How and why lending decisions go wrong .. and what to do about it >>

Introduction >>

Arranging finance can be time consuming and problematic and banks can be difficult to deal with. Even businesses with an unblemished borrowing history can struggle to get the finance they need. Some businesses pay too much, sign over too much security, or accept restrictive terms & conditions. Others unknowingly accept the wrong products, which can lead to problems later on. Why does this happen?

One reason is that business lending is very technical and some lending products are complicated; so anyone who has not previously worked in a bank, will be dealing with things that are beyond their area of expertise. As the saying goes, “You don’t know what you don’t know!”

Another reason is that it is extremely difficult for borrowers to exert any meaningful influence over a bank’s lending decisions. They are completely reliant on the bank’s personnel doing their jobs properly and on the bank’s systems working effectively. The problem is, the way banks go about making a lending decision is actually quite flawed and often leads to inconsistent decisions and unexpected outcomes. This is why borrowers can easily end up with inferior terms or with no finance at all. ‘DIY’ borrowers – those who choose to go it alone and arrange their own finance – are particularly at risk.

Before today, anything you have read about borrowing money, or any presentations you have seen, will probably have focussed on lending products, or on the information that banks look at when making lending decisions. This is misleading because it implies that lending is an extract science (it is not) and fails to explain HOW lending decisions are made and WHY they go wrong.

In this article, we are going to reveal the surprising reality of what actually goes on behind the closed doors of a bank when a lending decision is being made - we refer to it as ‘the flawed lending process’.

We will also outline some practical steps that you can take to improve your chances of a successful outcome when arranging business finance.

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The Lending Process as it appears from outside the bank >>

If you have borrowed money before, you will be familiar with the following scenario – it is the 'public face' of lending and all banks follow broadly the same process.

1. The borrower meets with a Lending Manager to discuss a request for finance – either a Relationship Manager, or one of the bank's Business Development Managers.

2. The Lending Manager requests information and asks various questions.

3. The Lending Manager writes an internal report (known as a credit paper) which contains a detailed analysis of the business and its management, explains the proposal, assesses the lending risks, and calculates the borrower's ability to repay any lending using a range of different scenarios. The credit paper also contains the Lending Manager's recommendation, with suggestions on pricing, security, conditions that the borrower will need to meet, and any covenants to which they will need to adhere.

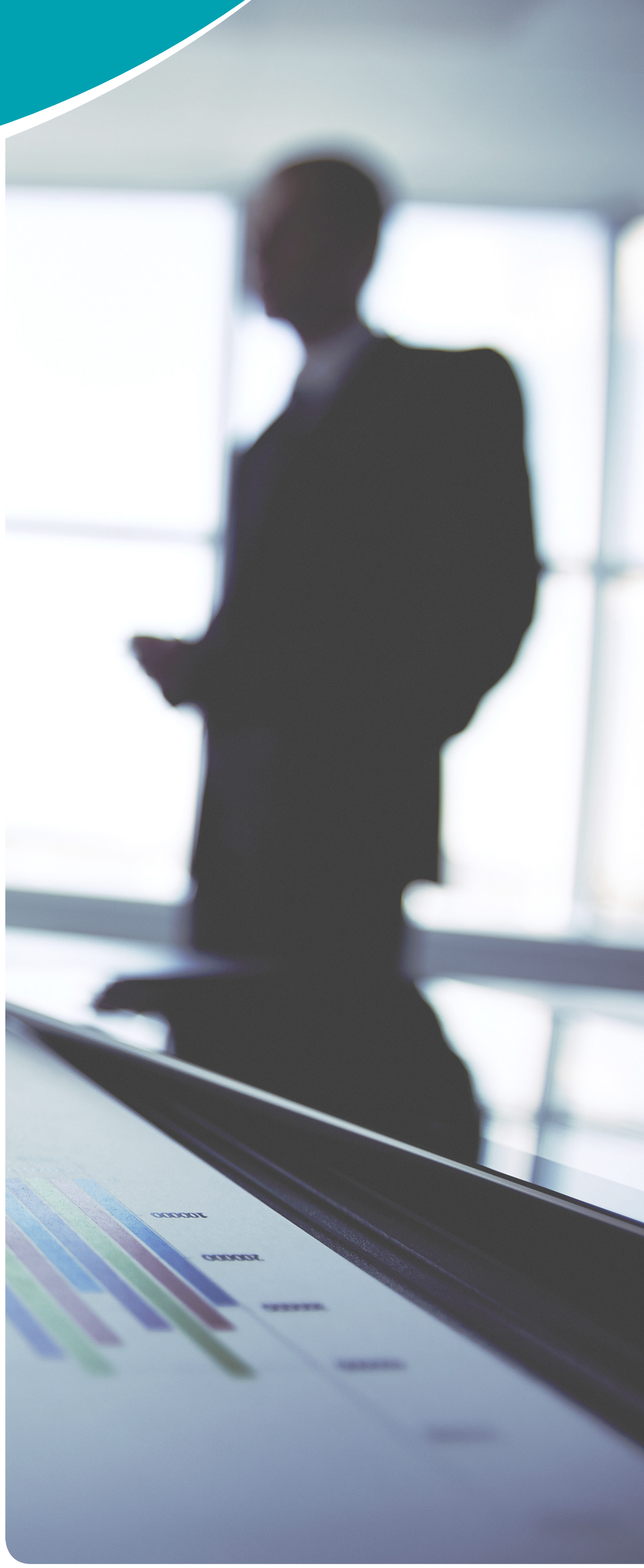
4. The Lending Manager sends the credit paper to a Credit Manager, and the two of them discuss it to arrive at a shared view. They agree the terms on which the bank will lend and the Lending Manager then notifies the borrower.

