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The Ten Commandments of Commercial Lending

In the current credit crisis, it is helpful to remember some rules for lenders to live by. I can only wonder if we would even be talking about a credit crisis had all lenders used these rules before now.

I was recently asked to do some training for new loan officers at a community bank. While I have done so many times at various banks when I was employed in the banking industry; I had exposure to trainees over extended periods so I could assist them with specific situations as they occurred; incorporating the training in a sort of case study method. The challenge here was to concentrate the training into a compressed period of time yet make sure these new lenders got the tools they needed to be very productive from the outset. In my career in banking and later as an expert witness, I recalled all the parables I was taught (and later taught to others) that really can't be found in one place, if at all. To, as best I can, consolidate all that I have been taught by some of the best bankers across the country in some sort of compressed format; I thought I would take the ten most important rules that guided me well over the years. So here goes…my ten commandments for commercial lenders (in no particular order).

1. Follow the Money

One thing that helps any lender separate out a good loan from a bad one is to simply "follow the money." Understand where your money goes from the time it leaves your hands until your loan gets repaid. Normally, for business borrowers, this is a simple way of describing the cash conversion cycle of your borrower. My distinction is you need to know exactly where the proceeds of your loan will go, step by step, until the loan is repaid for each and every loan you make on a case by case basis. Although it could be a separate commandment, since it relates to this topic, I will include here. Never put any extra steps between you and your primary source of repayment.

2. The Three M's of Credit

Everyone knows the five C's of credit and they are very important in any commercial loan but don't lose sight of one of your most important jobs as a commercial lender. What are the three M's? Management, Management, Management. Your assessment of management's abilities is critical. A poor management can take the finest business and balance sheet in the world and run it into the ground. Make sure you feel that management is competent.

3. All Bad Loans Are Made During Good Times

What is the difference between a bad loan and a good loan that later becomes bad? Lending is a risk business and loans are sometimes referred to as risk assets. Lenders are paid interest on loans at some higher interest rate than those of Treasury Bills because they are and should take some risk. Good lenders, as much as possible, identify and quantify the risks they are taking before making a loan. They then decide if the risks can be mitigated through structure, collateral, guarantees, etc. to where the prospective loan exhibits an acceptable level of risk. If so, the loan is approved and, to the extent possible, is a good loan. This same good loan made by a good lender sometimes goes bad. Our current poor economic situation gives many examples of how that can happen; bad economic conditions, sudden illness or injury, acts of God and other things can turn a loan that was good when made into a problem.

A bad loan is a loan when, at the time it was made, deviated from long-standing, successful underwriting standards. Usually, this occurs during periods of economic prosperity, boom times. Things are going so well that aggressive, poorly structured or "sales/growth" oriented loans are either paid or bailed out. When the economy turns down these bad loans are exposed for what they are…bad loans when made. Hence, most bad loans are made during good times.

4. The Collateral is Never There When You Need It

Contrary to what you might think from reading the paragraph heading, this section has nothing to do with loan fraud or diversion of collateral. It is simply a fundamental concept of lending. Placing too much reliance on collateral as a source of repayment to justify other weaknesses in a commercial loan is a fool's promise. When a commercial loan begins to exhibit problems causing the lender to re-evaluate the collateral position; it, very often, occurs because the borrower has already attempted to liquidate the collateral and has been unable to do so. If the loan was properly underwritten to begin with; the lender has already assessed management as experienced, capable and having a successful track record. If the lender's initial judgment of management was correct, the lender thinking it can liquidate the same collateral at any reasonable price that an honest, experienced management could not is delusional especially if the borrower's difficulties are the result of industry wide conditions.

5. People Are Going Broke Today That Have Never Been Broke Before

Almost no one asks for a loan at the same time they are thinking that a business or venture for which the loan is needed will fail. People who request a loan fall into three categories: cautiously optimistic, optimistic, and wildly optimistic. Hopefully, all of these people have many, many years of current or past experience in the line of work for which the loan is requested. The lender's main responsibility, using the 5 C's, my 3 M's or these 10 Commandments; however, is, to the extent possible to predict the future. While all the previous elements are most certainly important; the ultimate question the lender must ask themselves is "Do I think this project (loan request) will be successful?" The lender must take into account their broad range of experience with other current or past borrowers in similar situations and whatever intelligence they can gather from similar borrowers about prospects for the future. A requestor's successful experience thirty years ago does not guaranty similar success in the future. <u>Although no one can accurately predict the future, lenders must give it their best shot to be successful</u>.

