

## HAVE WE OVER-CONCENTRATED ON CREDIT CONCENTRATIONS?

It's about time we remembered that "credit concentration" is not a profanity, says Ed O'Leary

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We've heard a great deal about concentrations of credit the last many months. In fact, concentrations appear to rank on the top rung of problems cited by banking supervisory authorities during the current economic turndown. The question that needs to be examined:

Are all concentrations equally bad in terms of jeopardizing bank safety and soundness?

Where we've been

In over 40 years as a commercial lender, credit administrator, loan review manager, problem-loan workout manager, and CEO, I learned that concentrations can be very dangerous to bank soundness and solvency. They do deserve close attention and analysis. Above all, they need to be carefully and thoughtfully understood by bank boards and supervisors.

The current scrutiny of concentrations is primarily focused on commercial real estate concentrations in the loan portfolios of community banks. Regulatory emphasis and concern has been expressed since the summer of 2006. Bank examiners noted with growing concern that commercial real estate outstandings were rising as percentages of the total loan portfolio, both fundings and commitments, and as a ratio of equity capital. Led by FDIC, supervisors began to caution lenders on the potential hazards.

My own recollection of this issue during that summer was shaped by my experience in reading and grading papers for a national banking school. The particular assignment for all first-year students was to analyze their own bank's internal controls for monitoring and maintaining credit quality. (Such controls include loan policies and loan review systems.)

What struck me were the almost uniformly adulatory comments by commercial bankers, mostly with lending experience, about how "effective" their banks' systems were in assuring a high level of quality.

The possible disconnect between what field examiners were seeing in both concentrations and other underwriting deficiencies and what the bankers seemed oblivious about occurred to me as a possible concern.

"No credit process is perfect" was my thought ,although I had no direct way of testing for such a disconnect.

It wasn't too many months before the bubble in real estate lending, residential as well as commercial, was shown for the dangers it posed to the health of the industry. What the bankers failed to see was a growing concentration of a certain type of credit that seemed out of proportion to orderly growth and business locally. (It's important to note as well that had economic conditions not deteriorated as badly as they did, the examiners' concerns would seem much less prescient.)

Stuck between FDIC and a hard space

The implications for community banks are now painfully obvious. FDIC, having had its concentration warnings spurned in 2006 and into 2007, has been outspoken on the degree of unfavorable exposure to real estate concentrations that exist

today. It's hard to argue with the downside risk that community banks have undertaken. It's too much of the wrong product at the wrong time for most local and regional economies.

But here is the community bank's dilemma.

Over the last 30 years, competition for loans, has been ferocious.

Community banks have lost market share in virtually all credit product types (except commercial real estate) to alternative providers of credit, and to very large banks.

What has been left to the community banks is commercial real estate credit-those sorts of real estate projects that benefit the local community and represent the physical expansion of the market place. Infrastructure growth driven by population expansion is among the most solid types of loan growth that a bank of any size can respond to.

What's been left out of this discussion is the plight of the local banks who have been doing exactly what they have always done in response to market growth. Community banks are the best and most logical providers of commercial real estate credit and they know their product line well. While there have been reports of lending excesses in some markets and by some overly aggressive banks, most community banks have labored consistently and conservatively in responding to their customers.

Objectively speaking, demand outstripped supply, and then, in the response to that demand, supply has now outstripped demand.

Is the appropriate supervisory response one that by intimidation discourages commercial real estate lending for the indefinite future? And one that imposes almost punitive sanctions in terms of capital adequacy measures and asset quality determinations?

The nature of the beast

The issue of credit concentrations is a valid discussion topic. But it seems important to understand that every community bank is exposed to a degree of "natural" concentration due to geography alone. Small banks must necessarily define their trade areas more exclusively than larger banks. And they must certainly do it more so than non-bank lenders doing business with no reliance on depositor funds.

Does this not expose them to higher natural levels of concentration than larger banks?

Is this necessarily bad?

How are community bank owners and managers to develop rational and successful business strategies without some sympathetic understanding of the limitations of their current circumstances by supervisory agencies?

To most cities and towns across America, community banks are the principal economic engines in their communities. They do some things very well and commercial real estate lending is one of them.

Something's badly needed-before real damage is done to community banks and community banking. That is a responsible discussion of concentrations of credit and how such concentrations should be understood and rationalized as we emerge from this long and deep recession.

Parting shot: "Concentration" is not a four-letter word

Not all concentrations are evil.

What about concentrations of quality?

Yet in the current environment, even a portfolio of credit secured by U. S. Treasury securities would probably be subject to criticism on the basis that the portfolio lacked the ability to earn a market return.

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 free audio interviews with Ed about workouts here. You can e-mail him at [etoleary@att.net](mailto:etoleary@att.net). O'Leary's website can be found at [www.etoleary.com](http://www.etoleary.com).

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