



Credit Risk Ready Podcast

Host Linda Keith CPA With Michael Wear

The Third 'R' Of Triage Outcomes: Remove Yourself From the Lending Relationship When the Borrower Is Unlikely 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, even in a pandemic recession, no one wants to give up on a borrower. These folks fully intended to repay their debt. They're grieving the loss of their business and, in their minds, perhaps the loss of their dignity. And yet sometimes it is in the best interest of the bank, and truly also in the best interest of the borrower, that we unwind the lending relationship. And that's the focus of our episode today.

Our counselor in this process is Mike Wear, owner of 39 Acres Corporation, specializing in banker training and bank consulting services in credit risk underwriting and loan portfolio risk management. With 41 years in banking, 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. Mike has been front and center on the decision to back away from a credit, as well as the conversations with those borrowers.

Thanks so much for helping us with this, Mike.

Mike Wear:

You're quite welcome. Happy to be here.

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Linda Keith:

In our episode on rehab, I likened you to my physical therapist, who I rely on to help me understand my situation and take action to get back to my pre-injury condition. Today, and talking about that third 'R' — remove, I'm thinking of you more as a counselor. Does that analogy resonate?

Mike Wear:

Partially. And here's my thought on that. As bankers, one of the coined phrases out there in the last few years is: "Bankers should be trusted advisors." Absolutely. I have a little rock on my desk and it has the word 'integrity' engraved in it. It reminds me every single day that I have to maintain as hard as a rock that word to describe what I provide is in the best interest of the person I'm talking to. And, also, I have no ulterior motives.

Now, our job is also to not cost the bank capital. Our employers. So, there's a line that you do need to understand. That's where you want to help your borrowers, but you don't want to expose yourself or the bank to lender liability. I always like to use the Golden Rule. I want to try to do no harm. That's why we have to address these situations early while we do have a number of options.

I talked about a funnel analogy. Initially, we have a nice wide berth of potential options, which include the previous 'Rs' we've talked about: rehabilitate or restructure. Now, we might get to the point that through discussions and our diagnosis of the situation for this borrower, we may not have as many of those options before us. We talked earlier, and I'll just paraphrase shortly, these diagnosis areas. That would be the capital position of the borrower; the liquidity position of that borrower; the total liability; the structure; and the debt schedule of all debts. That includes vendors.

Then we look at the macro. We talked about supply chain constraints and toughness there that we're seeing. Getting inventory or the potential inflationary pressures of that. On the reverse side, the demand drivers for the product and service. We talked about some of these ease of exchange to non-brick-and-mortar and using technology for buying habits of consumers.

Now, I want to add one more for this diagnosis for this step of potentially removing the relationship and that is looking at micro: at the management, the key staff. Does the borrower have what it takes to get through this? Sometimes the answer is no. We don't, again, want to expose ourselves as being part of management and making those managerial decisions. Because that could expose yourself personally, as well as the bank, to lender liability.

Linda Keith:

Isn't that why it's always safer asking questions than it is answering questions? If they're good questions?

Mike Wear:

Yes, and ask those questions with two officers of the bank present. Workout discussions should always have a witness that also is somebody that, in case something does happen or the primary lender is no longer with the bank, you have a backup that has been there. It also gives another viewpoint. Somebody who maybe has had tons of experience with this than the last recession, perhaps. Or, like me, several recessions. But I survived.

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Linda Keith:

I've got to tell you, Mike, I'm not on my second, third, or fourth recession. Just saying.

Mike Wear:

Yeah. I'm right with you.

Linda Keith:

I don't think I'm even on my fifth one. I think I'm probably on number six.

Mike Wear:

When I started in banking, we had 19% prime rate. So, yeah.

Linda Keith:

I remember that.

Mike Wear:

Fun time.

Linda Keith:

And long, long lines to get gasoline.

Mike Wear:

Yes, absolutely. So again, the Golden Rule: 'treat others as you would like to be treated.'

Again, this is their livelihood. This is not just their income. This is potentially their retirement plan. This is their legacy. They could be second-, third-generation owners that the burden has been handed to them. Now they may have their children coming up in the business and so they'd like to have something to pass on to them.

So, we need to have these discussions early and often when we do our triage of their past-rated portfolio to help determine together with the borrower, "What options are available to us?" Do we have a potential rehabilitation where they can come out of it, maybe with a little help on the debt side of restructuring of the current debt? Or, perhaps, some new debt can even help them grow? Then, of course, to make that tough decision that our relationship has run its course and we would like them to explore other creditors as options. We all know that discussion has to be done way early before the financials really demonstrate irretrievable weakness.

