Credit Risk Ready Podcast

Host Linda Keith, CPA, With Michael Wear

The First 'R' of Triage Outcomes: Rehabilitate When Your Borrower is Expected to Recover

Hi, this is Linda Keith, CPA, with Credit Risk Ready, a podcast where we interview senior credit and lending professionals from community financial institutions across the United States, their regulators, and banking advisors to better understand and mitigate credit risk.

Now the concept of loan triage for problem loans is a hot topic during the pandemic-induced recession. Our guest today, Michael Wear, will help us zero-in on one result of the triage: rehabilitate. The borrower is expected to recover. How do we recognize a problem loan that can be placed into rehab, what does the conversation sound like, and what tools do we have to help?

Michael Wear is the owner of 39 Acres Corporation, specializing in banker training, bank consulting services, credit risk underwriting, and long portfolio risk management. 41 years in banking, about the same period of time I've had my business and bank training. Mike retired as a senior analyst in the credit risk administration department of a $23-billion community bank. He developed and conducted credit training programs and he currently consults on customized credit analytics, effective prospecting, and loan portfolio risk management strategies and tools.

Now, Mike, I know a lot about what I know a lot about, but you know about a whole bunch of other things. So please help me welcome Mike to the podcast.

Michael Wear:
Thank you, Linda, pleasure to be here.

Linda Keith:
So glad to have you. Now while this episode focuses on rehab, what are the other two 'Rs' that we might uncover in triage and that we do, in fact, cover in two other episodes of this podcast?

Michael Wear:
Yeah, more to come. Rehabilitate is where as a banker, after we look at the prognosis of the borrower, that we feel that they can pull out of the external environment that is causing an economic recession.

Second tool is restructure. That's where we believe the borrower just needs some help and by restructuring the present debt, that could be with or without lending additional money, we believe that will help them pull through as well.

Then remove is the third 'R' and that's an unfortunate one, but we do need to make that decision. That part of loan portfolio triage is to identify those businesses that given the economic circumstances, given their capital adequacy, given their liquidity, position, and their ability to obtain external financing, we have a hard decision to make sometimes. So those are the three 'Rs.'

Linda Keith:
It is a hard decision, isn't it? We don't get into this business to have to say "no" after we have said "yes," right?

Michael Wear:
Yes, but our primary responsibility is the capital preservation and growth for the bank, not the borrower. So we have to always keep in mind who we are working for. It is difficult sometimes, but it's much easier to talk about these things early than late. You only have maybe a couple of choices, such as changing the locks or changing the borrower.

Linda Keith:
Yeah, yeah. Well, and I'm looking forward to that episode, because there is a lot to unpack, actually, in both the episode on restructuring and retiring, and so how soon do we need to figure out which it is? Is it rehab, restructure, retire? When is too soon?

Michael Wear:
There is no "too soon." It is not too late to start, but it is later than you think and here's why. Just like a funnel, you have a lot of options initially. As you proceed through the funnel, it narrows down to, potentially, as I mentioned before with remove, just a couple choices and neither one is fun. So, looking at this holistically, factually, but also empathetically for the borrower's position, the time is now and we will do our borrowers a disservice if we wait too long.

Linda Keith:
Well, and sometimes that whole remove option, it actually is also better for the borrower to do it sooner than to wait until their credit is destroyed and they run through their retirement money and everything else trying to save something that actually, if you've been able to connect with them early on in conversation and so forth, you both would have realized that it needs to unwind.

Michael Wear:
Correct. And unfortunately, I've been called in by other creditors, including the US Small Business Administration, to look at businesses and in many of those cases, it's too late. Nothing I can do.

Linda Keith:

Nope, no, too late and a lot more damage than maybe had to be handled.

Michael Wear:

Yes.

Linda Keith:

Well, so, let's move back to of the three, the happier version, which is that we have a borrower who, yeah, there are some challenges, but as the regulators have said, we get to use prudent judgement to work with borrowers who have short-term set backs. And I don't always know what prudent is, or even, what short term is, or even if we can tell, but if we are in a situation where rehab is possible...

