O'LEARY'S CREDIT ESSENTIALS: THE ART OF THE LOAN DEAL

Neglect the structure and things may fall down around your ears

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How many of you who regularly exercise lending authority have encountered other lenders who really didn't understand how a particular credit worked?

I've seen it more often than I ever thought I would. It reminds me that no matter how hard the industry tries, there can be surprising gaps in the quality of credit training across our industry.

The big banks generally get it pretty right, as they organize the training effort with scale in mind. There's more formality, starting with the syllabus and progressing through the presentations of components of big bank training, than among community banks' efforts.

That's understandable, but some of the gaps are still surprising, or at least they were when I had the opportunity to view them up close. I've seen things that remind me of an incident bank in my Florida banking days.

They just didn't "get it"

Some years ago my bank in Miami was one of 20 or so money center and regional banks in a large syndicated credit to a real estate developer. The developer operated primarily in Florida, which is why we were involved. However, the credit was very large for its day and well beyond the legal limit of my bank, then the largest in the state. We had periodic meetings of the participating banks, and I vividly recall one where I was the official co-host with the loan officer on the account from First National Bank of Boston. First of Boston was the true lead bank, as its exposure considerably exceeded that of my bank.

The real estate market is classically cyclical and we were in the middle of another real estate sales "trough." Product, consisting of finished lots and completed dwelling units (a combination of single-family detached and condominium apartments in several active sites primarily in Florida) was accumulating, as sales had been slower than the company's projections for the last two or three quarters.

Some of the attendees at the meeting were becoming anxious about the overall condition of the credit. Something didn't seem to be working properly from their perspectives.

The fellow from Boston was very patient in responding to the occasionally nervous queries from other bankers.* But at one point he virtually exploded in frustration at one of several obtuse comments and questions from some of the participants.

"You don't understand how this credit is supposed to work!" he exclaimed at one point.

He then launched into an explanation of the real estate development process, beginning with the acquisition of raw land; the development of finished lots; and then either the sale of the finished lots to other builders or the construction of dwelling units for ultimate sale by our customer.

"We don't get paid until either the finished lots are taken down by other builders or our customer builds and sells the final product," he said.

Amazingly, there were some in attendance who apparently hadn't understood that.

They had a participation in a note with a contractual maturity date and expected to be paid on that date.

Period.

Look for the skeleton, the architecture

This experience always helps me remember that loan deals have structure to them and are designed to work in certain ways. Students of architecture learn the expression "form follows function."

It's a useful expression to describe why a physical structure is designed the way it is, but it's useful for a credit structure too. And when you stray ...

How often in our quest to be accommodating to our customers do we violate some very basic lending principles?

It happened a great deal in the latter phases of the recent credit cycle. Many banks were severely disadvantaged for overlooking some basic things.

The biggest memory lapse was in ignoring the truly ancient lending principle that one does not fund long-term uses with short-term sources and vice versa. A printing press with a useful life of seven years should not be financed by a series of 90-day notes. Inventory and receivables are not properly financed on term notes with maturities several years into the future. That's not how each of those underlying transactions are supposed to work.

Why structure matters and how to get back to it

Our industry began to think more formally about loan and deposit structuring starting 30 or more years ago as the asset-liability management process came of age.

Old time lenders always knew these things. But in the rush to expand loan outstandings, we as an industry became too "limber" in our approach to both the structuring and the funding of credit.

Perhaps some of you reading this are active in the credit training of community bank lenders.

If you are, here's a common sense approach you might want to consider in helping new lenders understand and remember the logic of proper loan structuring. There are only three ways that loans are repaid:

1. Conversion of the working assets of the business. Inventory becomes receivables and gets collected in cash.

2. Long-term earn-out from the cash flow stream of the business. Amortization of a term loan in a period of time that is less than the useful or technological life of the asset it financed).

3. Liquidation of assets of the business.

This last alternative is seldom a legitimate structure; more often than not it's the result of a failed deal. In other words, a deed in lieu of foreclosure is never an acceptable repayment source contemplated in the original loan negotiations.

Consider these three options. Every deal under the sun is ultimately structured within these three discrete sources of repayment.

We as lenders unfailingly seem to get into trouble when we are unclear about our true repayment sources. In other words, we lose sight of how a particular deal is supposed to work.

Sometimes too we get carried away with complexity under what appears to be the notion that the more complicated we can make a deal, the more progress we're making.

As we and our customers recover our financial health, let's make the concerted effort to restore a level of simplicity and clarity into our loan structuring practices. Simplicity and clarity should be benchmarks for community bank lending by purpose and structure though judging by the extent of the wreckage of the current recession, those clearly have not been the norm.

It's time for a change and it will make our jobs easier as the credit cycle peaks and heads down, as it surely will again someday.

* Perhaps some of them really were unfamiliar with the credit and were only there because south Florida is more pleasant in February than Boston, New York, or Chicago.

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 has been 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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