CIT'S HISTORY AND ITS LESSONS FOR LENDERS

John Thain's appointment to CIT executive suite gets Ed thinking about which lenders take which risks

Recently CIT Group announced the election of a new Chairman and CEO, John Thain. Thain is the former CEO of Merrill Lynch and presided over his company's acquisition by Bank of America in January of last year.

I became interested in the CIT situation a few months ago when the company's problems burst into the headlines. Initially, I concluded that CIT's problems and subsequent bankruptcy was probably not of particularly wide interest. However, Thain's appointment has caused me to reevaluate that original conclusion. There are lessons here for bankers.

CIT and the commercial finance niche

CIT is best known as a commercial finance lender to small- to medium-sized businesses. "Commercial finance" is shorthand for lending against the working assets of a business-typically inventory and receivables. It's the sort of thing that bankers do, more or less routinely. But what sets commercial finance apart from general small business lending by banks is the specialization of commercial finance lenders in administering the collateral and the resulting risk exposures.

Many clients of commercial finance lenders are thinly capitalized businesses. Their financial leverage is relatively high compared to the universe of small- to medium-sized businesses. Commercial banks should operate in a relatively risk-averse way and shun risks that they are not in a position to control or monitor closely. This gave rise to commercial finance-type lending opportunities in the early part of the 20th century. CIT is considered a leader in the field and has been doing this type of lending for nearly a century.

Commercial finance lenders do not avoid the risks of such lending. Rather they monitor and control collateral in sufficient detail that the risks of collateral dependence within their loan portfolios are significantly abated. Historically, CIT was very good at this line of business and it remains one of the core strengths of the company.

So what went wrong?

How a credit culture shifted

CIT hired a new CEO, Jeffrey Peek, in 2003. He had been a senior hand at Merrill Lynch and was broadly experienced in the financial services industry. In his early days at CIT, he set about to change the corporate culture.

One of his first strategies was to move the headquarters from the edge of a large shopping center in northern New

Jersey into Manhattan, as the principal occupant of an office building on Fifth Avenue. He brought in a corporate psychologist to help change the mindset of the management group that Peek apparently found too risk averse and narrowly focused. He introduced several asset diversification moves, including the acquisition of a boutique-type investment banking firm and a company that originated and serviced student loans. CIT also embarked on an aggressive acquisition of mortgage- backed securities to bolster the company's return on assets.

In some work I've done examining cultures of companies, I noted that very often companies' actions do not align with governing documents and pronouncements. Among the latter are such items as mission statements, vision and values statements, and externally focused statements of a marketing and promotional nature. What interested me was understanding where had the board of directors been during the Peek transition, and what was CIT's public posture on governance, particularly relating to enterprise risk management.

A breakdown in corporate governance

CIT's website seems to be almost a model of disclosure and transparency. There was some months ago (and still is) displayed the charter of the Risk Governance Committee, where the enumerated duties and functions seem comprehensive and sensible. Still, something wasn't seen by that committee or, if it was, the warning signs were ignored.

To me, at least, what I saw was "silo thinking." Functional areas of the company were conducting what seemed to be reasonable activities to assess risk but no one was watching over the expansion of the sheer size of the company. To nearly double the balance sheet in a few short years in lines of business not closely related to the core commercial finance business seems particularly risky and unwarranted. Further, the company was financing its evolving mix of assets with a significant component of short-term commercial paper borrowings. In other words, they were in part financing permanent and substantial business expansions with significant reliance on short-term funding.

Banks do this as part of their credit intermediation function-but there's lots of scrutiny and financial modeling that accompanies the day-to-day activity of managing a bank's assets and liabilities. Maybe these activities were conducted contemporaneously at CIT too, but the danger signs seem very obvious to me. If your bank's balance sheet or mine is expanding rapidly, the examiners are all over us wanting to know what we're doing and how well we're doing it. They are skeptical and their skepticism is healthy and well placed.

John Thain is a competent financial executive with an impressive resume and series of accomplishments, including chairmanship of the New York Stock Exchange. He succeeds Peek, who left the company a few weeks ago. What Thain is best remembered for during his brief tenure at Merrill Lynch is a low seven-figure renovation of his office suite and his lobbying for a reputed bonus of $10 million for having arranged and facilitated the Merrill acquisition by Bank of America. The latter point reflects a rare lapse in judgment made all the worse by its timing amidst the populist sentiment that was building to a crescendo following two infusions of TARP monies into BofA relating to the Merrill acquisition.

By the way, Thain's salary (relatively modest by public company standards) is $500,000 per year plus a multi-million stock grant with vesting periods extending for up to three years into the future. CIT falls under "Pay Czar" scrutiny as CIT's lending arm converted itself into a bank holding company to qualify for an investment of TARP funds in 2008.

Looking to the future

CIT has recently been through a pre-planned bankruptcy filing that appears to have restructured the balance sheet into manageable and more prudent proportions of debt and equity.

The company should be in a position to weather the financial problems of the current economy and continue its long and distinguished record of lending to small- and medium-sized businesses. The company's recent experiences are nevertheless instructive. The hazards of performing comprehensive risk assessments by boards of directors and executive managements is an uncertain process under the best of circumstances and should be driven by facts seen through a wide- angle lens.

- 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. O'Leary's website can be found at www.etoleary.com.

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