I've never actually had a situation where I, as a borrower, need rehab thankfully. My husband was in construction, so I was the CFO if his company and I have my company and we are real estate investors. I am in rehab for lumbar disc degeneration and resulting left-side radiculopathy, which sounds to me like a Harry Potter term, but I'm not even going try to talk about what that really means, but here is what I know. I need to trust my physical therapist to know what I need to understand and to do to recover.

So Mike, how is a lender just like a physical therapist when it comes to helping a borrower through rehab?

Michael Wear:

Well, without violating any more HIPAA rules, the relationship between banker and borrower is so critical. If we look at it from just the borrower standpoint, how important is the banker? Well, number one they have their livelihood at stake, their income. They also may have their family's income similar to you and your husband. The entire family's income is derived from that business and, even more importantly, they may have their retirement all wrapped up in the future sale of that business. And then looking longer term, this might be their legacy. It might be the legacy handed down for multiple generations to them. It might be their children's legacy. So, we need to really take into account how serious these discussions are no matter which path is decided upon and treat the borrower with empathy and respect and communicate effectively along the process.

So, to use your analogy as a physical therapist, we will call the banker a financial therapist. The first thing is to accurately diagnose the problem. And if you don't accurately diagnose a problem and sometimes those problems are ones that the borrower does not want to hear, such as they lack a succession plan. They have not put away for the rainy day. They've spent too much money on equipment that isn't producing enough revenue. Tough, tough discussions about those decisions. So, the first step is the accurate diagnosis and then options. And the banker should take into consideration, not just the short-term results of the options, but also are they congruent with the borrower's long-term strategies and goals? Such as if they are looking to sell the business in five-to-10 years. If we are looking at a

10-, 15-year amortization on a real estate loan, we are definitely taking that into consideration or should take that into consideration.

The second thing is to use your skills to not only accurately diagnose, but also use your skills as a banker to learn from what has worked and maybe what has not worked for other borrowers. Just as a doctor would gain from his or her experience of what has worked or has not worked so well in physical therapy, using your analogy.

And in third is the continual communication and evaluation along the way, because a borrower's situation can change. The macro environment, as we've seen in the last six months, has changed so much, so quickly. And there's longer-term underpinnings of change as well. So we have to take all of that into consideration. And hopefully the borrower/patient here, using your analogy, will pull through and come out stronger than ever and cognizant of the value that the banker has helped them with throughout this time of trouble.

Linda Keith:

Well, you know the Chinese character for danger is crisis and opportunity. We certainly are in a crisis, but there are so many opportunities and one of the ones that really stands out to me is the opportunity. This is for you to call your business borrowers and have conversations, which in this environment they will see as helpful and in a previous environment they might have wondered, "Why in the heck is the banker calling?"

Michael Wear:

Oh, exactly, and that should not be a surprise because the banker should be calling the borrowers and talking to them periodically, not just when times are tough.

Linda Keith:

Yeah, absolutely. Well, let's go through your steps then, because I love these steps. Let's go back to diagnose for just a moment. What are some of the first steps to even get an accurate diagnosis as to whether they are in trouble at all, and if they are, is it rehab, restructure, or remove?

Michael Wear:

Well this recovery… we've heard of the V shape, the very narrow V, and again, we are technically in a recession. And it might be short-lived using gross domestic product as the traditional definition. But remember, the committee that officially calls recessions called it before two consecutive quarters of GDP loss occurred, so they called it early. So is a true V? Or, I believe, it's more like a lower-case k.

Linda Keith:

I've been hearing that.

Michael Wear:

Where you do have a very good recovery for some industries and businesses? They won't be able to replace that revenue, but they won't be damaged permanently because of it. It will hurt in the short run, but they will come back. They may not come back to the full extent, hence the shape of my analogy. And then there's going to be some industries and some borrowers that will definitively feel the affects for a much longer period of time and may not come out of it.

Linda Keith:

Right, so we got to try to guess the shape of this. I will say we've had an economist on the podcast. He was going for an upside-down square root sign, which would be it will come back, but not as high for quite some time.

Michael Wear:

Concur, concur; there is some permanency to these economic winds.

Linda Keith:

Right, I mean I should have just set the stage for our listeners because someone might be listening to this podcast later. We are doing this interview in September 2020. We are trying to reopen states. We are trying to reopen schools. Some of the states are then backing off of that. We are having the repercussions of Labor Day and summer weddings. So, we are still in a heightened state of uncertainty. And there's no real indication, in my view, I don't know, maybe you have a different idea, Mike. I don't think there's really a good sense of when the uncertainty will abate.

