

TURNING THE TABLES ON THE MOST IMPORTANT "C" IN THE FIVE C'S OF CREDIT—AND WHY IT'S MORE IMPORTANT

The Five Cs of Credit have been a durable way of teaching credit principles to bankers for many years. Bankers are taught that the first and most important C is Character, the overarching qualification for an applicant to receive credit. Today there are implications concerning Character for both sides of the loan desk.

DEFINING CHARACTER

The unabridged dictionary definition of character contains two notable definitions for our purposes:

1. "a distinctive trait, quality or attribute";
2. "an individual pattern of behavior—a moral constitution";

The first definition ventures into the area of morality. Today, morality can be a thicket of disagreements among reasonable people over what constitutes "moral" behavior. The second definition, one referencing a distinctive trait or behavioral attribute, is more useful for our consideration.

In the last decade or so we have witnessed individual misbehavior on an epic scale. A President of the United States impeached on an issue of personal misbehavior; presidential cabinet appointees' aspirations dashed because of personal tax issues; professional and amateur athletes' careers savaged over steroid use; inflation of corporate earnings reports to enrich the personal bonuses of executives; and stories of personal misdeeds of corporate chieftains for personal profit and personal aggrandizement. The United States Chamber of Commerce has estimated that in 2007, personal misdeeds in the workplace have cost our national economy approximately 6% of Gross Domestic Product, a number that approximates the recently enacted Stimulus Package or the Troubled Asset Recovery Program, as originally proposed for banks.

If Character is an essential C of credit, it appears that the general population is not heavily populated with persons worthy credit consideration.

Character, as a distinctive trait, quality, or attribute, conforms very well to what most of us mean by "ethics." Ethics to most of us means expected patterns of behavior by members of a group. In our case, the group is inclusive of those who borrow money from our banks. We are members of an industry with well understood and anticipated patterns of behavior. Our collective sense about what we mean by character and associated particular behaviors become a shared value within our industry. Character, to us, represents the intent to repay a debt to the best of the borrower's ability, in spite of difficulties and hazards that may be encountered in our personal financial or business activities.

Circumstances may preclude ultimate repayment of all debt. All of us are familiar with stories of borrowers who make final payment on their debts long after the lender has given up any prospect of repayment and even after the debtor has been legally discharged of responsibility by bankruptcy.

IMPLICATIONS OF CHARACTER

This is what we mean by Character and we are right to value it highly as we go about our primary institutional role of lending money to consumers and businesses. Such borrowers possessing the attribute of Character are said to be responsible. A responsible person is attentive to his obligations and repays his debts.

Actions have consequences. If a borrower is unable to repay his debt in full, his credit rating suffers as a consequence of that circumstance or fact. In consumer credit, banks understand that personal circumstances such as unemployment, divorce, and serious illness can be mitigating circumstances. And they understand that individuals can earn back a good credit rating over time. If a bank's loss is tied to fraud or other forms of unethical behaviors, then properly, that borrower's good credit rating is never restored.

Responsibility is a concept around which we as bankers (and most others too) can have complete agreement. Certain behaviors are universally regarded as responsible, while others are universally regarded as irresponsible.

TURNING THE TABLES ON CHARACTER

Now, while we're having this discussion about responsible behaviors and their relationship to the repayment of debt, what responsibilities do bankers have toward their borrowing customers or to the institutions for which they work? Is the character discussion completely one sided?

As lenders, we have arguably lost our way in recent years on what are reasonable and prudent risks to place in the loan and securities portfolios of our banks. How else can we understand the pervasive sense of unease that many of our banks may be insolvent due to imprudent lending and investing? A healthy economy requires healthy banks to lend money and to clear our streams of check payments. There exist now systemic risks to our banking system that are man-made, and not faults of the system's architecture.

We've been talking about Character as the prime metric of a worthy borrower. How about including Character as a prime metric of a worthy lender? Lenders have to be worthy of their responsibilities. There are right ways to lend money and wrong ways. There are also responsible ways and irresponsible ways. We've seen way too many examples of wrong and irresponsible in recent years.

As responsible bankers we have to believe that what we're doing and the way we're doing it are right. We have to choose to do the right and prudent thing.

Otherwise, our behaviors tend to produce "lowest common denominator" results. Our balance sheets are in relative terms leveraged—leveraged with the debt we owe to our depositors. Our obligations run no less to the depositors, borrowers, and our stockholders.

We are in the process of rebuilding our businesses and our reputations. Let's put Character squarely back in the lending vocabulary and make sure that it's properly represented on both sides of the lending desk.

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 a frequent speaker in ABA's Bank Director Telephone Briefing series. You can hear 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.