BETTER LOAN WORKOUTS HINGE ON BLENDING FAMILIAR AND ATYPICAL SKILLS

Relationship banking has a place on the cleanup side

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Optimizing Distressed Loan Books , by John Michael Sheehan, which I review in ABABJ.com's Books for Bankers column this week, discusses why bankers don't always optimize problem debt resolution outcomes.

As I was reading the book, Sheehan's point reminded me of certain tendencies by both the lender and the borrower that can confound successful results. Some of these are organizationally driven, while others relate to the training and experience common to many lending officers today. I thought both bore some discussion, out of the context of a book review.

Key step: Recognizing the design constraints of a bank

Banks are organized to generate new credit outstandings in a series of discrete processes designed to maximize results and minimize risks. These comprise the traditional loan origination and servicing landscape familiar to all bankers.

However, those "peacetime" routines and processes tend to not necessarily be designed to address the problem borrower in the most constructive, innovative, and flexible ways.

There's not a lot that an individual lender or a local loan manager can do about this other than to recognize it. Both the lender and the manager are "in it," so they must step back mentally to remember that processes designed to smoothly and effectively generate credit are not always the ones that produce the best results in problem debt restructurings and collections. But I argue that they shouldn't abandon them completely, either.

Banks' tendency to shepherd problems into herds

Of particular interest to me are those activities and choices that lenders can make to improve their performance in resolving non-performing debt and to minimize additional problematic issues. The author identifies several that my own experience confirms to be impediments or enhancements to ultimate success.

First is the human enough tendency (as well as the organizational inclination) to switch from a relationship orientation into a pooled problem asset approach.

This is the view--or at least the bias--in banking that all problem borrowers should be transformed to a liquidating mode. Forbearance is often shunned, while liquidation of assets is emphasized.

My point here is that so often the best results are those that are individually negotiated with the borrower, rather than imposed on the borrower by the bank with a one-size-fits-all template.

Our skills as relationship managers should help us at times like these--but so often they are forgotten or abandoned.

Some banks' inability to separate good, bad, and ugly

When faced with a mountain of problem assets, rather than performing credits, bankers can have two different reactions, each understandable but each potentially toxic to good outcomes.

- • "What problem?" One reaction is to engage in an exercise of chronic denial. Relatively inexperienced lenders often have no useful background to draw upon for such an assignment. They fail to act responsibly and lose valuable time unless some experienced hand oversees them.

- • "Everything's a problem." The other tendency is to slip into a posture of hard-nosed collector. This may be appropriate with certain borrowers but as a blanket approach, it's likely to be unproductive.

Lender liability can be a consequence of poor handling of problem credits. I have seen such consequences both as a workout professional and as an expert witness in support of financial litigation.

Lender liability to me is often the deliberate effort of the borrower to allege actions by the banker that represent inappropriate collection or restructuring efforts. This activity inhibits any mutually satisfactory negotiating process and can hopelessly and irretrievably make any relationship completely dysfunctional.

The lender who behaves as if he is a hammer (and his customers are nails) can unwittingly encourage pushback by the borrower. Both sides become locked in a conflict. Then little if any constructive result is likely.

There are many human enough tendencies that can contribute to this unhappy result from either side of the desk but they are not a subject of this column. Rather, my point is simply to make the lender aware of the potential consequence of an un-nuanced approach to a problem borrower.

It doesn't have to happen this way. A lender liability sort of deadlock and impasse is not an inevitable outcome. But it should be viewed as a distinct risk precipitated in part by unintentional actions of the lender.

Aim for something between "The Collector" and "The Bureaucrat"

Bank lenders can exhibit a wide variety of behavioral characteristics from being overly aggressive in developing new credit ("casino lenders") to those who are characteristically negative (highly risk averse). Either is a hindrance to good outcomes in maximizing problem asset collections.

The various behaviors in between these extremes, ranging from respectful but firm negotiating posture to asset protection and proper valuation techniques, should be carefully nurtured and encouraged by bank managers. They are ultimately responsible for achieving the desired outcomes.

The sad reality is that both the overly aggressive collector and other bureaucratically inclined can leave a lot of money on the table uncollected or unresolved. Why so many banks fail to understand this basic point is probably at the heart of why community banks often do not manage their collection results as effectively as they might.

The overly aggressive collector may resolve too quickly, while the bureaucrat often moves too slowly.

In the first instance, the borrower is often unable to negotiate a satisfactory long-term resolution and is frequently confronted with a take it or leave it approach that may include a substantial or total liquidation of assets.

In the latter case, a protracted time period is not the friend of the resolution manager. Values dissipate and the business languishes for want of remedial action cooperatively negotiated between debtor and creditor.

A lesson for lenders and a lesson for lending institutions

So, overall, a useful insight to both workout staff and executive management is to recognize that the traditional business model of generating performing assets is never compatible with an environment of dealing with a mountain of problem assets. The bank that realizes that and adapts quickly is likely to have a better resolution result.

Regulatory activity directed at the bank in the form of administrative agreements or enforcement actions are often an impediment to negotiated settlements with troubled borrowers. This should not preclude possible bank cooperation with the borrower. But it does place a high burden on the bank to develop effective if not creative resolution plans and approaches.

Going back to the book: Author Sheehan is pessimistic about finding the needed skill sets for successful asset resolution outcomes among the typical lending staff. I disagree with his pessimism.

Problem asset resolution requires skills primarily in credit analysis and negotiations. The rest of the skills can be supplied by the organization on an organic or outsourced basis.

Success does require mental agility and sound judgment. Fortunately, my experience tells me such skills and attributes liberally populate most lending staffs.

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.

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