Sounds simple enough; and since banks have been lending money for decades you would assume that by now the process works well. However, anyone who works for a bank in a lending role will tell you that this is often not the case at all.

As you can see from the above, a lending decision is not the collective view of a bank, it is a decision taken by two individuals who work there, at a given point in time - a local Lending Manager (who you see) in conjunction with at least one Credit Manager acting in a supervisory role (who you do not see).

You are therefore totally reliant on how effectively they manage the process - the quality of the Lending Manager's analysis of your business and assessment of the proposal, the strength of the Manager's credit paper and the outcome of the discussions that subsequently take place with the Credit Manager. None of which you have any real influence over.

The Role of the Credit Manager >>



The Credit Manager has a big part to play in lending decisions. Lending Managers do not have the authority to make a lending decision on their own: it requires ratification. The job of a Credit Manager is to act as a ‘second line of defence’ for the bank by reviewing a Lending Manager’s credit paper and recommendation, and only if they are happy with the proposal, to give final approval for the lending.

The problem for borrowers is that they never meet the Credit Manager, or speak to them, so cannot influence their thinking.

Another important point to note is that the jobs of a Lending Manager and a Credit Manager are fundamentally at odds with each other. A Lending Manager’s job is to earn more profit (i.e. lend money and win new customers) while a Credit Manager’s job is not to lose any money (i.e. minimise the bank’s risk as much as possible, or if in doubt, not to lend). Factor in the emotive issue of personal targets and you have a perfect recipe for arguments and personality clashes. Against this backdrop, it can be difficult for individuals to take a balanced view, look at things objectively, and not allow their personal feelings to colour their judgement.

Some Lending Managers and Credit Managers can work well together. However, speaking from experience we know that many working relationships are difficult and that the outcome of a lending decision can often depend on seniority, rather than on the merits of the case itself. Although this should not affect the outcome of a lending decision, it does.

What actually happens behind the scenes in a bank? >>

With this in mind, let us look at each step of the lending process as described earlier and explain what often happens in practice, highlighting the fundamental flaws. Whilst some of this may surprise you, if you had worked in a bank then it would have a familiar ring about it.

1. The borrower meets with a Lending Manager to discuss a request for finance

Even at this early stage in the process, a borrower is at a serious disadvantage and a number of unforeseen factors can begin to influence the outcome, human nature being one. Here are some examples of human factors that might influence how a Lending Manager deals with an application for finance:

- Lending Managers have targets to meet and sometimes it is how close they are to meeting those targets that will influence the terms they offer, rather than their relationship with a customer.
- They are always busy, so they cannot afford to spend a lot of time for no result. If the proposal to lend to a business is complex, involves a lot of work, or has less chance of approval by Credit, a Lending Manager may well give the proposal lower priority, or decline to get involved.
- Heavy workloads, demanding bosses, family pressures, tiredness, stress, and illness can all have a detrimental effect on someone's effectives and ability to perform; they can all lead to mistakes and have an adverse effect on the outcome of a credit application.
- Career minded Lending Managers or Credit Managers are often fearful of taking too much risk and making a mistake. If a Lending Manager has recently made a mistake and their Credit Department has them under the spotlight, then they will tend to be more cautious and turn business away, or try to redeem themselves by lending on terms that are very favourable to the bank.
- If they had a bad experience with a business before, that may colour their view of lending to other similar businesses, or in similar circumstances.