Linda Keith:

Well, not only that, but it takes time to court another creditor anyway even if things were good. So, it's not like in two weeks you could go find something else to bring in to replace.

Let me just tell our listeners. If you have not heard them, there's an episode on rehabilitation, another on restructure. The one on rehabilitation is where Mike went into more detail on that whole diagnosis process. I encourage you to listen to that.

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So, you've sort of answered the question, "How do you decide whether it's rehab, recover, or restructure by that diagnosis approach?" I'm thinking that there's so many people who they have, may have, a business fail. But you hear so much about people who are successful business owners, and you find out that they've had some failures before. So not only is it the right thing to do to show respect and be empathetic as we go through this remove process, but it's also something that can preserve a relationship so that when that person or someone in their family is in a position to refer, they send their referrals to us. When they're in need of a banking relationship again and qualify, that they absolutely come back to us because of the way we treated them with respect and helped them unwind. Unwinding is something that a banker might understand way better than a business owner who's never failed before.

You mentioned having two people in the room and one might be more experienced. That more experienced person has walked through this process, too. Talk about a learning opportunity, once again, for somebody who hasn't had that experience yet. You team up. You can see both how to approach it from an empathetic approach, but also how to be firm, I guess, if you will, in making it really clear, without being wishy-washy at all, "This is what needs to happen next."

Mike Wear:

Yes, and that's where that genuineness of following the Golden Rule and empathy for others come shining through. They see that.

Linda Keith:

They do. Are there any particular resources you reach for when you're moving into this process of unwinding the loan? Either you, as the lender, or maybe some tools you can provide to the borrower that helped them in that process?

Mike Wear:

Absolutely. Again, the first step is to — it's similar to a 12-step program — understand that there is a problem. But again, don't personalize it. You know, keep it objective and see if there's a way to solve the problem. Or a change of ways for the borrower to solve the problem themselves.

So, always start wide, like that funnel analogy. With keep brainstorming different ideas and, sometimes, you know, they'll come up with something themselves and take ownership of it. If you do need to put an agreement together, absolutely a written workout plan. I would suggest very detailed steps with specific dates. Date-specific, "Borrower will do this by this date." Such as sending in financials. Such as making managerial decisions that they have originated. Again, that helps the business. Now, this can benefit you as the lender because — guess what? — you don't have to put on your watchlist report every month, "Continue monitoring." Nobody wants that in a watchlist report. They want to see specific dates. They want to see specific action plans for betterment.

And then, on the flip side, what happens if the borrower doesn't do those things? Yes, there's a negative side to those specific action plans and steps in those specific dates that we do need to have progress here.

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One of the very first things I did... I mentioned the Golden Rule, but I also did this. I said, "I'm here to do one thing. And that is to protect the bank's capital and get the loan repaid." Now, doesn't mean it has to come from the borrower. It could come from others. We've heard about the greater fool. And that is, "Is there a greater fool out there that could refinance us?" Well, if we do this often and early, and call the ball early, you have a much higher chance of getting refinanced. Albeit it might be a more expensive creditor, given the risk at hand. But if you wait too long, no creditor will take them. And then that does a disservice to that business and doesn't give them very many outs.

Linda Keith:

You know, if you haven't waited too long, those other sources of financing, they price for their risk. So, if they are willing to take that risk, and they've got a price that will work and the borrower could do it, then that's so much better for everybody than a default on the loan.

Mike Wear:

Absolutely. I've had too many situations where the borrower was desperate, sitting across the desk from me. It was because they had a bad banker who just painted them into a corner.

Linda Keith:

Yeah. When I had my accounting practice, this is a long time ago, but one of my clients... I had him because, actually, I knew his wife. He had a small little retail shop in town. His wife, Colleen, got cancer at, I think, 29. That was a heck of a year. And he completely took his eye off the ball with his business. It was there; it was running and so forth. But unfortunately, his bookkeeper was making some major mistakes in the accounting. And so it was way worse than it looked. The banker is getting these accounting statements and he's thinking it's okay. And by the time anybody... And I was an annual tax return... prep was what I did for him. So, I wasn't monitoring it, myself. He wasn't looking close enough to even see the numbers didn't make sense for what was actually happening. Banker's getting bad information. Shortly after Colleen finally passed, and we're all trying to sort of step back in and step back into the business, it was just way too late. Way too late. Nobody had seen it. In this case, because, well, because nobody was really looking. The bookkeeper was not intentionally... I don't even remember what the mistake was. So, there are definitely times when if you let it go too long, it cannot be turned around.

