and to the company's network of suppliers. My respondent put it memorably this way: "Are you sure he wasn't trying to sell that factory back to the Yankees"?

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It took some help from other trainees and the boss for me to figure out that comment. The "Yankees" referred to was the insurance company. The question really meant, "Was that fire arson?"

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We concluded that it probably wasn't, but it did put a new light on our internal analysis, because the suspicion was part of the trade chatter.

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The case of the politically connected borrower. Another time, after I had left the credit analysis department and become a junior lender, I was having a phone conversation with a business owner in New Jersey. He said that he was heavily involved in Republican politics and did extensive fundraising for elected officials.

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I mentioned this to my boss, who showed immediate interest.

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"I don't know what that means," he told me, "but it's important."

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Sure enough, about three years later that gentleman was identified as substantially involved with then-President Richard Nixon. The man subsequently fled the country in a storm of political and legal controversy when his Republican connections failed him in his legal battles.

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Both of these examples illustrate the importance of due diligence as a continuous and seamless process of gathering and evaluating information.

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The rating agencies generally did a miserable job of rating securitized mortgage-backed credit earlier this decade. So much of what had been believed to be Triple A quality was, in fact, junk based on a series of unrealistic assumptions and a complete lack of independent due diligence.

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Conclusion: We can't assume that "reality" is necessarily what it appears to be. We have to check it out when we're able to and we don't do it nearly often enough.

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Building for success-or failure?

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Loan structures are critically important. This has always been true, but moreso today than ever.

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Bankers need to remind themselves that there are only three ways to repay a loan:

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1. Conversion of the working assets into cash (inventory becomes receivables becomes cash);

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2. Substitution of sources (long-term take-out for short-term construction loan or a long- term earn-out where relatively small increments of retained equity gradually amortize debt) , and,

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3. Outright liquidation of the collateral.

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Incorrect structuring of the loan can get you and your borrower in trouble.

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You would not very likely finance a printing press on a series of 90-day notes.

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Nor would you provide seasonal working capital on a five-year term note.

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As architects say, form follows function.

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The structure of a loan should fit its purpose. We should endeavor to match the use of the funds (the loan) to its source (s) of repayment.

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Here's the urgency of structure in today's environment.

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Examiners evaluate a loan's performance. If the structure is working and the loan is performing within its originally negotiated terms, then it's likely a pass. On the other hand, if it's got no structure, or an inappropriate one, it will go under the microscope and very often will not be a pass.

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What this says as clearly as any lesson can be learned is that we have to understand the basics of our business no matter how complicated they seem at times. Structure is basic.

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Self-improvement: It's largely up to us

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Ultimately, the source of self-improvement lies in the first part of the term.

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We may be fortunate enough to work for a company that has a strong commitment to training.

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Or, we may work for a company that's fighting to survive and the training budget has been eliminated.

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Either way, it's up to us to find ways to constantly enhance our skill sets.

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We can attend classes at the community college or at the university. We can read extensively in our fields of business concentrations and interest.

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We can always learn, but for long-term career benefit, this has got to be a planned and deliberate activity. We should strive to be strong where our employer is strong, where our strengths enhance the business of the bank.

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The ultimate education

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Finally, we can go out and visit a customer.

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I never felt I learned much sitting behind my desk and that brings us back to where we started--due diligence. Go see for

yourself and make an assessment.

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Lending money can be as hard as we want to make it. We can eliminate a lot of the pain and uncertainty by doing our jobs better. That means due diligence; proper structuring so the credit can work as it's supposed to; and building our own skills sets.

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We're never done. Good lending habits need constant reinforcement.

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- About Ed O'Leary:

Veteran lender and workout expert O'Leary spent more than 40 years in bank commercial credit and related functions, working with both major banks as well as community banking institutions. He earned his workout spurs in the dark days of the 1980s and early 1990s in both oil patch and commercial real estate lending.

O'Leary began his banking career at The Bank of New York in 1964, and worked at banks in Florida, Texas, Oklahoma, and New Mexico. He served as a faculty member and thesis advisor at ABA's Stonier Graduate School of Banking for more than two decades, and served as long as a faculty member for ABA's undergraduate and graduate commercial lending schools.

Today he works as a consultant and expert witness, and serves as instructor for ABA e-learning courses and a frequent speaker in ABA's Bank Director Telephone Briefing series. You can hear interviews with Ed about workouts here. You can e-mail him at [etoleary@att.net](mailto:etoleary@att.net). O'Leary's website can be found at [www.etoleary.com](http://www.etoleary.com).

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