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## CAN YOUR BANK'S COMMERCIAL LENDING PROGRAM STILL COMPETE?

Time for a new model in community bank business lending?

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Most of us will agree that classical commercial lending is an acquired skill, with specific rules and an internal discipline and consistency. Seldom is this a "lone ranger" effort, but rather one that involves teamwork, with the interaction of documentation specialists, analysts, clerks, loan review, and credit committees. This is all in the context of a culture that is supposed to make sure that all the components come together in a harmonious and complementary way.

Unfortunately, that's easier said than done-but it's not impossible. Many banks have demonstrated this through good business cycles and bad.

But what does the future hold for this core commercial banking function?

Balancing tradition and profitability

To consider this, we first need to understand what's driving bank lending profitability today. It's the maximization of net interest income.

This relies on competitive but compensatory pricing; a stable source of core deposits, to provide the bedrock of funding loan assets; and careful cost control of all non-interest components of lending activity.

The two major cost components are interest expense and salary expense. In most banks, interest cost is number one, followed closely by salaries. While both of these cost components are understood to be in the category of discretionary, they are not completely so. Deposit prices are largely determined by the local market and money market forces well beyond the control of local managements. Salaries, too, are competitively based, although management has some discretion owing to how much staff will be hired.

However, the emphasis in the last 20 years applied to commercial lending in many organizations has been to limit the salary component of total costs. This is why commercial lending has moved from custom fabrication to a largely commoditized process, especially at the larger banks.

Tools like credit scoring; centralized underwriting; strict product parameters dealing with maturities, borrowing covenants, and related items of boiler plate in documents increasingly hew to a standardized line.

Paraphrasing the ubiquitous TV commercial, "It if fits, it ships."

By reducing the process to discrete components that can be replicated, standardization accomplishes two important objectives:

The risk is controlled, in that it can be statistically predicted and adjusted into acceptable parameters.

The process can be made as efficient as any industrial assembly line.

Peter Drucker once observed that the back office of any enterprise should be "boring." It should hum with efficiency and not with the cacophony of competing voices, opinions, or activities.

Is this part of the picture of commercial lending's future?

Commercial lending in branches

Another remarkable change is that banking companies with large retail branch networks have led the way in converting commercial lending, at least in the smaller-dollar segments of the business, into a branch product.

No longer does the small businessman put on a necktie to go downtown to see the banker. He or she just goes to the branch, where the level of formality is noticeably different. It is also true at many banks where commercial lending is a branch-accessed product that there is a lower level of commercial lending expertise available for consultation with the borrower.

Many of us who trained as commercial lenders decry the loss of commercial lending expertise at the customer contact level. However, a key question we should ask is, do the routines that converted commercial lending largely into a

commoditized business subject the institutions to higher levels of credit risk? I suspect that the results have been and continue to be satisfactory, from a risk management view.

Many of us with formal credit training miss the old way of doing business. The borrowing customer isn't getting the years of experience of a commercial lender who has seen good and bad over a multi-year career.

It's the customer who is the loser in that respect. He or she doesn't receive what our customers in past years did—a level of independent input and expertise that is simply not available from the customer service representative in the branch. To be sure, the large-dollar credits are handled much as they have always been, with an account officer overseeing a personal portfolio of credit, generally handled out of the main office.

Where is community banking's credit model headed?

Where the change is most pronounced is at the community bank level. Community banks struggle with the same factors of productivity as the regionals and mega banks do—salaries and interest costs.

For community banks to thrive (and after the experiences of the last two years, who wants to simply "survive"?) we have got to embrace a two-pronged approach to reinventing commercial lending at the small- to medium-sized dollar level.

First, we have to embrace the cost-containment activities of process and move toward centralization of documents, standardization of underwriting, and, yes, even some use of credit scoring.

The other prong—and this is the more difficult to accomplish—is to credit train more effectively.

At most community banks there are not very institutionalized ways of teaching and administering credit. We have been successful largely in spite of ourselves.

This won't be enough to thrive, though, so we need to think this piece of the strategy through very carefully.

For many years, as both an industry practitioner and as consultant, I've heard and participated in discussions of what community bank credit training should look like.

We don't have it completely right yet. However, many banks "get it" and are trying to work in constructive directions.

It's time that the community banking industry had a full and open discussion of the subject allowing for identification of principles and best practices.

Then, and only then, will we be positioned to implement a solution unique to each bank but fitting the industry and the best interests of our commercial borrowing customers. As we emerge from the dark tunnel of the last several quarters, it's time to get serious on the subject.

And time to get it right.

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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