2. The Lending Manager requests information and asks various questions

This is where a borrower's lack of expertise leaves them at a significant disadvantage. They cannot tell whether a Manager is asking them the right questions and/or asking for the correct information. They have to trust the Manager to do their job fairly and to the best of their ability – whatever that may be.

3. The Lending Manager writes a credit paper

The success of an application for finance is hugely dependent on the quality of the Lending Manager's credit paper, because it influences the subsequent negotiations with the Credit Manager.

In their defence, it is not easy to distil mountains of information about a business and summarise it succinctly in a written report, accompanied by a detailed financial analysis of historic performance and future expectations. Unsurprisingly, it takes a lot of time as well as expertise to do properly; no two businesses are alike and their borrowing requirements are different.

However, because of the pressures on Lending Managers they are often far too busy to properly analyse and present most lending cases to best effect. They simply do not have enough time to get to the required level of detail and so they may cut corners or make mistakes.

Unfortunately, borrowers are not allowed to see the bank's credit paper so cannot check whether the Lending Manager had understood everything properly. Even if they did see it, they would probably not be able to tell if their case had been presented properly, or if the Manager had omitted information that was important to the lending decision.

4. The Lending Manager and Credit Manager discuss the proposal to arrive at a shared view

Credit Managers will nearly always be cautious, and if something makes them feel nervous then it becomes much more difficult to get agreement from them on the terms originally discussed between the Lending Manager and the borrower. The Credit Manager may think "has something been missed; how will it look if I put my name to this proposal and it goes wrong?"

Here are some examples of things that make Credit Managers nervous – again, none of which the borrower is in a position to influence:

- The strength of the Lending Manager's track-record within the bank is crucial – how good they are at their jobs, and whether they have lost money in the recent past - will influence a Credit Manager' decision. A Lending Manager with a poor track-record is not seen as a safe pair of hands, so represents a potential 'risk' to the bank. A Credit Manager will therefore be on their guard and will look much more closely at applications from anyone whose internal standing is below par, and this can have a detrimental affect on the outcome of an application for finance. Sometimes the Credit Manager will change the proposed lending terms in order to manage this internal 'risk' – even on an acceptable lending proposition. For example, they may insist on more security, increased pricing or stricter lending covenants. They may even decline to lend.

- Inexperienced Managers are also prone to making mistakes and so find the going tough, as are those who are just not very good at their jobs. The outcome is often the same: Credit Managers are on their guard, so it is more difficult to get approval for an application, or at least an approval on the terms originally discussed with the borrower.

- Finally, there are the lazy Managers who are not too interested in doing a good job. Their approach is to prioritise those cases that are easier to do and that will help them to hit their targets. When faced with a case that is not straightforward they cobble something together and send it to the Credit Manager on the basis that "If I get an approval then it's a result; if I don't then I haven't wasted too much time on it". These types quickly get a reputation for poor work and abdicating their responsibilities and they find it even harder to get things agreed.

For all these reasons the outcome of this dysfunctional system is sometimes that the final lending decision may not be what the borrower had expected, based on his initial discussions with the Lending Manager. This is because Lending Managers and Credit Managers often have to make compromises in order to agree a way forward that is acceptable to them both.

This happens more than you might expect, as the following section will demonstrate.

Tell tale signs of the 'Flawed Lending Process' at work >>

Here are some examples of the flawed lending process at work. Some of them will no doubt be familiar; they may have happened to you or to someone you know.

- The Lending Manager keeps asking more and more questions
- Time passes without much seeming to happen
- The bank misses agreed deadlines
- The terms of the bank's proposed offer keep changing
- You start hearing comments such as "Credit says this or that" or "Credit wants this information now…"
- Late in the day, the bank changes its mind and wants to make fundamental changes to the terms it originally proposed
- The Manager's appetite for the proposal seems to wane
- The Manager becomes elusive and does not respond promptly to 'phone calls or emails
- Despite being very keen at the outset, the Manager returns with an offer that does not match what you thought you had agreed
- The bank declines, citing reasons that do not make sense

How the Flawed Lending Process effects you >>

As you can probably now appreciate, there is much more to arranging finance than providing the bank with information in the expectation that it will reach the correct decision. Do not be fooled by 'advisors' who tell you that all you have to do to improve your chances of success is to put forward the right information. That is a reliable sign that they do not understand what they are dealing with.

