
CHARACTER IN LENDING—AN UNCERTAIN QUEST

Why does "Character" seem like an option these days?

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All lenders are taught that a borrower's Character is the most important element in any credit transaction. The reasons seem obvious enough, but why is the identification of "good" character so elusive at times?

Character versus being a character

I was talking to an old credit "war horse" (like me) the other day. He observed that there seems to be much less formal "due diligence" on a borrower's character today than there used to be. Extensive checking with other creditors before extending credit to a new borrower seems remarkably distant in history.

Simply out of curiosity, I Googled the term "due diligence" and found a dozen or more explanations relating to business transactions. Amazingly, not one of them directly confronted the issue of the character of the borrower (or the counterparty to a non-lending business transaction). This is instructive on a number of levels.

First, people don't seem to be as interested in the question as they were a generation or more ago.

I wonder why. Maybe the question is too basic and the answer is implicit in the terms of the contractual relationship or in the protections that collateral can provide.

Or, ominously, perhaps we have entered into a "post-character" phase of credit extensions. The future of lending seems to envision an almost completely impersonal (indirect, if you will) environment for lending, including credit scoring and an attitude of "never touched by human hands."

Second, maybe lenders just assume that all parties to loan transactions share the lender's set of values.

After all, most of us believe that we are highly ethical, so isn't everyone else with whom we would choose to do business?

Do you really intend to bet the bank on an assumption like this?

You probably don't--at least not intentionally--and never consider the risks involved.

Are we asleep or ignoring what's around us?

Given the level of alleged and documented fraud in business today that has been the subject of newspaper headlines since Enron and before, this lapse seems inexplicable.

Is there something naïve or perhaps even reckless in the way we approach our business today? Are we shortchanging our shareholders and perhaps even the Deposit Insurance Fund by our apparent ignorance of such a traditional building block of a traditional lending transaction?

Do our actions imply that character is no longer particularly important?

The reasons for considerable care on the subject of character are several. However, the principal one is that if a borrower intends to cheat you, he will ultimately be successful. Your normal protections will never anticipate every eventuality nor reduce the risk to zero in the face of a crooked borrower.

Fraud isn't new. But this issue is more urgent than it perhaps ever has been before.

Look at the lending/borrowing contract from the point of view of the borrower.

Try the other side of the desk for a minute...

Assume for the moment that the borrower has been ethical in all respects in the negotiating and execution of a credit transaction. Then along the way, conditions deteriorated and it became difficult or perhaps impossible for him to perform according the originally negotiated deal.

The borrower is then confronted with the choice of behaving responsibly and cooperatively or just "throwing in the keys." He can leave the bank as the hapless holder of a failed deal or he can continue as before and do what he can to minimize the damage to both himself and the bank.

If we as lenders act as if the borrower's character is unimportant, what practical incentive to continue from a business point of view does a troubled borrower have? He may conclude that he's ultimately broke either way.

If the bank doesn't give a damn about him, why should he care about the bank?

As both a full time and occasional problem asset manager for banks, I've seen borrowers with all manner of attitudes and in all sorts of personal and business predicaments. I've seen some behave with dignity that I doubt I could personally muster. I've watched others abandon all semblances of personal responsibility and scramble to minimize damage with no regard to the carnage or the wreckage inflicted on anyone who happens to be in the way.

During the depths of the two very deep business troughs I've lived through as a lender over the last 30 years, I've seen borrower behaviors that have disappointed me but seldom truly surprised me. The exceptions tended to be those individuals who acted honorably and ethically even though to have done otherwise would have been much easier and to their personal benefit and to the exclusion of the bank's.

The rub: Responsibility isn't always normal

Acting responsibly does not always represent conventional behavior today and that's what's wrong with our character assessment process. Our assessments tend to be "lowest common denominator" sort of thinking and laden with unverified assumptions.

In other words, if we don't expect too much, we'll not be disappointed and as proof of this, generally we are generally neither shocked nor outraged however outrageous a borrower's behavior is.

According to my set of ideals, learned in a different environment than what seems to be the norm today, I still have high expectations of my customers. I owe it to them too as I've sold myself to as a lender who has certain fundamental values.

Character in lending is not just important, it's EVERYTHING on both sides of the transaction. If character is to be important to borrowers, don't we have to show that it's integral to us? After all, aren't lenders the principal beneficiaries of borrower integrity?

Due diligence is not complete without a formal assessment of a borrowers' past behaviors. The past is not an infallible guide to the future. But it's the best one we have.

This is more than just payment history and the rigor it requires takes individual and institutional effort. Why do we in the face of considerable evidence to the contrary fail to act as if character is important?

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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