Michael Wear:

No.

Linda Keith:

We don't have a vaccine yet. We don't know when we will have that. So there's so much uncertainty that even a company that has pulled it off so far, that you would diagnose maybe last month as being in pretty good shape, give them three more months of this and they could be in a very different place. So, it's not only initial diagnosis, but how often do you have to go revisit the loans you already have in your portfolio?

Michael Wear:

Right, and that's why I'm recommending to all my banks that I'm consulting, as well as my students out there, part of this triage is to do modeling. In other words, look at a worst-case scenario based upon what's happening in that industry and what the prognosis for that industry is. Obviously, restaurants: immediate, but there's a lingering effect of the lower occupancy standards required. That's going to run for several months at the very minimum. Hotels: obviously, those that are very much dependent upon business travelers, conventions, large gatherings of people, sporting events even. So, there are some industries that absolutely have been hammered by this and the prognosis, short-term, is not that great.

So modeling has to take into account the industry trends, but also the ongoing effects of these consumer change of behaviors. Because remember, the GDP is 68- almost 70% consumer spending. Look at your main street businesses. How many of those depend on consumer spending? So, one thing I've been asking everybody is really be cognizant of your local unemployment lingering effects after the hire-backs. I know many, many businesses that are not going to hire everybody back. They are going to have some permanent unemployment levels. Federal Reserve is estimating that at the end of this year nearly 10% unemployment. We were at under 4% as a nation going into this pandemic quarantine, economic quarantine, so there's definitely some permanency going on and that's where looking at this now, not when your borrowers hit the past due or overdraft report.

At my bank that I worked in, as well as in my viewpoint, it's too late. The damage is often greater than we expect, too. So, I would say, let's look at not just historical financials as a backdrop, but we have to talk to our borrowers as to what they expect and work their projections into our modeling. Then also look at our projections based on what we see and research for those industries as to the timing and severity of the impact on the businesses themselves. We need to do that right now. And, for everybody, that is a significant concentration for the bank, whether C&I, CRE, even ag. There are some definitive waves of this economic tsunami or headwind that affects almost every business. So this one's unique, obviously, but it's also localized where we have to look at the impact on a local basis. Not so much on the national, other than if you are lucky enough to have a customer with a national marketplace.

Linda Keith:

So, when you look at the modeling, two things come to mind. One is the very kind of questions you ask your borrower to think through your model. They are extremely helpful questions to them because if they haven't thought of those questions yet, it might make them realize, "Oh, I guess it would be good if I could figure out at what revenue level I have to lay off people before I have to do it." So, the very questions we ask them might also help them do some of this contingency planning that is so critical right now.

Michael Wear:

Absolutely, and it helps your loan write-up because you can then say, "Lender has asked the borrower about this adversity and borrower has already addressed this. Here's what they did." It shows that the borrower is proactive in that case, so it could go either way. It could be a shock to them that they didn't see it coming and catching it early is good or it could also be a ratification of that capital 'C' of character in the five 'Cs' of credit.

Linda Keith:

Right, right. Well, and then when you include this in your write-up, seeing that we are having to look at so many loans right now, you know we are not required to remember those conversations because you have done a good job. So, I guess, if we talk about how important it is to document your thinking and document your conversations, it's way more important now than it has been in recent years.

Michael Wear:

Oh, absolutely. Again, you look at loan loss reserving for banks. We are moving from a historical loss perspective to a forward-looking modeling.

Linda Keith:

Perfect timing.

Michael Wear:

It is. It's unknown territory and the same thing with the regulators. They don't know what's going to happen any better than us but we know our portfolio better than they do. So, this is the time to talk with our borrowers and address these rehabilitation tactics that we can do.

Linda Keith:

Well, and the regulators have told us they will not criticize us for prudent judgement, but we have to document well enough that anybody, including us, our loan review; us, the loan originator loan review; but also the regulator, can actually see there was prudent judgment. Because we have written down what we were thinking and what information we gathered to do that.

Michael Wear:

And they are going to measure the effectiveness of our responses. Not just did we respond, but the effectiveness of it. They are going to be watching us.

