
CREDIT C'S CAN BE A USEFUL MIRROR

Use these classics in a new way--to see how we're doing from the customer perspective

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The "Cs of Credit" are as old as the hills--Character, Capacity, Conditions, Collateral, and Capital--listed in my own order of priority based on personal experience. I think that they are as relevant as they have ever been.

To some, today, they sound trite. Practitioners often think of them as a sort of checklist, but they are much more than that. They are principles on which we base our judgments on how our borrowers can and should perform on their lending contracts with us.

Some of the Cs are pretty simple and straightforward and to experienced lenders are commonsense rules for the evaluation of sound credit. In that way they may seem just like components of one more checklist. Others are like terms of art requiring experience and perspective to evaluate properly.

Considering the Cs

The C at the head of the list is Character.

It's also one that has no wholly objective criteria on which to base a determination. And it's the one from which there is no hiding if there is something amiss, in a personal behavioral sense. A defect in character is a defect not only in the deal or transaction but in the nature of the moral foundation of the transaction which is trust. All human interactions are based on trust. You can be trusted to do what you say or not.

A serious doubt on that level and the deal, any deal, is fatally flawed.

Capacity is another C that is fundamental to a successful transaction.

Our borrower has the wherewithal to get the deal done, or not. We can err in our estimation of capacity. Events can overwhelm or cripple the borrower's best intentions. But a belief based on analysis and observation that the borrower can do what he says he can do is fundamental to a successful transaction.

Conditions, a relatively new addition to the list 25 or so years ago, relates to the local business climate in which the borrower and the bank operate.

Is business good or not so good? Are the participants optimistic or excessively cautious? Conditions may be thought of as the "speed governor" that influences, if not determines, the pace of overall economic activity. It's critical to assess it properly and whether it's in the process of changing.

Collateral is one of the Cs that can be problematic.

Some lenders have a tendency to evaluate collateral at the expense of capacity. They fail to see that collateral is hardly

ever meant to be the primary source of repayment but is rather a way of mitigating risk in the transaction.

If a borrower's Capacity fails or is insufficient, then Collateral can be used to bridge the short fall. It's secondary, not primary. Then there are the issues of valuing Collateral--and inspecting it, monitoring it, and making sure you know what it is, where it is, what condition it's in, and what it's worth.

It's not necessarily simple, though many hardly give careful consideration to the full ramifications of management of collateral.

Capital is important, though it's at the end of my list. The reason is that at the small end of the loan size spectrum, it's generally scarce. Small business owners usually risk all they have in the early years of their business lives. Bankers, understanding that, will tend to emphasize Character, Capacity, and Collateral rather than the size of the capital cushion in their evaluation of a borrower's risk.

Turnaround is fair play, especially now

As our industry has struggled to burnish its tarnished reputation the last several quarters, perhaps some of these same principles should be used to evaluate how our borrowing customers might evaluate us. The first three seem uniquely relevant to a process of self- assessment and introspection.

Character: Do we reflexively consider what's best for the customer? Perhaps that means saying "no" when that's the better response for both the borrower and the lender. Do we mindlessly peddle fee generating product without a rigorous sense of value added? Are we conscious of our responsibilities to properly underwrite credit to save the borrower from the adverse consequences of our careless habits? Are our actions and dealings with our internal and external constituencies always ethical and responsible?

Capacity: Do we have the "right stuff?" Are we properly trained? This is particularly a community bank issue today, as lenders often start their careers at much smaller institutions, those often lacking formal and broad-gauged lending development programs.

Do we have more cumulative chronological training than cumulative qualitative training? If we suspect this may be true, what are we doing about it?

Ultimately, the customer and the bank are best served when the lender has the right skills --and assumes an appropriate degree of personal responsibility for his or her own career development. Consider too whether our banks' hiring practices emphasize qualities such as intellectual curiosity and a pleasant personality. Would you rather teach a new hire how to analyze credit? Or how to smile?

Conditions: Are we attentive to what we see and hear? Do we tune in on incongruities that come to our attention? Do we readily turn data into information on our communities, our business base, and our competition? Can we synthesize and generalize about our environment with the information we have acquired? Does it register on us if parking lots are half empty at what should be busy sales periods of the day or week?

Probably the best sources of information are our customers. We should frequently be asking them "How's business?" and then listening carefully to their answers. We shouldn't expect to do any better than our customers given local market conditions. It's impossible over time to successfully run a "bull market bank" in a bear market.

And if we're doing our jobs well, this is probably the greatest source of value added in dealing with us as individual lenders.

Digging into the Cs reveals lessons

I think you've gotten the idea, but to wrap up, let's look at some remaining facets of the list.

If we get the risks seriously out of kilter at our banks, then we are the ones responsible for having impaired the ability of the bank to function properly. This is hardly the customer's fault, yet he or she suffers for our shortfalls.

If we are undercapitalized, then the bank labors under a serious deficiency.

If the examiners have us under an administrative agreement, our customers find us much more difficult to deal with. We are not only distracted, but also often have to jump through many additional hoops to deliver our normal level of service if indeed in distressed circumstances that's even possible.

The Cs of credit are not absolute measures of how to do anything. Instead they are principles and are as useful to us in evaluating our customers as they can be to our customers evaluating us. In the words of Robert Louis Stevenson, "Mirror, mirror on the wall . . . ?"

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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