

## DON'T LET 'CHARACTER LENDING' LABEL EXCUSE UNTRAINED UNDERWRITING

Character should be a fundamental

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My good friend Jeff Judy, a credit training professional with a national practice whom many of you probably know, wrote very recently about what it means to be a "character lender." That term, to me, is an old-fashioned put-down of those lenders whose analytical skills are poorly developed or very rusty from disuse.

In other words, if you were a character lender, it usually meant that you didn't know how to analyze credit beyond the first C.

Lending on character, collateral, or capacity

Examiners tuned in on this issue in the early 1990s. Only back then, it was couched in terms of collateral lending. To me, character lending and collateral lending are different sides of the same coin. If you couldn't analyze the second-most-important C of credit, Capacity, then you were likely one or the other--a collateral or a character lender, or perhaps both.

I remember one of my close colleagues at Southeast Bank in Miami. He had been trained at Citibank and was a whiz at analyzing corporate cash flow. I wasn't formally trained at The Bank of New York that way, as I guess I came along a few years earlier than the now well-understood and practiced cash-flow lending discipline. I was impressed, though, as I picked up on the specifics of the skill that my friend Dick had. I recognized that it was a tool of some importance.

From the later perspective of many years of lending and problem asset workout, I think the lack of Capacity analysis is probably the largest single deficiency that lenders have exhibited. They have not been well trained to analyze the ability of the borrower to repay the debt.

I'm not referring to the will or the disposition to repay. Rather, I'm writing of whether the lending transaction as presented, understood, and underwritten really makes sense and shows a realistic probability of generating the funds for repayment. (Capacity as a C of credit is sometimes referred to as "Cash flow" and I don't quibble with that term.)

Character's important, but ...

So what has Capacity to do with Character or Collateral?

If the deal isn't well structured from a capacity perspective, one gets quite quickly to the adequacy of any Collateral supporting the repayment and/or the Character of the borrower to get it done.

We've all seen and heard anecdotal evidence of how borrowers, against all odds, manage to retire their debt in full, even in some cases after the debt has long since been charged off. Yes, that's Character.

But Character is more than that.

It's the whole approach that the borrower takes to the credit relationship-his candor, his cooperation, his attitude toward the relationship, and its relative importance to his reputation.

If the appropriate Character component is missing in any relationship, then any credit belongs on the Watch List from the moment the commitment is made.

But what do you do as a lender if you really don't know how to assess the borrower's Capacity? The tendency seems to be to think in terms of the familiar clichés, platitudes like, "He pays like clockwork."

Or, a perceived strong collateral position is advanced as the reason that risk has been reduced to bankable proportions.

What lender, other than one who really doesn't understand the tools of his trade, makes a credit decision primarily based on liquidation of the collateral?

Sure, there are some lending products--residential construction is an example--where the primary repayment source is collateral conversion.

But that's not very often the case in most commercial lending situations. Collateral is secondary support, not primary.

When healthy skepticism doesn't get a seat

I have recently been involved as an expert in a lawsuit involving the insufficient analysis of a borrower's ability to repay. The information was present in the underwriting phase, but it was under-analyzed and so some important information was simply not considered.

The borrower did in fact have some demonstrable but limited ability to service debt, but the reliance was placed on the liquidation of real estate collateral. When the project was complete and ready for sale, the market had tanked. The borrower's capacity was never very strong and it was inadequate to make much of a difference in this situation.

That was all knowable up front--if one had a healthy initial skepticism about the collateral as the primary source of repayment. So much for the liquidation value of collateral as a repayment source or the relevance of "pays like clockwork," which became a non-sequitur in the context of that default.

The deal was structured properly for the sort of transaction it was but the secondary source of repayment, the personal cash flow of the borrower, was woefully inadequate before, during, and after.

So what did the borrower do? Unfortunately, he blamed the bank for doing a lousy job of underwriting and asserted that he shouldn't be forced to repay due to the bank's negligence.

The case was ultimately resolved by compromise. But neither the bank nor the borrower had very satisfactory outcomes. And all of this was avoidable and had precious little to do with either collateral or character, though, in the final balance, both were irrelevant, as well as coming up short.

Inconsistent training yields inconsistent lending

What bothers me today is that there is a large segment of the industry, consisting of many smaller community banks, that have not been particularly successful in training their lenders in analyzing credit. It's not that they haven't tried, but rather that they haven't been consistent about it.

Consistency in this case means:

1. Assuring that the lenders have the skill sets appropriate to the business base of the bank.

2. Then helping the lenders maintain those skills as the business base grows in size and sophistication both organically and by acquisition.

Lending is a series of correctly applied principals, not just lists of things to do and things to avoid. The latter is compliance, but it's not underwriting, not in the classical sense.

Lending is a skill, not a checklist

As we look forward to a return to a healthy business environment, the C of credit standing for "Conditions," let us not lose sight of the skill sets that the next business cycle will demand of lenders if they are to be successful.

Actually, the next cycle is not likely to be much different than previous cycles, except that many current practitioners haven't kept up.

There's not a lot new under the sun, so this should not be an impossible situation to fix. The problem is with the recognition of the reality. It's time to move beyond the denial phase and do something constructive for our banks, our customers, and our local communities.

About Ed O'Leary:

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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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