Linda Keith:

Well, as well they should. If they don't watch now, when should they be watching, right?

Michael Wear:

Exactly.

Linda Keith:

Exactly. So, these are some specific ideas about rehabilitation, which is borrower's in a little bit of trouble, but we think they can make it through, both in terms of how we diagnose, what kind of conversations that we have, and how we determine and write down what those judgement calls are. And really some specific steps: diagnosis, skills, and then communication, that will keep us in the loop with those clients and continue to help them through. And, I suppose, spot it as quickly as possible when rehab is just not going to be enough.

Michael Wear:

Right. For alternative financing, I have two main goals. Number one, try to increase the borrower's cash flow while concurrently decreasing the risk to our institution. And it can be done.

Linda Keith:

And can that be… I know that would certainly be a restructure step, but if you're in the rehab space, maybe it's not that you need to restructure. Maybe there simply needs to be some additional financing for a short period of time to get them over the hump.

Michael Wear:

Correct, and you mentioned it earlier, Linda, where there is adversity, there is opportunity. We saw how community banks across the nation were the first economic responders under the PPP program. At this time of this podcast recording, we are going through the forgiveness stage of these PPP loans.

Linda Keith:

Exactly.

Michael Wear:

That's evidence right there that there are opportunities. This would be an excellent opportunity for somebody to do a merger or acquisition, perhaps, as a borrower. Expand market presence either through the local market and marketing or to expand into different markets. Gain efficiencies through technology as we are using online meetings now and things like that. There might be ways to gain efficiencies in their sales process using new technologies. There are so many different things about rehabilitation. Obviously, these are the three 'Rs' for problem loans, but again if they are not experiencing problems right now, this could an opportunity for the banker to really help them set up the business for decades to come.

Linda Keith:

Well, and problem loans don't mean a failed relationship.

Michael Wear:

No.

Linda Keith:

Problem loans don't mean that at all, so having that point of view that yes, we need to work out this loan situation and support you in this process and there are some opportunities here and moving into that kind of conversation. I remember from the Great Recession, '08-'09, there were a lot of business that really refocused on their core mission and really looked more closely at all the different things they did and made better decisions and actually came out stronger, because of the shock of the recession. That will happen again this time.

Michael Wear:

That's right, and I was a commercial lender at that time and I picked up some of my best clients.

Linda Keith:

Yes, and this is the time to call on those folks because maybe their banker isn't and you are.

Michael Wear:

Absolutely, this is where bankers show their stripes. They earn their stripes with those borrowers and prospects. And the word-of-mouth advertising is never as strong as when you help somebody in time of need and it may not even be doing a loan. I have a business here in town that, when I see the owner, he thanks me for telling him no on something.

Linda Keith:

Exactly.

Michael Wear:

Yeah, so it's part of the human element of being a community banker and help thy neighbor. When we help our community, it helps us. We are only as successful as our customers.

Linda Keith:

Well, and the fact is community financial institutions, this is your chance to have the word community mean something. Because the community banks underpin the community and the economic health. If we can save ourselves, save our borrowers, and save our communities all at the same time, and I believe that we can, what more would you even want?

Michael Wear:

Right. So, to try to provide the attendees the punch list of the things that I would do when I would do my triage is, I mentioned the capital position. That obviously is the teeter totter of debt-to-worth or debt-to-tangible-net-worth. Not just the balance sheet financial leverage, but also the income statement operating leverage, which would be your funded-debt-to-EBITDA-type of ratios. And by looking at capital position from an adequacy standpoint, and also to be able to absorb losses, is critical, but sometimes that capital is in illiquid form. It's equity in certain assets and we all know in recessions value of collateral, value of pledgable assets, do tend to go down. So we have to really know where we stand as far as the cushion of capital for borrowers, even if we think they could pull through. But we have to be prepared that if it continues to decline. How much run do they have left without additional debt?

Linda Keith:

Right. If they don't have enough cushion, then they are counting on our cushion.

Michael Wear:

I concur. Either internal or external financing. Yes, absolutely.

Linda Keith:

Exactly. With particularly small businesses… I always share with the loan originators, who are the ones I work with the most, credit analysts and lending professionals… with a really small business, often that liquidity is actually on the owner's balance sheet, on the guarantor's balance sheet. They haven't really left and you can have loan covenants to change that around, but before you decline something or worry too much about it with a smaller business, you really need to look at that global cash flow and global balance sheet to see what they really have access to.

