FIVE WAYS TO PROTECT YOUR BANK DURING STAGFLATION

O'Leary's advice on avoiding a bad road—a followup

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Last time this column talked about the growing concern by some that the U. S. economy may be heading into a period of "stagflation." Stagflation is a term that attempts to describe economic conditions characterized by low or nominal growth of Gross Domestic Product and an increasing levels of price inflation.

A look back, to look ahead

Normally, higher market rates of interest often signal an improvement in loan demand. While that may occur in coming months, it is also possible that the prospectively enormous federal deficits in the current and near-term future fiscal years can result in a higher level of rates basically divorced from underlying economic activity. It's possible that buyers of U. S. Treasury securities will demand higher absolute levels of interest rates to be enticed to buy the debt that must be issued to fund these deficits.

Our national economy experienced several consecutive quarters of stagflation in the late 1970s and early 1980s. Inflation raised price levels of most everything, while higher interest rates increased costs of doing business without reflecting any underlying improvement in real loan demand.

Asset totals inflated, while income (particularly tracked by the key measure of ROE) languished. In other words, we more or less marched in our places, while our balance sheets gradually ballooned and our profitability diminished.

Are we really heading towards "normal"?

As we have begun to emerge from the very difficult past two or three years, some bankers have expressed optimism that our world is returning to normal. But how can we be sure?

Bankers should develop an institutional awareness of the presence of inflation in our markets, both locally and nationally. Probably the best way to do this is by using the federal government's GNP Price Deflator. It's an index that measures price changes in GDP. I'm not going to advocate a particular level as a threshold of concern, but each of us should be aware by this simple measure just how much inflationary pressure there is in the market place. Many, if not most, economists consider anything above an annual rate of 3% as unhealthy and unwelcome to our long-term economic health.

Preparing for stagflation risk

There are probably dozens of things that any bank can do. However, long lists imply no particular priorities. If we're going to protect ourselves and our banks from possible stagflation, there are a few things that we can do and should set about doing pretty promptly. They are all subject to discussion in our loan policies.

1. Build on today's lessons.

We should make sure that we have incorporated the obvious-and perhaps not so obvious-lessons of the current economic cycle into our policies.

This includes everything from minimal acceptable levels of due diligence to lending rules driven by common sense. It's not time to build a stronger "straightjacket," but rather a time to articulate a series of lending principles.

Rules beget more rules. Principles, if properly framed and presented, guide behaviors in a more thoughtful and constructive way.

2. Avoid the temptation to be a "Cheap Charlie."

We should guard against being the "lowest-cost-provider" in our markets. We under-priced our loans during the last credit cycle and blamed the competition for irresponsible pricing; all the while, we continued to chase the same deals with equally competitive rates. As a result, we unnecessarily stimulated increased loan demand, while funding it at lower rates. This eroded both credit quality and net interest margins.

3. Sniff out and reject any loans that are primarily speculative in nature or by purpose.

Most loan policies contain statements like, "We seek productive loans" and "We avoid loans of a primarily speculative nature."

We say that, yes, but do we mean it? Do our actions reflect our words?

In the 1970s, many loan facilities were increased to accommodate borrowers' increasing costs of inventory. But how much financing were we bankers doing of a speculative nature when we granted temporary or permanent increases in facilities to assist customers to make large, advantageous (by price) inventory acquisitions?

If the timing of the purchases and related loan increases were to anticipate pricing changes, rather than actual demand for raw materials, then we were, like it or not, contributing to the speculation. We had embedded some harmful biases in our economic assumptions.

Speculative activity does not create long-term value, jobs, or increase our productivity as participants in local, national, or regional economies.

4. Emphasize liquidity in your analysis of borrowers' capacity to repay.

The seductive temptation is to focus on collateral values in a liquidation scenario, as these values are being pushed up by inflationary pressures. But in reality, it's the cash conversion cycle that provides for the repayment of most bank debt.

Remember that the debt repayment load increases as asset prices inflate. We need to be sure that our borrowers have the capacity to pay comfortably (defined as without undue strain) from current asset conversions.

It's really as simple as it sounds-inventory becomes receivables becomes cash. Anything that strains this normal conversion is unhealthy. Be sure that the bank is not adding to the pressures by funding speculative asset acquisitions.

5. Protect bank profitability with unwavering focus.

In a stagflation economy, assets are inflating while profitability is slowly eroding. This means that bank capital accounts are under a silent but relentless pressure. Assets grow, but equity as a source of funds is constrained. The growth will be financed by debt.

We learned painful lessons about debt levels in this last cycle. Next time around, our balance sheets might be stressed by both more debt and less equity. We must be vigilant.

Above all, pay attention to policy

Banks operate with relatively short average lives of both assets and liabilities. But as inflation increases prices, it does nothing about turnover rates. Said another way, the average life of our assets stretches out in inflationary periods and over time, our balance sheets undergo significant changes that are all but invisible to the unwatchful eye.

This time we have to be smarter by avoiding participating in speculative lending by purpose, pricing properly for risk, and watching the composition of our balance sheets.

It all starts with a well-written, principles-driven loan policy and the determination to enforce consistent and sensible practices.

Check out Ed's previous column on stagflation.

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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.

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