Core Values: Overlooked and Under Pressure

By Gerald M. Sherman and Sam Gurwitz

Lessons from both sides of the borrower-lender transaction.

The middle-market lending industry's evolution is the subject of an ongoing plethora of literature. Topics of particular interest include the impact of technology, alternative loan origination and loan servicing models, drivers of borrower satisfaction and the impact of industry consolidation.

These are all worthy topics. But a comprehensive scan of industry literature published in the past 10 years suggests that another important topic has been overlooked: the importance of strongly embraced core values to every successful lending institution. (*See* the references at the end of this article.)

In his landmark books BUILT TO LAST and GOOD TO GREAT, Jim Collins correlates the presence of enduring "core values" with a company's long-term growth and profitability. This article will explore the general concept of core values and the challenges lenders face in maintaining a commitment to many of the core values that have historically played a significant role in middle-market lending success.

The Concept of Core Values

In essence, core values act as a company's internal compass, providing a clear sense of direction. Accordingly, core values permeate an organization and are a key consideration in major decisions and policies. Thomas Watson, IBM's CEO during its early years of explosive growth and profitability, stated his belief about core values as follows: "If an organization is to meet the challenges of a changing world, it must be prepared to change everything about itself except its basic beliefs as it moves through corporate life. The only sacred cow in an organization should be its basic philosophy of doing business."

To be effective, core values must be carefully articulated: well defined, simple and succinct. Sony hails itself as a "pioneer" and makes a great effort to "encourage individual ability." Disney is dedicated to "the nurturing and promulgation of wholesome American values." Similarly, a family-owned business might choose to define itself as being committed to the maintenance of a supportive environment where employees are given both job security and every opportunity to succeed. As just one benefit for the family business, this core value can lead to an extraordinarily loyal workforce and a level of effort that's consistently above what might be considered the norm.

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Collins's research methodology included an analysis of a significant number of the most successful companies in the United States over the past 100 years. Banking industry leaders Wells Fargo, Citicorp and Chase Manhattan were in the group of companies considered. The research demonstrated a clear relationship between the extent to which a company truly embraced its core values and its long-term success. Significantly, the research also

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found that the specifics of a company's core values were not themselves necessarily crucial. Rather, what does matter is that a company "lives, breathes and expresses it [their core values] in all that it does."

Critical Core Values for Middle-Market Lenders

Some Perspective

In the 1950s as a young boy, I loved spending time at my father's office. He owned and operated a distribution company that supplied many of the key raw materials shoe manufacturers used. Occasionally, I'd walk over to the bank with him at lunchtime. On one of those walks, he explained that he had to go over and sign a note for the money he had borrowed that morning by phone. At the time, the comment didn't mean much to me. Now it does. His bank provided a level of service that made him feel like the valued customer he was. When this local institution north of Boston with about 15 branches was sold in the mid-1980s, we were told that our family business had been the longest standing commercial customer on its books!

In the late 1970s, as a young loan officer with a major Northeast regional bank, I specialized in asset-based lending and truly enjoyed working with my borrowers. Over a year or two, I was able to develop good working relationships with many of them and came to enjoy the daily back-and-forth: the handling of problems, the sharing of good news, even the occasional crisis. In 1981, my lending group adopted a new model and officers were assigned to either the new business or portfolio management groups. Having shown the ability to generate and close new loan opportunities, I was assigned to the new business group. Accordingly, I was relieved of all loan administration and relationship management duties, the part of the job I enjoyed the most. It's also worthwhile to note that this shift was made without discussing it with me in advance. Clearly, that bank didn't embrace a collaborative work environment as a core value! These circumstances were the final factor in my decision to leave banking after six years.

Since early 1983, I've worked as a loan workout and turnaround consultant and have represented more than a dozen banks and commercial finance companies in assignments ranging from prefunding due diligence to borrower evaluations to liquidations. I've also assisted numerous companies with the placement of new debt financing or the restructuring of existing debt.

Late in the 1980s, I took a hiatus from consulting for two years and acquired a client through a leveraged buyout in partnership with the company's CEO. Taking on the role of chief financial officer, I was responsible for managing the company's line of credit borrowing relationships with four banks. Our lenders ranged from the largest bank in New England to two *de novos* that had been in business less than five years each. It was a fascinating experience. The approaches the banks took were each so different that I sometimes commented that it seemed like we were four different companies. For any number of reasons, two of the four banks quickly became valued resources and the other two became nothing more than a necessity.

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Four Core Values

In 2005, having observed and/or participated in thousands of loan transactions, I'm very clear about four core values that I've observed both as central to building middle-market lending success and as a *great challenge* to maintain in today's environment. These four core values are competence, integrity, consistency and customer focus.

