TRUSTWORTHINESS: THE ACID TEST OF CHARACTER

Assessing "character" in the age of "strategic defaults"

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The Five Cs of Credit proved a durable and effective way of presenting the principles of lending to several generations of commercial lenders. The first known reference to anything like such a list was late in the 19th century, as I recall.

The question today regarding the prime "C"-Character--is:

Why have we failed on a timely basis to spot so many borrowers with questionable activities in their pasts?

Has our due diligence been that poor? Or have our attitudes been changing?

Did we dumb down Character?

It is possible that today we pay more lip service to Character than we actually examine it.

This can be understood in the recent context of building loan volume, increasing market share, and "making the numbers." It's not that we normally welcome borrowers with sordid or checkered pasts. But maybe we just haven't looked that hard or have turned a blind eye to signs that in other times would have generated more rigorous analysis and higher turndown ratios.

Maybe we just didn't consider some behaviors as disqualifications, in the context of the present day.

Ask yourself: What sort of behavior constitutes unacceptable character traits at my bank? Where do we draw the line of what is acceptable?

And then ask about your bank's own "statute of limitations." Should a particular action or activity have a time limit for consideration? How long should normally negative information appearing in an individual's credit bureau report, such as a bankruptcy or mortgage loan default, be considered an indicator?

I recall working with the CEO of a bank who learned that an applicant for a large credit had had a conviction for a drug offense.

The man was in his late 50s when he applied. At the time of his conviction he was in his early 30s. His business record was impeccable and his "youthful indiscretion" had been voluntarily disclosed in an addendum to his curriculum vitae. Is such information relevant today?

In the opinion of that CEO, that offense rendered the applicant ineligible.

Attitudes change. At The Bank of New York many years ago, we were instructed to retain any information of a negative nature, no matter how dated. That could include evidence from a years-old Dun & Bradstreet credit report of a reported fire loss to a personal bankruptcy to virtually anything at all.

Information of a hearsay or unsubstantiated nature was not included. But if the information had a credible source, particularly sources of public information, it stayed in the credit file.

Considering "trustworthiness"

Contrast this approach to today's evolving attitude towards "strategic defaults" on mortgage-related indebtedness.

It has been reported that some banks ignore default information on first-mortgage residential indebtedness after two or three years, even if the borrower deliberately and willfully chose to default on a residential mortgage. This is an urgent

matter to consider today. Significant numbers of borrowers find themselves "underwater" when the value of their homes is compared to the amount owed.

To me, here's the essential question to answer, in the Character assessment sense: Is a particular borrower "trustworthy"?

How do we know the answer? We probably can't always know it, absolutely. Let's consider two aspects of this.

Personal experience. Where we have done business with a borrower over time, we have our own direct experience. Usually, this is the most reliable measure. If we have experienced one or more full credit cycles with a customer, we have been able to observe behavior in a wide range of business circumstances.

Guard against complacency, however. The question to be sure to address in this context is whether we really are looking at the entire record. Do our credit files document sufficiently the behaviors that we value or that raise our concerns?

The new face. If we do our due diligence thoroughly, we should be able to satisfy ourselves about those prospects with whom we do not have extensive credit experience.

Public information sources should always be consulted. I was trained to investigate prospective borrowers where our experience as a bank was non-existent or relatively recent. We also did "mutual revisions" with other lenders of our experience with borrowers compared to the recent experiences of other creditors. We occasionally turned up information that was factored into the credit decision. All efforts were conducted within the context of the Dun & Bradstreet credit reporting code of ethics.

The remarkable thing in recalling these investigations is the realization that they were done routinely. It seems so removed from business credit extension practices today.

Coming to a decision: Is there trust?

Ultimately, we must come to a conclusion on the trustworthiness of every borrower. If we set out these standards in the form of a checklist, we'll likely miss something. Instead we have got to have a "values" sort of filter through which we screen each applicant and borrower.

Is there anything amiss in the borrower's behaviors?

Do any activities, past or present, conflict with our own values? Or those values that are incorporated in the bank's credit culture, including its credit policy?

Questions of trust ultimately affect the entire relationship with a borrower. Either we trust the customer or we don't. But we should have done enough due diligence on the front end to be sure--or have lengthy favorable experience to be able to answer this question fully and thoughtfully.

That brings me back to the growing issue of strategic mortgage defaults:

• Does your bank have a formal position?

• Do you agree, or not, that a strategic default creates a character blemish? In other words, should a borrower be able to unilaterally decide whether to continue to observe both the letter and the spirit of the borrowing contract?

• Does this have implications for how we assess trustworthiness and therefore the character of the borrower? It's another way of asking whether individual actions have consequences.

Looking ahead

Are bankers' attitudes toward credit integrity evolving? Are recent developments relating to formality and substance of this process constructive to the future of our industry?

This is a question separate from whether we are doing an adequate job of credit analysis.

Our jobs today are getting harder.

How much of this may be self inflicted?

Are we ignoring valuable and important lessons learned over the years?

Talk back! Ed's brought up some troubling questions. How would they be answered at your bank? How do you feel about them? Post your thoughts in the comment section below.

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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