
LENDING ETHICS BEYOND THE LOAN POLICY

Credit is a finite quantity. Are you always making the best choices?

Just about every loan policy I've ever read includes a statement on the purpose of a loan. These include such bromides as: "We encourage loans for all worthwhile, productive, and legal purposes"

This can be more of a challenge than it reads, if one adds the sometime ambiguous "ethical" to the checklist. This gets at the broader job and mission of a community's banks and bankers.

Credit is a finite quantity

The latter 1970s were characterized by a high price inflation. Lenders were challenged to figure out if some inventory or equipment loans were really primarily for speculation. Customers used to tell me that they needed an increase in their lines to buy inventory in anticipation of certain future commodity price increases.

I actually recall discouraging loans for that purpose, but it's hard to turn down an otherwise worthy customer on the basis of anticipated increases in inventory prices.

A better way to frame this sort of question is to ask whether the purpose of the loan is a productive one. Merely facilitating the making of a lot of money by a borrower is not necessarily a worthy and productive purpose in the employment of a finite supply of a community's deposits. Bank lending should contribute to a higher level of community economic activity, including employment.

Flashback to the 50s: Banks doing their job, or not

Perhaps some readers are old enough to remember an iconic figure in banking in New York and New Jersey of several years ago, Charlie Argemian. Argemian ended his distinguished career as CEO of a large bank holding company in New Jersey, but for many years he held several senior positions at Chase Manhattan, including serving as the bank's Controller General and later as head of its large correspondent banking division.

One time in the 1950s Charlie was interviewed by Fortune magazine about his work at Chase as a correspondent banker. He made one observation in that interview that I came across several years later and that I'll never forget.

Argemian said that as he traveled around the heartland of America and visited his bank customers, he could tell whether the local banks were doing their jobs. It showed on the face of the community.

The community either looked reasonably prosperous or somewhat "down at the heels." These conditions are not necessarily the sole doing of the banks in town, but in a sense they often are. Are the banks making credit available and facilitating the creation of wealth and prosperity for their communities and customers?

Remember that this observation predates by more than 20 years the enactment of the Community Reinvestment Act.

Sorting out "rights" and "wrongs" of credit

The issue is more complicated today. Productive loans are still a paramount lending condition. But with the credit wreckage of the last few years, one wonders what signs we missed. There is also the question of whether a loan's purpose is legal, and assuming that, is it always appropriate to make it? Maybe the answer is "no" if the purpose is primarily speculative and does not fit a reasonable description of "productive."

An analogous issue has arisen in recent years in trust and investment activities. "Socially productive investing" is a frequent condition imposed by religious and not-for-profit investors and managers of investment funds for such groups. Often, securities issued by manufacturers of tobacco, alcohol, or armaments, or those engaged directly or indirectly in gambling, are on the prohibited list. I wouldn't be surprised to learn that such restrictions may have gained relatively wide acceptance in certain bank credit policies.

I can't ever recall directly confronting the question of whether a certain type of lending was "unethical" or whether a particular loan might have been made for an "unethical" purpose or to facilitate outcomes that are deemed to be "unethical." I have been involved though in lending activity known as "leveraged buyouts." Community bankers see these sorts of opportunities where one owner wants to buy out another owner. The bank supplies all or most of the money to accomplish this. As debt is the primary source of the money, it is a leveraged buyout.

In recent years, this type of economic activity has become common and the deal sizes are often enormous. Companies often seek to acquire competitors or companies in complementary lines of activity. Advocates of this type of lending note that oftentimes the acquired company is underperforming or underutilizing its assets and its capital. A leveraged buyout frees these assets for more productive uses. This is not an argument to be dismissed lightly and most can see the sense to it. That doesn't necessarily make it so, however.

A look at the Simmons Mattress deal

The use of a high degree of leverage may also be used to accomplish hostile takeovers where the target company does not want to be acquired and has what it considers to be an appropriate long-term business plan.

A notable transaction of this type occurred last year, the leveraged buyout of Simmons Mattress Company. The deal has been cited as one where the sole benefit of the transaction went almost exclusively to the benefit of the acquiring company and to the detriment of the acquired company's employees, many of whom were terminated by a deliberate downsizing. Critics of this transaction have noted that the acquirer gained control of the company, and divvied out a large proportion of the cash on the balance sheet to itself. The company was ultimately put into a Chapter 11 proceeding and a significant number of Simmons employees lost their livelihood.

A great deal of bank money went into that transaction. Could it be that given the very negative outcomes in human terms that this transaction rises to the level of unethical? It certainly strains the definition of "productive" given the fact that there were large and very conspicuous losers, while a relatively small group was handsomely enriched. No doubt proponents of such deals have their own arguments.

Applying this thinking to your own portfolio

These sorts of transactions are not normal or routine for community banks. Yet we need to consider if the issue of productive lending and ethical outcomes might still be present in lots of smaller deals, more of the kinds of deals we find in our own backyards.

I think it's time banks revisited these issues and what our attitudes are about things like "productive purposes" and ethical "outcomes." It's at least time for a reality check.

As an industry we have a image problem these days, the causes of which and responsibilities for are beyond the scope of this column.

But every lender, and every bank, can police its own precincts, let the world do what it may. Let's be sure that we're not thoughtlessly perpetuating some short term, unproductive activity. Bank capital and community deposits are finite resources.

- About Ed O'Leary:

Veteran lender and workout expert O'Leary spent more than 40 years in bank commercial credit and related functions, working with both major banks as well as community banking institutions. He earned his workout spurs in the dark days of the 1980s and early 1990s in both oil patch and commercial real estate lending.

O'Leary began his banking career at The Bank of New York in 1964, and worked at banks in Florida, Texas, Oklahoma, and New Mexico. He served as a faculty member and thesis advisor at ABA's Stonier Graduate School of Banking for more than two decades, and served as long as a faculty member for ABA's undergraduate and graduate commercial lending schools.

Today he works as a consultant and expert witness, and serves as instructor for ABA e-learning courses and a frequent speaker in ABA's Bank Director Telephone Briefing series. You can hear interviews with Ed about workouts here. You can e-mail him at etoleary@att.net. O'Leary's website can be found at www.etoleary.com.

Order Ed O'Leary's two-hour "Improving Your Bank's Workout Function" CD