

WHY FORBEARANCE MAY BE A BAD IDEA (OR AT LEAST SHOULD BE THOUGHT THROUGH)

A lender's take on a controversial idea

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After you read Ed's blog, check out Jeff Gerrish's blog about forbearance, "Why Forbearance Can Be A Good Idea."

And check out the story about bankers and "examiner angst" in the April 2010 ABA Banking Journal Digital Edition.

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It has become abundantly clear in recent months that the bank supervisory agencies consider forbearance to be a bad idea. Why is this so?

First, examiners were stonewalled by many bankers, starting four years ago when FDIC and the Comptroller's Office began to raise the specter of possibly unhealthy concentrations of real estate credit, especially commercial real estate credit. Nobody likes to be stonewalled, especially when they were more right than the bankers, as things turned out.

Second, bankers, especially coming off several good years, not to mention a bubble of real estate lending activity, were notoriously slow to recognize problems.

Why? Bank lenders are largely salespeople. I know-I was one. We see opportunities first and problems second. It's the way we are and why we're good at growing the earning assets of the banking system.

That's what we're paid to do. The internal controls are supposed to be in place to be sure that there is some sort of "governor" on the throttle.

Finally, experience in past downturns, especially in the late 1980s, which was the last big real estate bubble before the current one, suggests that delay in cleaning up soured loans begets more losses.

Forbearance and "Prompt Corrective Action"

Picking up on that last point, consider the saying, "The first loss is the best loss." That's an old and tested bit of banking logic. There are many bankers today who will swear by the value of this statement.

Remember the history of Prompt Corrective Action, years ago? Supervisory authorities and legislators believed, from the cumulative weight of evidence at the time, that speed in cleaning up problems was preferable and less expensive to the insurance fund than dragging out the process. That became enshrined in the law—specifically, the FDIC Improvement Act of 1991. It's unlikely to be repealed, let alone relaxed, based on the relatively recent circumstances of the sort that gave rise to PCA in the first place.

There is a durable bit of "workout wisdom" that suggests that problem loans have as their primary cause some analytical or structural defect in the origination process. This suggests that underwriting, rather than underlying economic conditions, is the primary driver of what creates a problem asset.

I don't particularly subscribe to that view. I find it simplistic. But I can attest that, in my work over the last 25 years, such an attitude remains alive and well.

Forbearance issue doesn't stand on its own

All of these factors combined seem to be driving a particular outcome that is unwelcome to many community bankers. Many seem to feel that there is a secret agenda to reduce the number of banks to a number significantly smaller than the current total of around 8,000. The existence of such an agenda item should be a matter of public debate, as it would be rightly seen as strategic, in the context of financial reform that is moving to center stage in our national legislative dialogue.

Many of us already see much to dislike in the proposals that are circulating about financial regulatory reform. The dialogue itself is healthy. But the pushing and tugging on long-settled and well-understood duties of determining "safe and sound" does us all a disservice.

Perhaps the regulatory pendulum has swung too far during this business cycle. The system was clearly out of whack during in the early phases. That's to be seen in hindsight by the excesses of risk assumption, competitive practices, and abdication of common sense. Some overcorrection is to be expected—though not necessarily welcomed.

I am concerned about a political backlash in the current context against the bank supervisory agencies. They are already political creatures, as they owe their existence to law. These agencies are entrusted with responsibility for ensuring a safe and sound banking system. One might ask, "How can they do their jobs through one business cycle to another if the banking industry is in a position to lighten the 'touch' or impact of supervisory activities?" On the other hand, such tension between the industry and the supervisors is healthy, as there are many competitive and conflicting interests that must be recognized and balanced.

An issue that needs more debate

Overall, we have a system that has worked pretty well. I hope that the bank supervisory agencies have the best interests of the banking industry and the general public in proper balance as we prepare ourselves for the coming new era of banking. We won't find the years to come to be particularly like the years we have recently lived through.

We need more sunshine and air on the issue of forbearance and how this can relate, directly or indirectly, to the larger question of the shape of the industry to come. In addition, what seems urgent, to me, as a veteran banker, is a public dialogue over what the private banking system should look like, in terms of individual participant size, regulatory structures, powers, and the like.

Remember, as debate begins again in Congress, after the Easter recess, that we still don't seem to be any closer to a generally accepted answer to the question of banks that are "too big to fail." This as urgently deserves an answer as the issue of what banks may be "too small to survive."

Are we all asking the right questions in the right contexts? I'm not yet convinced that we are.

What do you think?

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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. O'Leary's website can be found at www.etoleary.com.

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