WHY CHARACTER LENDING IS MAKING A COMEBACK—AND HAS TO

Old standby may be community banking's secret edge

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A recent article in The Wall Street Journal tells us that character lending is making a comeback.

I thought, on reading the WSJ:

What a sad state our industry must have descended into in recent years that a reporter in the national press thinks that this is worthy of comment at all.

To properly trained credit people character is the essential pre-condition of every deal.

Defining a fundamental of lending in 2011 terms

Character is primary among the five principles of lending. It is what has been in prior times at least the most prized and respected of all the elements of a desirable lending transaction. Yet it is more challenging now.

The problem: We live in a pluralistic age, where truth to many is relative; absolutes are few; judgments about what constitutes good or deplorable behavior are to be avoided where possible; and what is considered acceptable behavior is more broadly defined with each passing day.

If you want to do something that's becoming increasingly difficult, try to define character-without religious references or imagery, or in terms that will assure a high degree of agreement or consensus among conversational participants.

In an old-fashioned sense, a person of character is one who knows right from wrong and consistently chooses to do what is right.

"Right as defined by whose standards?" you may ask. See what I mean?

Here's the point to keep your eye on: The relevant standards are those of the group in which the context of the action or activity is being conducted. For the bank and the borrower, it's civil society and its attitude toward contract law, personal behaviors, and responsibility. If a customer promises to repay a loan, then there is the high expectation that he will honor his word.

This is the Character component of credit; it stands first in the line but not necessarily alone. With it are Capacity, Collateral, Conditions, and Collections, those other principles of credit the presence of which makes any deal "bankable."

Character stands taller than the others and all experienced lenders consider character to be the glue holding every borrower/creditor relationship together.

So, where did this big "C" go?

Character is a core value among lenders, so how could anyone get the idea that character had been written out of the lending contract between bank and borrower?

Unfortunately, there are some conspicuous reasons for this misapprehension and we as lenders and bank managers should resist this idea vigorously.

Understand, lending is a labor-intensive business line with salaries of the lenders and support staff the major item of cost-second only to the cost of lendable funds.

Managements are responsible to the stockholders to produce the service in the most cost-efficient way. This means that the Five Cs of credit should be in a harmonious balance.

But it also means that productivity must be enhanced where possible by shaving costs out of the process. Central underwriting, credit scoring, central document preparation, central funding, and the like are all tools that can both limit human involvement and speed the delivery process.

The inevitable consequence for both the bank and the borrower is that the entire process has become less personal. Fewer human intervention points suffice to underwrite credit on a safe and sound basis.

Take the typical consumer loan. A borrower's likely payment behavior can be modeled prospectively based on prior payment habits that are recorded and reported through large databases we call credit bureaus. This has been an evolving process for years in consumer lending and it probably owes as much to the explosion of auto financing through indirect methods and practices by the car dealers themselves. The human element has been nearly squeezed out of much of the loan approval processing. And the buyer today drives away with a new car and never visits the bank to complete the deal. Where's the face-to-face relationship?

The pressures on cost in commercial lending are similar but not identical.

How commercial lending got watered down

Commercial lending, at least for deals at the smaller end of the size range, has become increasingly a retail banking product.

Increasingly, the point of service is the branch. Not too many years ago, even banks with large retail networks never used to offer a full range of commercial lending at the branches.

Instead, there were a relatively few branches staffed by or at least populated with experienced lenders to interface with the commercial borrower. These are now quite rare at least among those banks that the banking public would consider as large institutions.

For the commercial borrower, especially the small business owner, the costs are substantial and are altering, probably negatively and irreversibly, access to commercial credit. Large commercial negotiations are still typically conducted at a headquarters location. Smaller deals, though, are handled by branch people, many of whom have had little or no commercial lending training or even orientation.

Downsides of the retail evolution

In my view, three things are being lost:

The ability of the borrower to have serious, sensible, and helpful negotiations with a commercial lender.

Lenders are repositories of experience and expertise that are otherwise extremely difficult for the small business owner to access.

Who is in the business of assessing character first-hand and in the first-person-singular sense anymore?

It doesn't happen much now and we as an industry are the worse off for it. Credit increasingly is rationed for the wrong reasons, rather than the ultimate enabler, which is good character.

In the quest for efficiency banks have forgone the ability to spot a good commercial lending prospect.

Too often, the person handling the customer's transaction-any transaction-hasn't been trained to look for those things that create opportunity for additional loans or fee-based services.

Is it any wonder that loan volume has shrunk and banks everywhere are lamenting the difficulty of generating new sources of non-spread income?

As an industry, we began this process of depersonalizing lending, consumer and commercial, many years ago. The early manifestations were the "hunter/skinner" model which spawned the expression "the empty suit."

Who wants to do business with an empty suit? Our customers want you or me or one of our counterparts (the phone menu's equivalent of a live person).

Want to survive? Rediscover character lending

If there's a silver lining in the direction of today's lending business and particularly commercial lending at the smaller end of the size spectrum, it's that only community banks are really able to deliver the service and expertise the old-fashioned way. The big boys will argue to the contrary, but it's all hype largely delivered by the man in the empty suit.

It's time now to get back to basics by those banks and bankers that even pretend to have a clue about what it takes to serve clients today. This is where the opportunity is and we as bankers can continue the practice of assessing character first hand.

That's what we've always done and those who do it well are survivors and help build their communities.

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.

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