6. Yes or No

One of my favorite commandments has to do with the range of responses a lender has (or doesn't have) in granting a loan request. First, some advice to borrowers.

A popular myth among some borrowers is to artificially inflate the amount of a loan request so as to prepare for a lender's offer to make the loan at a reduced amount. My advice to borrowers and lenders---Don't do it! It's okay to allow some margin for contingencies much the same way as is provided for on the contingency line of a construction loan budget but any loan request that is artificially inflated for any reason is a huge red flag to any good lender.

My advice to lenders is to <u>say yes or no to the loan request but definitely not "I can only lend you 50%."</u> Here's why. A cardinal principal of lending is to either grant a loan request in full or deny the request entirely. This is a proven and time-tested principal used by every knowledgeable loan officer and properly administered lending institution. It is also based upon decades of experience, simple logic, and motivation to protect your own loan. Simply stated, this principal says a lender's response to a $1 million loan request should only be yes or no. If a borrower requests $1 million and the lender, in its due diligence, determines that only $500,000 was necessary to complete the project for which funds are being requested; then the applicant has misrepresented to the lender, is untrustworthy, and should be denied credit. If, on the other hand, the lender's due diligence reveals that the borrower truly needs $1 million to successfully complete its project yet lends only $500,000; the inescapable path is that the borrower will be unable to complete its project successfully and will inevitably experience financial difficulties only now having done so with $500,000 of the lender's money!

<u>7. Asking Questions Is Not A Sign of Weakness</u>

Sometimes lenders are reluctant to ask questions for fear of looking dumb. Wrong! There are really two distinct situations that fall under this heading; questions of co-workers and questions of borrowers. For either possibility, not asking questions is dumb and dumber.

Trust but verify. Lenders should always spend a reasonable amount of time interviewing borrowers at their place of business and/or the project for which funds are being requested. There is no need to fire questions at a borrower like Machine Gun Kelly but a pleasant conversation about the borrower's history and current situation/problems will tell you a great deal about whether the loan should be granted or not. Also consider the natural consequences of making a loan to a borrower who cannot answer reasonable questions about their operations.

Second, most lenders will, invariably and eventually, run into a situation for which they are not previously and thoroughly experienced. Every borrower, industry and loan type has its own peculiarities, customs, and practices. Some lenders will be reluctant to ask questions of superiors, subordinates, peers or industry counterparts because they might somehow be perceived as less worthy. Not asking questions of another lender or someone more experienced in the borrower's industry and loan type results in the lender taking unanticipated risks, higher credit losses and the lender will then surely be perceived as less worthy.

<u>8. Murphy's Law Applied To Lending</u>

Remembering Murphy's Law ("Anything that can go wrong will") can be critically applied to lending. There is not a single business I can think of where, since its inception, it has not hit a bump in the road. Big companies, small companies, public companies, well managed companies; every company experiences a situation where something doesn't go according to plan. If the lender did proper due diligence before making the loan and had a comfort level with the loan situation before; a minor hiccup can be expected somewhere in the relationship and, when it happens, does not instantly turn your borrower into crook or a deadbeat. Of course, the lender must determine if any problems are a hiccup or a major sea change attributable to or not able to be handled by the borrower. If it's not a hiccup but a major sea change---skip to Commandment number 10!

9. Lending Is Not A Profession For People Who Need To Be Liked

Some of the very best lenders yield a net return on assets of about 2%. This means that for every $1 million mistake a lender makes; their next $50 million in loans must be perfect just to break even.

We all want to be liked, and the desire to be liked can cause inexperienced lenders to make popular decisions rather than the right decisions. Definitely with respect to borrowers and even with respect to co-workers, it is sometimes necessary to say no! No to a borrower's loan or no to a request for concurrence/approval from a co-worker. It is reasonably certain, even in just the short term, that saying no will not make you popular. If it is more important to a lender to be popular than correct, that person should immediately look for another line of work.

10. Your First Loss Is Your Best Loss

This is the oldest of the commandments that I know. When a borrower experiences significant difficulties that should have been handled or should have been anticipated but were not; it's time to cut your losses. Trying to salvage a small (or big) charge-off to avoid embarrassment, in the hope that "things will get better," the source of the problem can fix the problem, a wave of the magic wand or another lender will bail you out or many other reasons will only result in a bigger loss down the road and is sometimes even illegal.

These Ten Commandments have been handed down to me since the 1960's from lenders who received them even earlier and, I hope, they will be useful to you. If you follow their common sense logic; I am confident you will be a successful lender.