Five Principles for Developing Better Loan Officers

By William J. Hass, CTP and Shepherd G. Pryor IV

Two questions have plagued bankers for years, how to train bankers, and how to have them use the skills that they have been given through the training.

Different Banks Have Different Needs

Officers are trained and developed in banks according to how their banks plan to ask them to pursue their jobs. At one end of the spectrum, the relationship manager is a full service banker. This banker calls on the customer, solicits business, analyzes credit, negotiates agreements, monitors progress, and may even become the workout officer, should the need arise. At the other end of the spectrum, the banks have fragmented the job, creating a series of specialists to handle the needs of a complex banking relationship with the corporate customer. We sometimes hear the phrase: "finders, minders, and grinders" referring to the various job categories in this type of organization.

Both types of banking organizations are subject to periodic bad loans, as the business cycle intermittently punishes the business community for collective overcapacity. When the cycle causes bad loans to rise quickly, senior bankers are always surprised at how unprepared the cadre of younger bankers are to deal with the pressures of a rapid decline in both cash flow and collateral values in their customer base. What they frequently witness is less experienced bankers lapsing into disbelief at these declines.

Unfortunately, some banks witness something like a thermal inversion among the bankers: the younger bankers fall into denial, while the older ones are trying to snap them out of it. This bogs down the necessary process for recovery. What is needed is rapid action to determine the damage in the portfolio, and to identify accounts where timely and decisive action can save the bank's resources and reputation.

However, the denial and the infighting over credit quality, and the clash of officers hoping that "things will get better" with credit decision makers convinced that many of the accounts must be written off, frequently get in the way of progress. One helpful safety valve in many banks is the practice of shifting workout loans to a special unit, away from the protective influence of those who wrote the loans. This helps to remove the conflict that arises due to pride of authorship and to career protection reflexes that obstruct the necessary objectivity that workout decision makers should exercise. Yet, depending on how the bank is organized, interdepartmental profit and loss statements and incentives may get in the way of early identification and action.

The big questions are: (1) What causes delays in recognition of bad loans and starting to work them out? (2) Why are young account officers so unaware of the reality of bad loans? (3) What can be done to prevent it?

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(1) What causes delays in recognition of bad loans and starting to work them out?

There is no simple answer to this question. The problem comes from the interaction of a number of factors, some structural, and some individual. However, the central theme is that any stigma attached to bad loans will serve as a disincentive to recognize a loan as "bad" until all local remedies have been exhausted. In an organization where account officers individually cover all of the bases, a bad loan may be reckoned to be an individual failing. After all, the account officer "was responsible" for all aspects of the loan, so when it goes bad, the officer is an easy target for criticism. This may occur even when bad loans abound in the economy. It is still the individual officer's loan that has gone sour. This system gives strong incentive for officers to deny problems in their portfolio. Nothing (that I can't fix) is going on in the portfolio. Requests for more money by ailing borrowers are championed for too long by officers in this type of system, because it prolongs the uncertainty, and pushes out the day of reckoning. Better training and education regarding when to call independent advisors may help.

Experienced and confident officers in such a system may have no problem in signaling problems and moving ahead with appropriate solutions. However, the officer must have a storehouse of organizational credibility, before even he or she can be that objective. Experience is often an expensive way to learn.

At the other end of the structural spectrum, in the land of the minders, finders, and grinders, there is a whole roster of names connected with each credit. In fact, there are so many names that officers can fall into the "blame game" deftly tagging everyone but themselves with any responsibility for having "made the bad loan." Because this personal safety valve may be too easy to activate, there may be no one with adequate incentive to focus on the flagging borrower's problems and start the right processes within the bank.

Apart from the structure of the account officer function within the bank, the accounting treatment of loans can have an impact on the workout process. If workout accounts are shifted to a separate unit, what happens to the profit/loss from that account? When the P&L impact stays with the originating group, they will be motivated to make good loans, but not necessarily to transfer bad loans to the workout section, where they can no longer manage the cost of contact with the customer.

Finally, it is worth making a comment about the real ability of an individual account officer to avoid making bad loans. Most any senior credit officer of a bank will agree that a portfolio with no bad loans is a sign of missed opportunity. Banking is a business that makes its money by accepting prudent business risk. In an economy that fluctuates, the normal expectation is that there will be some percentage of loans in the portfolio that go bad. While it is clearly in the bank's interest to minimize the losses for a given portfolio, Tightening the risk parameters too tightly cuts off more profit than risk. (An analogy is a city government trying to wipe out crime. For a reasonable cost it can reduce crime, but wiping out the last vestiges of crime are more expensive in the aggregate than picking up the pieces and repairing the damage of the crime that goes unprevented.)

