

# **Why Effective Credit Risk Management Requires Borrower-Centered Workout Strategies**

Banks rarely suffer material credit losses because of a single underwriting mistake. More often, losses occur because institutions respond poorly once a credit begins to show stress. Across banks of all sizes, early warning signs are frequently identified but not acted upon decisively. When this happens, institutions default to legal enforcement or liquidation strategies rather than disciplined borrower engagement and remediation.

Sound credit risk management requires a shift in mindset—from viewing troubled credits primarily as enforcement problems to treating them as management problems that demand early, coordinated, and borrower-centered action.

## **The Cost of Delayed Engagement**

Credit deterioration is seldom sudden. Declining cash flow, operational strain, covenant pressure, or liquidity stress typically surface well before a formal downgrade or transfer to special assets. Yet many institutions allow these conditions to persist without meaningful intervention.

When banks delay engagement, they surrender influence. Liquidity tightens, management behavior becomes defensive, and enterprise value erodes. By the time liquidation is pursued, the range of viable options has narrowed considerably. Early borrower engagement preserves optionality and materially improves recovery prospects.

## **Where the Three Lines of Defense Matter**

Effective workout strategies depend on a properly functioning three lines of defense framework.

The first line—relationship managers and business units—must be willing and incentivized to surface problems early and engage borrowers (including guarantors) candidly when performance begins to drift. When frontline teams delay escalation to protect relationships or compensation, workout options shrink.

The second line—independent risk management and credit oversight—plays a critical role in challenging optimism, validating borrower-reported information, and ensuring that emerging risks trigger timely action. When the second line becomes passive or defers excessively to production teams, borrower stress often goes unaddressed until it becomes unmanageable.

The third line—internal audit—provides assurance that workout strategies are not only documented but effective. Audit functions that focus narrowly on policy adherence without assessing outcomes may miss systemic weaknesses that repeatedly lead to loss-heavy liquidations.

When all three lines operate as intended, borrower engagement occurs earlier, strategies are better informed, and corrective action is more likely to succeed.

## **Workout Strategy as Risk Management, Not Concession**

A borrower-focused workout strategy is not a concession. It is a disciplined effort to preserve cash flow, stabilize operations, and maximize repayment. Successful workouts require transparency, accountability, and realistic assessments of what a borrower can sustain.

This often means imposing tighter controls, enhancing reporting, narrowing business focus, or requiring operational changes. It may involve difficult conversations and firm conditions—but these measures are most effective when implemented early, before liquidity is exhausted and leverage becomes fatal. This is particularly true when borrowers are overextended both financially and managerially and need to refocus on core business.

Liquidation remains necessary in some cases, but institutions that rely on it as a primary strategy frequently discover that value has already been destroyed. In addition, what might have been a successful enterprise with proper attention fails.

## **Compensation Structures That Undermine Workouts**

Misaligned incentive compensation is one of the most powerful—and least visible—drivers of failed workout strategies. When incentives emphasize origination, growth, or fee generation, there is little motivation to acknowledge early credit weakness. Recognizing deterioration can delay bonuses, invite scrutiny, or lead to loss of relationship control.

This dynamic encourages delayed downgrades, suppressed escalation, and resistance to borrower engagement—all of which increase eventual losses. Even in workout units, compensation metrics may emphasize speed of resolution rather than quality of outcome, favoring liquidation over recovery.

Banks serious about reducing credit losses must align compensation with the full life cycle of a credit, rewarding early risk identification, effective remediation, and loss avoidance—not just deal flow. Failure to truly implement policies requirements such as penalties in performance evaluations and even clawbacks signals that the policies are for show.

## **Governance, Culture, and Outcomes**

Ultimately, workout effectiveness reflects institutional culture. Banks that encourage escalation, empower independent challenge, and view borrower engagement as a core risk-management function consistently achieve better outcomes than those that treat distressed credits as legal problems to be exited quickly.

Boards and senior management must set this tone. They must ensure the three lines of defense are functioning as intended, that incentives reinforce prudent behavior, policy requirements, and that workout strategies are actively managed rather than passively administered.

## **A More Durable Approach to Credit Risk**

Borrower-centered workout strategies—supported by aligned incentives and a functioning three lines of defense framework—offer banks a more durable path to credit risk reduction. Institutions that engage early, manage actively, and resist premature liquidation preserve value and reduce loss severity.

In a more volatile and complex credit environment, this approach is no longer optional. It is a defining characteristic of safe, sound, and resilient banking.

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**Note:** *This article provides general guidance on risk assessment best practices for commercial banks, with particular emphasis on community bank applications. Specific regulatory requirements may vary based on institution size, complexity, and charter type. Banks should consult with their primary regulators and qualified advisors when developing or enhancing risk assessment programs. The views expressed represent the author's opinions on effective risk management practices and should not be construed as legal or regulatory advice.*