

## 'Old School' Underwriting & Risk Management Brings ABLs Back to the Basics

BY JERRY OLDHAM

**There's nothing like a fresh start.** With the economy just starting to level out and a rebound expected to start in 2010, now is as good a time as any to get back to the basics. 1st West's Jerry Oldham tells us why the four Cs of Credit still matter.



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**T**his was the early credit training when I began as a lender... Somehow the basics worked then — and they still work today. A loan that is underwritten with these four basic principles in mind, and the notion that it is the owners and management of the business that ultimately repay the loan, will still lead to a successful outcome. How the owners and managers manage their business over time, in good times and bad, generally gives a lender a pretty good indication as to how they will manage their business in the future.

Oh, so you ask, "What are the 4 Cs of Credit?" Before reading on, ask yourself: "If you don't know, just what might they be?" What is certain is that they are still categorically the most significant elements of any credit underwriting and monitoring. Every aspect of the due diligence and monitoring process falls into one of these four buckets — *Collateral, Conditions, Capacity and Character*.

I know all of this may be beginning to sound pretty elementary, but that is the point. Focusing consistently and continuously on these four basic principles will always provide a lender its best chance for a best outcome. Now is always the best time to get back to the basics. You are hearing this everywhere — in business and in our personal lives — "Do the right thing. Do your homework. Get the details. Know the facts. Back up your best intuition with the best information. Exercise a little caution. Trust but verify. *Don't* be a Tiger." Well, you get the point.

### The 4 'Cs' of Credit

**COLLATERAL** — No lending group on the planet spends more time on this component of the equation, start to finish, than asset-based lenders. What would be the outcome if a consistent and ongoing valuation of the collateral was not maintained?

**CONDITIONS** — What are the current conditions of the borrower's market and the general economy at the time the loan is underwritten and beyond? Who are the borrower's competitors, and is the borrower in a new, maturing or mature market? Asset-based lenders certainly pay close and consistent attention to this. What would be the outcome if this was not assessed thoroughly during the initial underwriting and beyond?

**CAPACITY** — What is the borrower's financial capacity to achieve its business and income objectives? Does the borrower have the right management team, current technology, adequate facilities and the marketing strength to compete ... and succeed? Does the borrower have the cash or other liquid assets to sustain its business in an economic downturn? If fact, if there were a fifth "C" of Credit, it would be Cash.

**CHARACTER** — Is there anything about the background of the borrower, its owners and/or its management that are unknown or undisclosed that, if known, would alter the decision to make or renew the credit facility or change the structure of the financing.

Since my lender days, I have been focused on the fourth C, which is always important and now, in a difficult economic time, getting more attention than ever.

### So What's New About the Fourth 'C' and Why?

What is new is what has changed over the recent past that makes understanding this element a more complex and dynamic task. For the following reasons the proper analysis of the fourth "C" of Credit during these times takes on a higher purpose — during the pre-commitment, post-closing and ongoing due diligence:

- Possible excessive and obsolete inventory levels, slower accounts receivable collections, increased dilution, deteriorating collateral

### A FEW TRUTHS TO LIVE BY

- Establish written KYC risk management, due diligence and background investigations guidelines to live by, and follow them without exception.
- Back up your best interviewing skills and intuition with the best information available.
- When in doubt, it's always better to walk away from a deal.
- It's always management that ultimately repays the loan. Discover the *real truth* about the backgrounds of the business owners and managers.
- Maintain your sense of humor because, when the collateral is gone and you're left to work out a deficiency with a known felon who has ravaged his last three ventures and committed untold acts of indiscretion, you'll need it.

values and reduced advance formulas make it critical that experienced management is at the helm and that it is not burdened by an illegitimate or unsavory past.

- Company owners and managers are involved in more businesses than ever, many of which are across state or country borders and may involve different and multiple partners. These “off balance sheet entities” could be the host of a problem.
- Lenders are often participating with other lenders and equity providers in the same capital structure, sharing increased risk with each other. Participants are often relying upon the lead lender’s pre- and post-closing due diligence in most cases.
- The world market is a greater target for new business and new business partners, and lenders are more in need of the best worldwide information in order to make an informed decision.
- The media plays a more intense role and is ever more real time. Lenders must know what the media knows and more.
- The world is ever more litigious, and litigation costs real time and real money. It is best to get the most accurate information up front in order to avoid a legal issue that could have been avoided.
- Information is more readily available within a time frame that beats the bell at a cost that doesn’t beat the bank.
- Lending relationships are frequently more transactional, less relationship driven. Banking services are often accepted by borrowers more *à la carte*, in spite of banks’ best intentions to cross-sell expanded capabilities as the best value proposition.
- Time is more of the essence with competition for the same deal ever more intense and coming from ever more financing sources. Lenders and borrowers share the same desire for a speedy decision, requiring the fastest due diligence possible.
- Corporate fraud, scandals and corporate governance have become more common in our business vocabulary. Corporate scandals are now front-page news, and the executives convicted of these illegalities against shareholders, investors and lenders are being held accountable.
- There are now regulations that require a Know Your Customer (KYC) policy and a certain level of background investigation. A few short years ago there were no insurance requirements or federal statutes that required a state or national bank, or federally chartered savings and loan institution to check a list for terrorists, narcotics traffickers or those engaged in the proliferation of weapons of mass destruction. The FDIC and the FSLIC changed all of that subsequent to the passing of the USA Patriot Act of 2001.

## BEST PRACTICE TIPS

- Lenders should be consistent about the KYC methodology that they employ. Lenders that perform background investigations by exception rather than as a standard practice could be compromised exceptionally — if and when it happens.
- Hire a background investigations firm that is consistent about its methodology as well. Ask the firm about its best practices methodology, and be sure it includes the next three items below.
- An investigations firm’s best practices must include a thorough research effort into determining all of the jurisdictions (counties or countries) in which the subject has resided, owned property and done business. Research must be performed in every jurisdiction where it has been determined the subject has resided, owned property and done business. To except even one jurisdiction could be to leave out the one where the deal killer issue resides.
- An investigation into public records (i.e., civil and criminal litigation histories, tax liens, judgments and bankruptcies) should always include a combination of independent on-site and online research. We find adverse public record information in approximately 30% of the cases as a result of performing on-site research that we don’t find when performing online research only, using the best databases available, a percentage too high to ignore.
- Always check the Office of Foreign Assets Control (OFAC), a division of the U.S. Department of Treasury, for Blocked Persons and Specially Designated Nationals. Those on this list are known fraudsters, terrorists, money launderers and financiers of these activities. This information is updated at least monthly.
- Establish a consistent monitoring system and track borrowers and managers periodically against their known history or “risk profile.” Things can change quickly over time, especially in a tough economy. **abfj**

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