ETHICS AND COMMERCIAL LENDING: UNDERSTANDING DUE DILIGENCE
The approval and execution of high-dollar loans is a risky responsibility. In order to avoid taking on dangerous loans, approval staff are obligated to be thorough and detailed in their analysis of potential relationships. Due diligence is the process of gathering information needed to analyze a borrower’s creditworthiness.

The due diligence process includes:

- Developing a management, business, and ownership profile of the company.
- Collecting financial information to support the financial analysis.
- Performing industry research.
- Conducting third-party credit checks to profile payment history.
- And executing lien searches and profiling assets, including environmental assessments, to support collateral qualification.

The greatest repayment risks are hidden risks that a thorough investigation would have disclosed. When poor due diligence allows a risk to remain undiscovered, your bank has no opportunity to evaluate the risk and other mitigating factors so that they can be managed through loan structuring. For these reasons, maintaining the highest ethical standards in performing due diligence is essential to protecting the bank from unknown but discoverable risks.

Performing due diligence is time consuming and can often feel very tedious. The process can also be uncomfortable when pressing business managers and owners for information they may find intrusive or simply prefer not to reveal. Amicable relationships with customers, fear of losing deals to competitors, pressure to meet closing deadlines—all of these can invite ethical dilemmas. The first step in addressing ethical issues within the due diligence process is simply being aware that they exist.
Important ethical decisions often hinge on the multiple perspectives of the people involved. The following case study involves multiple perspectives and illustrates how different parties approach the same scenario.

ASK THESE QUESTIONS

When faced with a compromising situation, asking yourself a few simple questions can help you decide whether a specific action would be considered an ethical violation.

- Is this action honest?
- Is this action being taken in the best interest of the client?
- Will this action undermine the authority of my supervisor?
- Will this action undermine the credibility of my employer?
- Is this action in compliance with legal and regulatory requirements?
- Would I be comfortable if this action were reported in the newspaper?

Being attentive and asking questions mark the difference between a stable work environment and a financial catastrophe.
Mobile Hydraulics sells high-value hydraulic and pneumatic equipment used in the mineral, petrochemical, and defense industries. Orders average $127,000 leading to about $25 million in annual sales. The company is a longtime and valued bank customer. It has several term loans secured by plant and equipment as well as a permanent working capital loan with a borrowing base that provides for advances against receivables and inventory.

Jacob Gladstone bought the company 25 years ago when it was struggling. He has managed it successfully since then, building a solid reputation for himself within the community in the process. He is on the boards of trustees of several charitable organizations and was named as one of the top ten community leaders by the local newspaper. Jacob attributes his success in large part to managing through positive reinforcement and motivation.

The manufacturing plant is located in the old, industrial portion of the city where many residents don’t speak English very well. Jacob believes in hiring from the neighborhood, but for plant safety reasons, he also believes that English proficiency is an absolute job requirement. He hires workers who have great potential despite their limited language skills on the condition that they take English coursework three times a week during their first year of employment. The company subsidizes the classes, which take place on company time, and Jacob guarantees a pay raise upon successful completion of a proficiency exam, which workers may take any time after three months of classes. Rodney, a relationship manager, has just finished his quarterly on-site visit with Jacob. On his way out, he pauses next to a large poster in the employee breakroom. The poster is updated weekly and shows the plant’s progress in meeting timely completion goals for customer orders.

Rodney, relationship manager: “In the six years I’ve been working with you and coming out for site visits, I’ve noticed that you’re really good about updating the plant’s progress in meeting timely completion goals for your customer orders. We’ve talked before about meeting aggressive completion-speed goals as one of the bonus criteria for your line workers, and every time I come here, the line graphs show very strong performance. [spoken in a jovial, light-hearted voice] So I just have to ask, are your workers really that good, month after month, or are your goals not quite as aggressive as you tell me they are?”

Jacob Gladstone: [chuckles] “I promise you, our goals are that aggressive. If you want, I’ll share my motivational secret with you. But
you have to keep it to yourself—I can’t have you telling my competitors how we do it.”
Rodney, relationship manager: “Of course!”

Jacob Gladstone: “Well, our management team makes sure that the company never misses production goals by more than three percent, but that full attainment only happens in nine or ten months of each year. That way everyone feels like the goals are challenging but still doable. Even in non-goal months, workers are motivated to press on because they know that the goal is within reach with just a bit of added effort. Basically, we make sure the nine-or-ten-month goal attainment is enough to trigger the bonus distribution, and all in all, the system keeps people motivated, as planned.”

Rodney, relationship manager: “OK. But how do you make sure that the completion rate stays within that three percent each month? I would think that just normal manufacturing challenges might be expected to cause more variation than that.”

Jacob Gladstone: “That can be a challenge. Sometimes I augment the list of jobs completed by having the plant manager certify one or two customer orders as complete even though they won’t be completely fulfilled until the next month. Then we adjust the next month’s goal as needed to keep it within the three percent range.”

Rodney, relationship manager: “Wouldn’t that create problems in your invoicing?”

Jacob Gladstone: “There’s that potential, especially since our invoices are generated automatically upon order certification. The plant manager sends an email instructing the controller’s office to add a few days to the customer invoice due dates and to manually place them in a special folder until the plant manager follows up to indicate that the jobs have truly been shipped and the invoices can be mailed.”

Jacob Gladstone is a good man and a successful business owner. However, his premature conversion of accounts receivable actually creates fraudulent receivables that may result in premature or excess advances on his revolving line. He has not recently begun this practice, so it is highly unlikely that Rodney is the only bank employee to have opportunity to question Gladstone’s business practices.

See how well you would respond when faced with this ethical dilemma. Refer to the Web page from which you downloaded this white paper and take our interactive quiz.

For more insight into this topic and additional real world case studies, please learn more about our Ethics and Commercial Lending online course.
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