Competence

Unfortunately, I've worked with a number of loan officers over the years who just didn't demonstrate an overall grasp of borrowers, their issues or their needs. Early in my career as a consultant, I was working with a client that called his loan officer "Pope the

Dope" (the nickname has been changed somewhat to avoid offending any of the parties). More recently, I struggled with a client that had to repeatedly answer the same questions from the loan officer. Eventually, that lender was terminated. This was clearly not the impression any institution wants to make. A weak loan officer is a real problem far beyond the risk of increased credit exposure. All borrowers of a size that justifies an ongoing relationship with a loan officer want to feel that the lender understands their business and will be able to respond effectively when needed.

It's a well-known fact that the banking industry has reduced its overall commitment to lender training over the past 20 years. It's also a well-known fact that smaller banks have traditionally relied on hiring veterans of major banks to meet their loan officer needs. Herein lies both the challenge and the opportunity. Even in today's world of mass media, a competent lender has the best opportunity to retain business as well as to generate word-of-mouth referrals. The banks and finance companies with a steadfast commitment to developing and retaining competent lenders should generate a competitive advantage *over time.* Admittedly, this commitment will result in ongoing expenses that may create a challenge during periods when industry earnings are being squeezed.

Another ongoing industry challenge is compensation. Despite the impact of technology and alternative servicing models, lending remains a people-intensive business. This simple fact makes it difficult for the lending industry to pay at the level of professions such as the law, accounting, investment banking, *etc.* Nonetheless, experienced, effective lenders need to be paid very well in order to maintain strong contributors and attract new talent. The pressure to maintain competitive compensation programs will continue, and successful institutions will need to find creative ways to compensate their lenders effectively. Further, these institutions will have to accept the fact that they will sometimes be spending more than they'd prefer in order to live by the core value of competence.

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Integrity

Integrity should be a foregone conclusion—but it's not. I've been disappointed throughout my career by what I consider to be the less than straightforward business practices of many lenders and their institutions.

The practice I find most troublesome is the premature issuance of "term sheets" for loan transactions. All term sheets contain language that makes it clear that they're subject to due diligence. Nonetheless, unsophisticated borrowers in particular take them very seriously. Further, these borrowers will sometimes make business decisions based on the assumption that the loan will be closed as described in the term sheet. Generally, that's not the case. It's impossible to produce a credible term sheet for a transaction of any complexity without a certain amount of due diligence and analysis. Regardless, there are institutions in the market that have adopted a practice of producing term sheets very quickly in order to gain the competitive advantage of making the first proposal. While acknowledging that this practice probably does generate a level of business, I'm not sure that the practice generates a long-term benefit. I'm less inclined to refer opportunities to these lenders and know I'm not alone.

Jack Welch was quoted as saying that people like to know where they stand, and it's certainly true for corporate borrowers. Nonetheless, borrowers and prospective borrowers are often told less than the truth or less than the whole truth. About 10 years ago, I was working with a rapidly growing and relatively leveraged client. They'd been asked by their bank to find a new lender because that bank was uncomfortable with the client's ongoing growth program. No more than a month after closing a refinancing with a new bank, an announcement was made that my client's new bank was being acquired by their old one. After I assured the client that he didn't have to panic, we agreed to wait and see what happened. Six months later, when the acquisition was completed, my client was given verbal assurances that his old bank would work with him. When the time came for the company's annual line of credit renewal, however, the bank's actions began to speak much more loudly than its words. Although representatives of the bank continued to give oral assurances that they would work with the company, they dragged their feet on the renewal. Eventually, it became very clear that the bank really didn't want to continue the relationship, and we ultimately arranged financing with yet another local bank. It was very telling that when I called the banker to advise her that the company would be moving its business, she made absolutely no effort to talk about finding a way to maintain the relationship. Under most circumstances, that type of discussion would take place.

It's also worthwhile to note that one of the benefits an experienced consultant can offer to a client is the ability to provide a very clear picture of the bank's true position on his or her company. While I'm happy to provide this insight, it's also a reflection of the fact that lenders will often sugarcoat or soften their thoughts when talking to a borrower about issues. While this is understandable to a degree, it is not when the borrowers don't know where they stand and can't make the right business decisions as a result.

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Consistency

Many institutions are consolidating; others are adapting their strategies in the effort to take advantage of market changes. As a result, many lenders have been modifying their lending parameters and approach to credit. At the same time, it's crucial for all borrowers, as well as their advisors, to understand their institution's "credit culture" and lending parameters. Consistent lending practices make it much easier for borrowers to determine whether or not their current financing source will be able to meet their continuing needs. Many borrowers have been surprised and disappointed after learning their banks wouldn't provide the additional financing they had requested. For example, a lender may make the decision to become less aggressive in a particular industry. When this represents a material change of policy, a borrower would have a legitimate basis for being disappointed. As a young loan officer, I happened to make three of my first four loans in the seafood industry. While it was just circumstance, I had become somewhat knowledgeable in the business and had started developing relationships that offered the potential to help generate new lending opportunities. I was greatly disappointed when my department head advised me that he didn't want to have any more loans to seafood companies. Within a year, two of my three seafood customers had gone elsewhere. With even greater disappointment, I watched a bank from outside our market open a local loan production office and become known as the leading local seafood lender in the region within the next two years.

