

DO BANKS REALLY WANT TO LEND? NOT A SIMPLE QUESTION

Political posturing aside, what fundamentals lie behind the debate?

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Do banks really want to lend money, or not?

There are a variety of ways we might pose this question. But how to do it in an honest and frank political dialogue seems to be an elusive goal. The only heat lately about whether banks can or should lend more seems to be from the politicians. This has the effect of reducing the lending dialogue to a "jawbone" exercise, rather than to a sensible discussion designed to inform and illuminate.

Liquidity, solvency, and profitability

First of all, we need to define some terms.

Liquidity-the ability to convert an asset into cash quickly with little or no loss.

Solvency-the excess of asset values over the amount of liabilities due. Such a surplus is called "equity."

Profitability-the excess of revenues over costs within a specific time period.

All lending revolves around these three concepts and they apply to both banks and to their borrowers.

Borrowers need to demonstrate liquidity to lenders. Loans are repaid in cash, whether earned as profit or the result of conversion of assets, such as receivables, into cash.

Borrowers also need to be solvent. If there's a shortfall of asset values over liabilities due, then the creditors will not permit the enterprise to continue for long. One or more of the creditors will take a loss, and losses are first absorbed by equity, to the extent that it is available.

Profitability is an obvious component of a successful loan transaction. No profit generally means either a near-term or an ultimate inability to continue the operation of the business.

The application of these principles to banking is equally basic. Banks "intermediate" along the "timeline" between users of funds (borrowers) and providers of funds (most frequently depositors). The ability to do this successfully requires that the bank be solvent and liquid. Liquidity is usually the more urgent of the two factors.

Unforeseen circumstances may force depositors to previously unanticipated actions to withdraw funds. If a bank's ability to meet withdrawals is seriously questioned, there usually follows a run, and the depositors demand all their funds at once.

One other aspect of intermediation is the simple observation that the "duration," or average maturity of loans by their contractual terms, is almost always longer than the duration of deposits. Deposits by their nature are payable on demand or pursuant to depositor contracts of a few months up to a year or two. Sixty-month car loans are typically funded by a combination of deposit sources, almost all of which are of a shorter average maturity or duration than the loan itself.

A bank's solvency can be threatened by losses. The cushion of solvency, which is to say the equity, is usually thin. That's the nature of banking, and is the reason why not all risks are for banks. Insolvency can result from a succession of operating losses or from the loss of values of assets. We have seen both phenomena in our industry in recent quarters.

Continued bank profitability depends on the collective ability of the bank's customers to repay their loans and that in turn depends directly on a local economy that will sustain the required level of economic activity for the borrowers to be successful.

A financial "perfect storm" and the political aftermath

So, in a way, we have been experiencing a "perfect storm" over the last couple of years, where profitability, solvency,

and liquidity of both banks and their borrowing customers have been under assault simultaneously.

Some of this is man made. For example, there is the portion that arises from the "vigor" and "enthusiasm" of examiners who are seeking to root out all rot from bank credit portfolios and are taking almost punitive actions against the banks in the process. This makes bankers and bank directors particularly cautious. They don't take casually the threats of lawsuits and civil money penalties by regulatory authorities. An uncertain economy makes lenders cautious too. If borrowers are materially less creditworthy because of underlying economic conditions, then banks are understandably more reluctant to lend.

Politicians on the national stage who voted for TARP to help banks recapitalize themselves to safe and prudent levels can't seem to understand why the banks are reluctant to lend. This, too, is a man-made problem. Banks need a stable and confident environment in which to lend, particularly in view of the seriously impaired credit environment of the entire economy in recent quarters. Politicians need to have sensible and rational conversations with lenders to understand what the concerns are and what constitute the "pinch points" in the flow of credit. The coarseness of the current dialogue clearly demonstrates that many politicians have not properly informed themselves.

Bankers are trained to lend money. They understand that growth and the future financial health of their institutions are dependent on a stream of solid loans to solid customers. No bank wants to lose money on bad underwriting decisions. But banks also know that forced underwriting of credit by political pressure, directly or indirectly, brings mandatory allocation of credit a step or two closer. The alleged excesses in the oversight of the lending activities of Fannie and Freddie are examples of the hazards of credit allocation through the political process.

Finding the right solution

If we back away from the heat of the moment, maybe we can all realize that it was the unbridled extension of credit in better times that has brought us to this point. Lending more money is not necessarily the answer, particularly if it happens in an environment of uncertainty and political gamesmanship.

The process of regulation and supervision of banks is a matter of national urgency that ultimately reports to and through the political process. But we need to insulate banks from political interference that is harmful to the entire economy. We also seem to be endangering the independence of the Federal Reserve System through the tendency of politicians to micro-manage and second-guess decisions taken during difficult and stressful periods. These collective actions do the banking system and the American economy no long-term good. Collectively, the constituents, public and private, of banks and banking need to replace uncertainty with confidence, confrontation with mutual respect, and political fiat with trust in a transparent economic system.

Editor's Note: ABA has done extensive work on the issue of small business credit in this environment. This includes a series of news releases targeted to small business owners. You can find that material [here](#).

- 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.

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