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A realistic, but uncommon way to understand the job of the bank account officer (or lending team as a whole) is as follows: The account officers can perform credit analysis on the individual loans and customers in the portfolio. However, they are analyzing the risk, and not predicting the outcome of the individual loans. Management may elect to lend at a level of risk where a certain "X%" of the loans will go bad during the next business downturn. The account officers may be able to predict which loans might have a higher risk of failing, but they still will fall short of picking which individual loans will go bad. Indeed, if they could do that, they would not make those loans, and there would be no risk. Unfortunately, it is convenient for management to ignore this truth about lending, and blame the account officers for individual failings. This takes heat of the management decision to accept the aggregate "X%" losses. Explaining that to the board can be uncomfortable compared with explaining the failings of the account officers. Yet all boards understand that some normal level of losses will occur. The issue is having everyone educated so as not to throw good money after bad.

(2) Why are young account officers so unaware of the reality of bad loans?

Younger officers are frequently frustrated at the resistance they encounter when trying to push for the acceptance of "creative loans." This is often symptomatic of the lack of experience of the younger officer colliding with the matured judgment of the older and more experienced credit decision makers. The credit officers, though have arrived at this stage because they have witnessed the melt down of collateral values and widespread business failures that can plague an entire industry when a recessionary downturn occurs.

Let us look at the part of this problem that the account officers bring on themselves. Account officers (whether individual or as members of various lending team activities) are responsible for determining the cash flow and debt capacity of the borrower, and also for structuring the debt to minimize the bank's loss potential. These are both areas that call for judgment and experience. For decades, banks have tried to systematize these two areas of judgment, to eliminate errors. However, the adaptability of corporations, the shifting value of collateral, and the changing nature of markets has continued to defy these efforts.

Let's take these issues one at a time. Cash flow analysis is only as good as the data that goes into it. In the past several years, we have seen that artful CFOs can warp their presentation of historic cash flow through creative accounting, a number that was previously thought to be immune to tampering. Further, the process of determining debt capacity relies on predicting cash flow, which relies on assumptions about the future. Even the brightest and most analytical account officer will have to be a veteran of many cash flow predictions before gaining an understanding of their ability to disappoint. Mechanical sensitivity testing can be done on assumptions, but a matured sense of which variables might move together, and just how far they might move is critical for doing it well. It takes years to develop experience in judging cash flow projections, the "personalities" of the managers that produce them, and the characteristic patterns of more than one industry.

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Loan structure is part of the competitive arena that bankers must learn to play in. If a customer does not like the offered loan structure, it may be that a competing bank will offer one more conducive to the tastes of the borrower, and the bank may lose a viable customer. "Vanilla" structures become more and more difficult to negotiate, as borrowers connect with each other and learn about the newest twists that they are able to negotiate in the market. New account officers introduced into this process may be unequipped to analyze the impact of the various covenants and structural nuances of the agreements. They often make assumptions that are not well connected with reality, primarily because they have not seen the collapse of such agreements when the business downturn hits. The same trap lies in collateral valuation. Newer account officers are more likely to opt for "going concern" types of valuations of collateral, ignoring or arguing against even looking at liquidation values. Again, officers who have been through a recession have probably seen collateral values dramatically melt down in some market, and are more likely to be skeptical. The skeptical banker looks more diligently for alternative sources of repayment and mechanisms for protection. The skepticism makes competing more difficult, as other banks may be willing to ignore some of the fundamentals, but it pays off in better control over losses going forward.

(2) What can be done about the problems?

We started with a simple problem: How can we educate new officers to prevent them from making old mistakes? But, along the way, we find that it is not simply a new officer problem. The outcomes result from the new account officers working within flawed systems. To get to the root of the problem, we need to prescribe medicine for both the front line officer and bank management.

Let's start at the top. Banks generally want to recruit and retain high quality bank officers. Hold them accountable for what they can control and give them an atmosphere where professional development includes learning, which allows the officer to make mistakes. (Build in processes that avoid big mistakes.). **Principle # 1:** Do not stigmatize officers with bad loans, unless there is a specific error that is found in what the officer did in making the loan. Bad documents, or bad fundamental analysis may mean bad account officers. Bad loans do not necessarily mean bad account officers. Take the management time to distinguish, and then be clear about who is being put in the penalty box, and why.

A critical issue for banks facing workouts is getting the bad news to the top of the bank as quickly as possible, while there may be time for bank decisions to materially affect the outcome. Strong adherence to the bank's loan rating system can be a help in this area, but it is the changes in loan ratings that are important in identifying problems. **Principle #2:** Changes in loan ratings need to be singled out and brought to the attention of senior management early.

Principle #3: The cure in the account officer ranks is in training the pre-recession banker to think like a post-recession banker. Trust, but verify. The tremendous growth in asset based lending is a good example of "trust but verify." Monthly collateral audits help to

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ensure vigilance and may reduce the "temptation" for more creative accounting. The use of third party professionals may be helpful in spotting more than changes in collateral.

Account officers should be taught: Be objective. Don't let pride of authorship of a loan structure impede your ability to see when the customer can no longer live with the covenants. Do sensitivity analysis with meaningful changes in variables. Ask the really tough questions. Compare the business resiliency of the prospective borrower with others in the portfolio. Ask, is this really a loan that belongs at this risk rating, or should it be rated worse, and hence structured more conservatively? **Principle #4:** Teach bankers to understand and identify the factors that "precede" change in loan ratings.

