
DON'T JUST LEARN THE OBVIOUS LESSONS FROM THE CRISIS

Spotting one risk doesn't mean you spotted them all—or even the worst

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There are some tentative signs that business is improving—and it's about time.

The factors that drive long-term economic growth like population, household, and shifting demographics, such as age, have not been seriously interrupted by the recession. Many people have delayed their personal plans, but relatively few have abandoned them permanently.

This has direct implications for banks and, in particular, for community banks. Smaller banks are probably closest to their customer base because of the face-to-face nature of community banking and the demand for funding for local infrastructure that community banks usually experience first. The concentration in real estate credit, especially commercial real estate as measured by a multiple of a bank's equity, is likely to be a significant constraint on growth in many markets primarily served by community banks.

Indeed, as business begins to perk up after a long siesta, our industry has to balance its need for earning assets with a healthy dose of reality

Balancing renewed growth with management

The concentration in real estate lending taught some painful lessons. Many bankers believe that credit concentrations must be better managed and monitored.

As business confidence slowly returns to more normal levels, banks will be anxious to respond to loan demand, both to replace credit that has been running off and to increase earning assets. Generally speaking, community banks are flush with deposits and have low loan-to-deposit ratios by normal standards. They are ready to lend.

But what if most of the initial recovery in demand is centered in products that are subject to intense scrutiny for concentration reasons?

Community banks have experienced higher real estate concentration levels than their larger counterparts and this will likely make them more "conservative" in approaching new lending opportunities.

Putting participations into perspective

In a portion of my work, I talk to bankers who rely on participations sold to other banks to provide liquidity for themselves and their marketplaces and as an integral component of risk management. This makes good business sense and has been a standard feature of lending and risk management for a great many years.

The other side of that coin, though—in the form of participations purchased—is where I see significant and perhaps underappreciated risks lurking in an otherwise improving economic climate.

Among consumer lenders, it is axiomatic that "indirect" paper has a higher overall risk profile than "direct" paper. An indirect loan is one made with no face-to-face or personal contact. The risk in this form of indirect lending, from the point of view of the buyer of the participation, is the lack of control or influence over the borrower's activities.

I'll illustrate my point with a story about a situation I have some knowledge of. Early in 2009, a relatively large bank failed.

I have personal knowledge that much of the loan portfolio that soured during the months leading up to the closure comprised participations purchased. They were largely acquired as a deliberate earning assets growth strategy, from correspondent banks.

The usual components of most failures were also present. These included hot money funding, relatively thin primary capital, and employees who pushed production through the pipeline while lacking serious skills required to recognize deficiencies in credit and documentation.

The doomed portfolio, though largely concentrated in real estate, represented considerable diversity-in principle.

Loans purchased included conventional and jumbo residential mortgages. The loans also included commercial mortgages secured by retail and office properties and purchased over a large geography. This included several smaller to medium-sized SMAs.

But if you think I'm criticizing this solely because of real estate concentration, you'd be wrong.

"One step removed" makes a concentration too

My point is that real estate, by purpose and collateral, was not the only concentration. Another, probably equally serious concentration, was the portfolio's largely indirect nature.

The originating banks, the sellers of the participations in our example, were dozens in number and were all community banks. Their loans taken as a whole represented characteristics typical of many community bank portfolios.

However, these were still indirect loans.

Unfortunately, not all lenders are equally well trained or experienced in documentation matters or in credit analysis. These are shortcomings that I've seen in the course of my consulting work and reflect the practical reality that today community bank credit and lending training is seldom the equal of large-bank training programs, in terms of consistency and sophistication.

When a bank buys a credit or a portion of one from another bank, it buys it "as is." Sound underwriting is every bit as important on the part of the buyer of the participation as it is by the seller, or originating, bank.

There's one difference, though. No personal relationship with the borrower exists when you buy the participation. The buyer doesn't know the customer and cannot apply its own collection techniques, which might be considerably more effective than the originating bank's. Any servicing or underwriting deficiencies by the selling bank become vulnerabilities that the purchaser inherits with no opportunity to fix or modify once the participation is booked.

This is one of the not-so-visible credit lessons of the recent recession.

As business begins to perk up after a long siesta, as I spoke of earlier, our industry has to balance its need for earning assets with a healthy dose of reality: Any participation purchased should represent pristine credit.

Simply "looking good" is not good enough. Caveat emptor.

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.