Michael Wear:

And then, the next step is to look at the liability side, particularly in the loan structure, to see how good is that structure to help the business given the prognostication of revenues and given the short- and medium-term outlooks from the borrower's outlook, as well as the bank's perspective. And then lastly would be the macroeconomics in what I call the supply chain, drivers, and the consumer demand or the demand drivers for that product or service for that business. That's where we really have to be attuned to macro level changes, which are influenced not just by technology, but by social change, too. Government regulation/deregulation. We have so many external forces that can impact how we do things. Now we have a new one. How do people feel comfortable getting back to a near-normal proximity to one another? So, this could be interesting.

Linda Keith:

I got completely confused. I have a pumpkin party every year where we have 20 people that come to our huge greenhouse and we do all this stuff. Somehow, it never occurred to me that I couldn't do it because of COVID. And I think it's because when Coronavirus really first started, it was so far away that I didn't put it on my list of things I wouldn't get to do. My May 40th wedding anniversary and my granddaughter's first birthday, you know, those were clearly May and June, okay, I probably won't do those. It was just last week I finally went, wait a minute, I probably shouldn't do that, either. So, it's hard to keep in your head even how long you think you need to modify, whether it's modifying things for your business and the decisions you make as a business owner or modifying them in your personal life, so we are in very interesting times.

I'm going to wrap up our rehabilitation piece, but boy, we've got some real specifics both in terms of how we look at it in the first place and then how we really key in on that diagnosis piece and how many elements are involved in that.

So, Mike, thank you so much for those ideas. Look in the show notes for what he shared with us. I really appreciate your input, Mike.

Michael Wear:

Thank you.

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Linda Keith:

Thanks for joining us on the Credit Risk Ready Podcast. Subscribe, comment, or share on social media to stay connected and spread the word. Join me next time as we bring our bank, our customers and our communities through the recession safe and sound.

Take care.

About Michael Wear

Mike Wear is owner of 39 Acres Corporation, specializing in banker training and bank consulting services in credit risk underwriting and loan portfolio risk management. *Less lecture—real business cases—more hands-on practice and more fun!*

Over his 41-year banking career, he previously served in commercial lending and senior credit management positions with Omaha-area community banks. Mike retired as a Senior Analyst in the Credit Risk Administration department of First National Bank of Omaha, a $23-billion community bank, specializing in underwriting larger ($10-100M) commercial real estate loans throughout the country. In addition, he developed curriculum and conducted multi-tier training programs in credit analytics on an enterprise-wide basis.

He is the Loan Portfolio Management Section Leader and serves as a member of the faculty at the Graduate School of Banking at the University of Wisconsin in Madison, as well as GSB's Sales & Marketing School and IT Management School. He is a former adjunct professor for the University of Nebraska-Omaha. He has authored articles for banking publications and has served as a textbook editor/reviewer for the American Bankers Association.

Mike is now expanding his advanced commercial and CRE lending workshops and teaches for several State Banking Associations. Bank consulting offerings include customized credit analytics, effective prospecting, and loan portfolio risk management strategies and tools to identify risk in the Pass-rated portfolio.

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About Linda Keith

Linda Keith, CPA, draws on her 30-plus years of experience consulting with and training lending institutions; background in public accounting; 15-plus years as CFO of the family residential construction company; and experience as an Examiner with the Washington State Auditor's Office and as adjunct faculty in Accounting Principles and Managerial Accounting to help lending and credit professionals say "yes" to good loans.

Of course, you know those are not consecutive years or she'd be over 100 by now!

Linda is known by her clients to be both practical and funny. In fact, there is a movement afoot to change the 'P' in CPA to stand for 'Playful'. The fact is, people absorb ideas and learn better when they are having a little bit of fun. So, Linda brings the fun along with her practical knowledge and depth of understanding to provide credit analysis training and presentations that make a difference.

She is the founder of Lenders Online Training, a virtual classroom approach to improving tax return and financial statement analysis capabilities; the host of the Credit Risk Ready Podcast; and a consultant/trainer on credit risk to banks and credit unions across the country.

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