WILL CHECKLISTS REALLY MEAN BETTER LENDING?

Good lending isn't as easy as 1,2,3 ... nor should you expect it to be

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Editor's Note: Usually we just let Ed launch right in. But it was almost spooky that not an hour before editing his column, we heard from a community banker who was present when a senior federal banking official spoke to a small group of bankers. The banker told me that the official stated that their agency's goal was to remove the judgment from lending. Now, with that in mind, read Ed's column. Also see Ed's afterword.—Steve Cocheo

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Sometime in the last few years, a notion has sprung up in some quarters that lending can be reduced to a checklist. If that were true, lending would be like stopping smoking-it would be so easy that people could do it all the time-again, and again, and again.

The most important advice I can give to new lenders (or old bankers new to lending) is that becoming a lender is a process of absorbing and learning principles. The dictionary defines "principle" as an important underlying law or assumption required in a system of thought. In credit, there are many principles, including liquidity, solvency, and profitability. A sound loan combines one or more of these elements in the analysis process, and very frequently all of them.

So there, I've begun a check list approach to lending. Maybe we can actually do something with this short list. The problem is that real lending check lists really couldn't be very short. Lending is a long and often complex process and very nuanced as one principle plays against another.

We love lists. But do they work?

It's no wonder that people like lists. They are proscriptive. And it's tempting to think that simply following a list will yield the desired result. If I have mastered the art of reading and complying with the elements of the list, then I should be successful, right?

Let me illustrate how wrongheaded that idea can be.

Perhaps your bank has an ethics policy. In recent years I've seen many. Most consist of lists of things to avoid. "Don't take gifts from customers or vendors in excess of $50 in value" is one common one but there are lots of others similar to it.

The unusual ethics policy is one substantially driven by principles. The individual is actually required to think through the implications of an action and assess impacts on various constituencies. Such is a hard policy to write and for people reliant on lists to negotiate problems and opportunities of daily life, it's a challenge.

"Just give me a list. That's all I want." If that's all you want, then that's all you'll get-mindless attempts at compliance with no underlying examination of the reasons.

Filling a box or filling the job?

It's pretty much the same in lending. If I were the senior lender in a bank, I could write a checklist for unsecured loans. I could require that the current ratio should never be less than two to one; the acid test ratio never less than one to one; and debt-to-worth ratio should never exceed one to one. These are examples of checklists of calculations to keep you and your bank out of trouble.

The problem is probably that you'd be in more trouble following such a series of rules if you could find many loans that fit neatly within these parameters in the first place. You probably wouldn't lend very much money that way. And if you did, you'd never understand why a particular loan went sour (other than you or the borrower violated one of the sacred items on the list).

Instead, lending is a series of judgments based on principles.

I've already mentioned several important ones—liquidity (the ability to meet short term obligations or opportunities to lend without stress or strain); solvency (the excess of carrying value of assets over contractual liability amounts); and profitability (the excess of income over expense). For the sake of the discussion here, let's assume that everyone is reasonably fluent in accounting methodology and that we understand the difference between cash, accruals, and such. But how could you write a lending checklist that gave you the ability to make nuanced judgments on the tradeoffs that you might be called to make? How would you explain to someone the importance of long-term profitability in light of the reason why you loaned money to an unprofitable business but based on a comfortable margin of liquid collateral?

Where do the lists stop? How long would they have to be?

Once a list had been constructed (regardless of its complexity) would it be a static one or could there be changes? How would you make exceptions? Perhaps you'd need a separate list for that.

Fallacy of change

Recently I spoke with an old friend who is a credit trainer for community and regional banks. He told me that he gets occasional evaluation comments lately suggesting that he update his materials.

This frustrated both of us.

• What's to update on the subject (principle) of lending only to those borrowers who have demonstrated good character?

• What's to go out of date on the principle of lending only to borrowers who demonstrate a reasonable capacity to repay?

• What new revelations have there been on how to thoroughly value collateral or the need to understand the economic environment in which the business operates?

Come to think of it, the best lending checklist that I can think of is the one laying out the Five Cs of Credit: Character, Capacity, Collateral, Conditions, and Collections.

This is a check list of principles, not a series of connect-the-dot phrases or mindless application of "how to proscriptions."

The temptation to reduce one's craft to a list of dos and don'ts is understandable. But it's dangerous. You can memorize a list perhaps. But if you don't understand the principles, you're always the mechanic, never the artisan. It's sort of like doing an oil painting by coloring by the numbers. When you're done, you know no more about creating an object of beauty than when you began.

Understanding the "why," not just knowing the "what"

Those of us who are serious about our craft of lending need to master the principles. That way we know what we're doing and why we're doing it. That way we can learn from situations, especially those that go wrong, in large or small ways. Continuous improvement has become one of the important practices in management today. It's also a very sensible way to go about one's work. But it requires knowing both the how and the why of our discipline.

It's important to realize that not all learning happens in the classroom. Much of it transpires in interpersonal relationships between bosses and subordinates, customers and bankers, and peer exchanges of ideas and information.

We need to be lifelong learners and just as there's no single way we learn, there's no single time either. In the early phases of learning credit, we are often spoon-fed ideas in a classroom or structured environment. Then we graduate into "learning by doing" and that's a richly rewarding experience for those who are intellectually curious and observant.

The opportunities to learn are endless but they require that one keep eyes, ears and mind open. That can be a tall order for some, particularly those whose comfort zone is found in checklists.

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A Postscript from Ed, Jan. 20, 2011: There was an interesting article in the B Section of today's
(Jan. 20, 2011) The Wall Street Journal
"Firms with Collateral Gain an Edge." It supported one of the points I was
trying to illustrate in this week's blog.
Lenders who operate on the basis of principles, rather than simply rules,
have to make judgments regarding things like cash flow and collateral. In this WSJ article, three principles contained in the Five Cs of Credit were in relief: Collateral, Capacity, and
Conditions. Any lender excessively

beholden to a checklist would be not unlike the famed donkey of philosophical disputes of the Middle Ages that died of starvation because he couldn't decide from which of the two side-by-side bales of hay to eat.

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 free audio 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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