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## THE LENDER'S EYE: WHAT'S AILING ABOUT LENDING TO DOCTORS

Second of a series: Will doctors still be prize customers for community banks?

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Last week we discussed the doctor who fell in love with the wrong deal. He was prosperous, smart, and a great customer of the bank. But what he wanted to do (and accomplish with the bank's help) really wasn't the best thing for his personal investment portfolio. This week we focus on the risks that doctors often present as borrowers and how this segment of banking's customer base is profoundly changing. Next week, some conclusions about the future of doctors and community banks.

In some markets, a physician business model is becoming very popular in which the physician is an employee of a very large, integrated health-care services provider. The biggest medical group in New Mexico is successfully operating almost exclusively on this model. Over the years, I've watched sole practitioners and small practice groups sell out to the big company and become employees.

This approach solves many practical issues doctors face, ranging from the costs of malpractice insurance to investment in and patient access to technology-plus the overhead burden of operating any small business these days.

My own family care doc no longer works for himself and seems quite content with the arrangement, especially because he has no formal on-call responsibilities nor is he required or expected to make hospital rounds. He collects a salary; makes 401(k) elections from a large, managed suite of offerings; gets a generous vacation allowance; and has weekends and Wednesday afternoons to himself.

Does this trend in medicine have implications for banking? Implications that might not be as "healthy" as we'd hope?

Independence, but at a high personal price

When I was an active lender I was prospecting a medical sole practitioner and had a shot at her commercial business through a home equity line of credit that she and her then-husband had taken out through my bank. The couple was since divorced and the doctor wanted to reestablish the line in her own name as a working capital facility for her general medical practice.

She appeared to be atypical of the physician practicing today-self-employed and completely on her own. When I peeled back the layers of her "financial onion" I was surprised by what I learned.

She had a revenue stream of almost \$500,000 a year and a diverse base of mostly healthy, younger patients. But she had an enormous overhead relative to her income-accounting and tax service, nurse, receptionist, professional suite rent, continuing education, and the myriad small but cumulatively significant expenses associated with her practice. Her overhead consumed more than half of her gross income and she had no backup for her own absences for vacation or illness. Nor was she well covered with life or disability insurance.

In the course of our discussions I learned that she was passionate about being an independent practitioner. She wanted to practice medicine in her own way and not have to fit the mold of the large group practices or the hospital service provider models.

I hope she continued to be successful, as hers is a business model that is rapidly disappearing and it will be missed by a lot of us. But her case illustrates how circumstances are changing.

From small business to highly paid employee

When I was cutting my teeth as a lender doctors and dentists were the cream of the market, in terms of desirable borrowing customers. They needed a variety of services that banks provided ranging from accounts to loans to investment and fiduciary products. They also had relatively high borrowing needs (appetites) both initially to start their practices and later to support upper-middle-class life styles.

What really made them so desirable as customers was their high earnings capacity.

It's easy to blame medical malpractice insurance as the principal culprit in the dramatic change in the prevailing medical business model and it has its place in that transition. But I think more than anything else it's the enormous growth of overhead for variety of technological applications and the infrastructure of the office supporting functions.

When you think about it, isn't this the bane of most small businesses today?

How are we as lenders preparing ourselves to understand and respond to the risks that this class of customers presents in the borrowing sense?

Is what we know--based on the accumulated experience of our bosses and colleagues--up to the new and evolving challenges? Or might there rather be conventional and familiar credit risk appearing in new and unexpected ways?

What seems new and different to me today with medical professionals is the reality that they are destined to be highly leveraged borrowers for the rest of their professional lives, if they maintain their own practices or partner up. They start with high debt from medical school loans. Once they begin working, most can't expect to ever match the net earnings capacity of previous generations of physicians in inflation-adjusted dollars.

Their practices are highly leveraged, too, with both high operating breakeven points and high financial leverage, owing to the need for sophisticated equipment.

Even the long-term calculation of financial capacity to service debt is clouded by uncertainties of the Medicare reimbursement formula and the structural changes likely to come from universal health care, however that ultimately shakes out in coming years.

The doctors who work for hospitals or large group practices are increasingly just "employees," albeit relatively well paid ones. But they don't need our specialized services pitched to the medical community quite the way they used to.

From 24-karat customers to .... what?

We need to rethink what it means to bank a doctor or a dentist.

Increasingly, it's serving and responding to either a salaried employee with the limited upside cross-selling potential apart from the business (the practice or the hospital) or it's dealing with very highly and probably permanently leveraged small businesses.

The credit risks are becoming increasingly similar in the generic sense with most other small business owners or blurring

into undistinguishable differences between doctors and other well-compensated salaried employees of non-medical businesses.

This marks a significant difference in how we approach our local medical communities in terms of resources, business potential, and risk assessment and management.

Disappearing slice of the local pie?

This is one more very visible way that our world is changing and in some respects reflects the compression of the variety and scope of our lending opportunities. We're in the process of losing something significant.

It's hard to know whether this will represent a true loss in the economic fabric of our communities. It does seem to be a shrinkage of our markets to a highly profitable and desirable segment of our trade areas.

In my next blog I'll address some strategies for carefully navigating this changing ground.

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](mailto:etoleary@att.net). O'Leary's website can be found at [www.etoleary.com](http://www.etoleary.com).

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