Mike Wear:

That's right. If you see that same person in a grocery store heading the opposite way in the aisle, can you look them in the eye?

Linda Keith:

Or their kids who thought they would have that business, etc. So, the idea here is that we step in. We be firm. We get enough information and we do it early enough that they actually do have some alternatives. And maybe even those loans are not alternative financing that we would do. It might be a bridge loan. It might be something else that a mezzanine kind of funder would do. But maybe we know who those folks are.

So it's not just a matter of, "You've got to pay this loan and you have this amount of time." But we're talking through with them, "Here are some other financing alternatives that some of our customers in

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your situation have found helpful to look into.” So, you're not getting the lender liability or advice, but you're giving them some direction that they might be able to move.

Mike Wear:

Absolutely.

Linda Keith:

I've got to tell you, it hurts my feelings to think about business owners who really lose their business. And yet, way too many of them go way too long. Spend their retirement. Put more money in. In a situation where if they'd gotten sat down with a knowledgeable person, like their banker, earlier on and actually unwound, that they would not have been as badly damaged as they are when they take it too long.

So, besides the tools you've talked about, are there any things, like I don't know, from the SBA or from the Economic Development Council? Are there any kind of tools out there that actually you could provide to this borrower that don't rely on you providing advice, but give them some ideas?

Mike Wear:

Again, if it's caught early, yes. You might have opportunities to secure a government guarantee. Again, a guarantee is not a substitute for cash flow. It is only a substitute for collateral and/or capital. If there's not too much damage done to the financials, or if there's a turnaround plan that is somewhat feasible, there might be an opportunity for a vendor-type creditor.

If you are not interested, or as we discussed before (restructure), if you are interested in maintaining the relationship but under a different type of loan structure, obtaining a government guarantee to protect the bank or credit union from loss while helping the cash flow of the borrower.

So, they go hand-in-hand: alternative finance alternatives and the decision to continue or not continue. All are part of this process as we go through the three 'Rs' here.

Linda Keith:

Well in the whole question that the pandemic recession really does bring to the table that is different than other recessions is the level of uncertainty. If it's a cash flow problem, the question is, “Is this a temporary cash flow problem? Or is this a business that as soon as there's a full reopening, or a vaccine, or whatever, do they have the legs to make it there? And then once they make it there, will they still have the legs to actually take back off?” I think that's going to be a harder decision in this recession than others.

Do you agree with that, Mike, or do you see it differently?

Mike Wear:

No, I think it's a difficult decision and we cannot do it in a vacuum. As I mentioned in previous episodes for this podcast, I wholeheartedly recommend you sit down with your borrowers and talk to them about their prognosis. What they see. They're experts in making and selling widgets, not the banker. It's a matter of what they see. Sometimes they can come to the conclusion themselves that they either need

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to unwind certain operations, such as we've seen with large public companies. They may actually change ways of doing business, which could help them be more efficient and maybe make it last longer. The business can last longer under a new way of doing this.

I always want to involve the borrower as much as possible in those discussions — and, again, they're discussions — before you're mandating actions. This has to occur now.

Linda Keith:

And there may be some of our borrowers who have looked at this whole picture — maybe they were close to retirement or close to being done — and they realize that, “For me to pull out of this, I would have to run losses for some period of time. And then by the time I rebuild it, you know, I won't be any better off than I am now. And yet, I will have been putting my assets, family, and so forth at risk in the meantime.”

I think the early conversations that we have now could also help uncover some of our borrowers who actually have made a decision to close. We just need to know it as soon as possible.

Mike Wear:

Right. Your first loss is often your least lost.

Linda Keith:

Yeah, I have heard that before.

Mike Wear:

Yeah. That's for them, too. The borrower as well.

Linda Keith:

Yeah. Well, Mike, thank you so much for sharing your ideas here. Especially in what I think is one of the toughest situations, which is, “You know what? We've got to unwind.” And there's a way to do it that is early and is empathetic but is structured in a way that you will best protect the bank, which absolutely is our first requirement. But in the process, that we will help our borrower even as they have to head out the door.

Mike Wear:

Yes.

Linda Keith:

Thank you, Michael.

Mike Wear:

You're quite welcome. Thank you for the opportunity to share some thoughts.

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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.

Resources

- LinkedIn:
<https://www.linkedin.com/in/michael-wear-crc-853b9828/>
- Commercial Lending Alternative Financing PDF:
<https://lindaKeithCPA.com/wp-content/uploads/2020/10/Credit-Risk-Ready-Michael-Wear-Alternative-Financing.pdf>

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.

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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](http://www.LendersOnlineTraining.com), 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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