You have to be able to exert as much influence as possible over the lending decision; otherwise, there is a real risk that you will sustain collateral damage as a direct result of this flawed process, not necessarily through any fault of your own. This could mean you receive inferior borrowing terms – restricted borrowing, higher costs, unnecessary or restrictive covenants, requests for more security – or even a refusal to lend.

Unfortunately, by acting alone there is little you can do in practice to prevent this flawed lending process from working against you:

- Unless you are an experienced, trained lender, your ability to negotiate effectively is impaired.

- You have no choice other than to deal with the Manager allocated to you, however busy, inexperienced, incompetent, or lazy the Manager is.

- You will not be able to distinguish between a good Manager and a bad Manager anyway, and nor would you know if they had a poor internal track-record with the bank.

- Regardless of whether you consider that you have a good relationship with your Lending Manager, ultimately the final say on a lending decision rests with the Credit Manager, who you are unlikely ever to meet, and whose decision you have no way of influencing.

Most borrowers would (understandably) assume that a bank would correct a flawed lending decision if the borrower were to appeal. Unfortunately, it is not that simple. Bankers work in a risk-averse environment. You have to be VERY brave to overturn on appeal a decision previously made by other colleagues.

Sometimes, a bank will issue something called a 'constructive decline'. This is a face saving measure where the bank deliberately offers facilities on terms they know the borrower cannot meet, or will find unacceptable.

The sad thing is that many borrowers assume that because one bank wants to change the proposed terms, or has said 'no', then all banks will give the same answer – so they do nothing about it.

What can borrowers do differently? >>

First and foremost, it is important to remember what you have read in this article. Do not make the mistake of assuming that your relationship with your Manager, or your track-record with the bank, is sufficient for you to always obtain finance on fair and competitive terms. Banks do not value a relationship in the same way: they value the businesses that they make the most money from, at the lowest risk.

You should also remember the following:

- Take advice from appropriately qualified sources in order to give you as much influence as possible over every lending decision that affects you.
- A finance broker is not necessarily a qualified source; you should try wherever possible to use a trained lender. There is a huge difference between a broker and a trained lender, and the latter is always going to be the best choice.
- Banks are not all the same, they have different credit policies that change over time. They tend to be more flexible with new customers than with existing ones.
- Consider the alternative finance market if necessary; alternative lenders might consider proposals that a bank would turn aside.
- When looking to borrow, never ride a 'one-horse race' – always approach as many banks as possible. This reduces the risk of the flawed lending process working against you. You are also less likely to be let down at the last minute by an unreliable lender.
- Put your facilities up for retender – at least every five years. Complacency can be detrimental to your wealth!
- Never sign restrictive terms that will tie you in to one bank; the ability to switch to another bank is a sensible option to have available.

How Independent Banking Consultants can help >>

Everyone at IBC has at least 20 years experience of commercial banking – as Lending Managers and Credit Managers. We are experts in our field with significant 'inside knowledge' of the system. The best person to negotiate with a lender is another lender.

We have the time and the technical knowledge to be able to properly analyse and assess a lending proposal, thereby compensating for busy, inexperienced, lazy, or poor quality Lending Managers.

A key benefit is that, when arranging finance, we write our own 'credit papers' for the banks to use, which gives us much more influence over a lending decision and dramatically improves the chances of achieving a successful outcome. This also builds a bank's confidence in the proposal, and saves them a lot of time.

We know from talking with Lending Managers that our credit papers have found their way onto the desks of some Credit Managers, which has helped to enhance our reputation with banks and improve our success rate.

We handle finance cases on a competitive tender basis, dealing with a number of lenders all at the same time, which improves the terms on offer and saves clients huge amounts of time. And although banks have to compete with each other to win business, we treat everyone fairly, which ensures they are happy to participate in our cases and do the best they can for our clients.

We have an extensive network of banking contacts, many of whom are in senior roles to give us influence on the chain of command when we need it. We also know of over 270 other lending institutions that we can use if the banks cannot, or will not lend.

The payback for our clients can be significant; they often recoup our fees in tangible benefits within a relatively short period.