Nobody would suggest that lending policies should be cast in concrete. That's not good business. A pattern of frequent policy changes, however, will sour both borrowers and professional advisors. Over the past 10 years, one major Northeast regional bank I've worked with has developed a reputation for being virtually schizoid in its lending practices. Needless to say, it's a significant disincentive to doing business with the bank.

Another significant aspect of consistent lending policies is its positive impact on the lending staff itself. Lenders, just like everybody else, like to know who and what they are from a professional standpoint. The issue is not what the policies of an institution are—it's simply that they're consistent. I've seen lenders from consistently conservative banks be very comfortable with that identity. Similarly, I've seen lenders with much more aggressive banks be equally comfortable. In both cases, the lenders are in a position where they can send a consistent message to customers and referral sources alike about what they can and can't do. This helps them both market effectively and do a better job with customers.

One last noteworthy aspect of consistency revolves around an institution's approach to problem loans. While borrowers always want leniency, professional advisors can view the issue somewhat more broadly. Even if a bank takes an aggressive approach to workout situations, it's better to know that up front so appropriate plans can be made. Not being sure what to expect is by far the bigger challenge.

Customer Focus

Every institution will say it is committed to customer service. The question, however, is what an institution and its lenders will do to live that commitment so that the customer truly experiences it. When I was a CFO, one of our line-of-credit relationships was personally handled by the bank's president. Our offices were a block apart, and we'd have coffee early in the morning every three or four months. We'd talk about business, the economy, opportunities, mutual friends, you name it. By his actions, the bank president showed he really cared about my business and understood it. I knew he'd take my call or get back to me as quickly as he could. Five years my senior, he became my professional role model. He also had a top-notch associate who took care of our day-to-day needs with ability, enthusiasm and a wonderful personal touch. I'll always remember the day I needed to get a wire to the West Coast to help out a friend who desperately needed $5,000. It was well after the cut-off time for the day's wires, but when I explained why I needed to get it done, she made it happen. Often, it's little things like that where a true commitment is displayed. In contrast, one of our other line banks took 111 days to close the transaction after it was approved. The lender handling the financing, the head of the commercial real estate division, was unresponsive and hard to reach. When the transaction was finally put in the hands of outside counsel, it just got worse. But for the need, we never would have consummated the transaction.

Lenders are pulled among many conflicting demands. They have to balance the needs of companies they work with, their associates and support staff; the need to stay current in their field; the need to network; and the many other requirements their job entails. Often, there are just too many tasks and too little time. Regardless, customers and prospects need to feel valued and respected. Needless to say, that doesn't mean a lender should give in on everything a customer asks for. What it does mean, however, is that the customer (or prospect) should *feel* that his/her needs are understood and will be responded to appropriately. I've observed many lenders and institutions that are able to make their customers feel important and valued. Many others, however, either can't or just don't. Overall, a true commitment to customer service takes time and costs money. Accordingly, every institution's commitment to customer focus will be tested regularly.

Implications

Market and economic dynamics suggest that lending institutions will be severely challenged to maintain an effective commitment to the critical core values of competence, integrity, consistency and customer focus. Accordingly, just as technology has grown over the years, successful lenders will also have to grow in the *management practices* they use to maintain the core values they adopt. Looking at this from the perspective of developing a strategy for middle-market lending success, there are many significant implications. Perhaps most important, a key implication is that institutions must adopt a long-term perspective. This is admittedly difficult for every publicly traded company that has to deal with quarterly earnings reports. At the same time, the cost of hiring, training and retaining highly competent lenders and support staff is an important investment in the future. With respect to integrity, consistency and customer focus, institutions simply have to develop and maintain satisfied customers and build an increasingly strong reputation in the marketplace. While this might appear to be obvious, it's just not that simple. Senior management needs to have the vision and the will to support required expenses and sometimes to forgo short-term advantages for long-term gains.

A second implication is that the impact of alternative delivery strategies or technologies just might not be as important as they're sometimes considered to be. A logical point of view might simply be that every institution should adopt the most cost-efficient systems and delivery models it can while also focusing on the need to assure that the underlying core values of its lending business are understood and maintained. In fact, when considering the cost of any significant investment in change, an institution should also include the costs required to maintain its commitment to its core value in the face of change. For example, if a lender is moving into a service model where an originating officer is turning over the ongoing relationship, the institution needs to consider the costs associated with the time and effort it takes to assure that the customer *feels* like it's an important bank customer throughout the transition in relationships.

A third implication is that in this era of continued consolidation, the senior management of newly combined institutions must fully understand the core values of the institutions being brought together. Further, they must give great attention and care to developing, articulating and supporting the core values of the new entity.

Looking back over almost 50 years of lending relationships and transactions, it's fair to say that the more things change, the more things stay the same. Competence, integrity, consistency and customer focus remain crucial. At the same time, the difficulties involved in maintaining these core values have changed substantially. No doubt, there's a great opportunity for institutions with the vision and will to truly live by these timeless fundamentals.

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