Factors that Precede Financial Indicators and Loan Rating Declines [[[Sidebar]]]

- Ineffective management
- Leaders without a realistic vision or plan
- Industry decline or shocks
- Quality problems
- Reputation issues
- Aggressive or new competitors
- Operational problems
- Growth of a low return business
- High management turnover
- Complex financial structure
- Unproven business model
- Conflicts within management/ownership group
- Weak accounting systems

War Story –Complex Loan Structures Have More Risk

I once inflamed a whole room of bankers by declaring that the structure they were offering would be elegant and workable only in space, where it would be insulated from having to stand the test of gravity. On earth, it would collapse of its own weight. Sadly, the borrower was on earth, so I could not accept the structure. Bright, inexperienced bankers may be able to knit together complex fabrics: agreements and contracts that would cover each objection of the lenders, just in time, as each prospective problem would arise. However, the same banker may lack the experience to know how strong each of the seams actually will be and with what impact each rising problem will collide with the fabric. -- Former Senior Lender

A more detailed prescription for education of younger officers

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New account officers cannot merely be told to act like they had more experience. This is an area where training can be significantly valuable.

A specific orientation of the credit training that is suitable for newer bankers in this volatile environment is analogous to looking through the "large end of the telescope." The missing link for most new account officers is that they come in through the marketing doorway of the bank, and they do not see the workout section and its eye-opening realities until far down the road. If they are visiting the workout or special assets section because one of their loans has gone bad, it is probably only the first of a series. If they have been systematically doing something that would produce future bad loans, the future (and perhaps a new career path) would be staring them in the face.

The valuable perspective that the workout section has is its more realistic view of collateral values, at the time of the business failure. They see whether the collateral would have a value "independent of the business" or not. They have first hand experience with the distinction between primary and secondary sources of repayment, their interdependencies and their strengths and weaknesses. New lessons are learned day by day in the workout sections of banks. While management would typically like to see those lessons learned throughout the bank, it is rare that a systematic feedback loop of lessons reaches the account officers who need it most.

Principle #5: Expose new loan officers to bad loans in a safe environment. A good exercise for account officers in a training environment involves tearing apart a number of bad loans from the standpoint of how they were made and monitored. Loan officers should seek the lessons and the wisdom in each of the situations that they study. They should not be looking for villains or fools, although they might find them. If the officers are trained to look objectively at the process of lending and to become students of the process of identifying bad loans early, their chance of reaching excellence will be much greater. Their professionalism and enthusiasm for the career path will grow, the bank's retention of its officers will improve, and exposure to potential failed situations will be reduced..

Five Principles for Loan Officer Education on Workouts [[[SIDEBAR]]]

1. Do not stigmatize officers with bad loans, unless there is a specific error that is found in what the officer did in making the loan. Bad loans are part of doing business.

2. Changes in loan ratings need to be singled out and brought to the attention of senior management early. Early focus and action reduces losses.

3. Train pre-recession bankers to think light post-recession bankers. This includes building a philosophy of "trust but verify" into the loan monitoring process.

4. Teach lenders to understand and identify the factors that precede changes in loan rating declines. Financial results predictably follow strategic and operational changes.

5. Expose new loan officers to bad loans in a safe environment. Education builds trust

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and confidence, critical to loan officer development.

To expose loan officers to techniques to identify and handle bad loans early, and to give them an opportunity to learn from the experience of others, the Turnaround Management Association has developed a variety of educational tools and workshops for lending officers with over two years of experience. These include:

The Troubled Loan Workout Guide[1]: this 60 page educational guide includes a wealth of the information on early-warning factors as well as the five stages of a typical turnaround. The five stages[2] are

1. analyze the situation: identify the core business
2. stop the bleeding
3. change management or “change” management
4. restructure the business and legal contracts
5. return to normal

The Troubled Loan Workshop -- Basic Version: This one day learning experience provides an overview of the troubled loan experience from early decline to bankruptcy. A morning lecture is enhanced with an afternoon case study and simulation appropriate for the audience.

The Troubled Loan Workshop in Early Decline: This one day Workshop focuses on identification and negotiation of the work out before a crisis forces a bankruptcy. The afternoon portion of the workshop features a case study which involves negotiation between lenders, a turnaround professional, and company stakeholders.

The Troubled Loan Workshop in Bankruptcy: This one day learning experience focuses on pre-bankruptcy preparation and negotiations throughout the bankruptcy period. Current topics in bankruptcy, such as DIP loans, 363 sales, and critical vendor agreements are often discussed during the morning session. Then in the afternoon, a case simulation allows participants to test their negotiating skills throughout the bankruptcy process. A bankruptcy judge often participates.

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*Hass and Pryor are co-authors of the book "**Board Perspectives: Building Value through Strategic Planning, Risk Assessment and Renewal**," to be published in Fall 2005 by Commerce Clearing House.*

[Photos on file with Cecilia Green.]

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[1] Contact Laura Ivaldi at the international offices of TMA for information and a copy of the Troubled Loan Workout Guide.

[2] The five stages are adapted from Don Bibeault, Corporate Turnaround: How Managers Turn Losers into Winners, New York, McGraw-Hill, 1981.

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