

# THE OVERCONCENTRATION NO ONE TALKS ABOUT

The toughest one to avoid of all

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An interesting and compelling case that the credit markets are better predictors of future economic activity than the equity markets was made in the latest issue of McKinsey Quarterly, a publication of the international management consulting firm.

Consider that there have been several stock market corrections in modern economic history, but not all have led directly to economic downturns. The best example of one such market decline that did not signal a recession was the one that many of us remember from 1987.

Bankers read the tea leaves

Credit markets, on the other hand, can be quite predictive. Banks make their net interest margins by the spread on rates between deposits and loans. And a positive spread is a consequence of interest rates on loans being consistently higher than rates on deposits for those types of debt that wind up on banks' balance sheets.

Bankers pay close attention to the slope of the yield curve on various maturities of debt instruments. Rates on longer-term instruments tend to be higher than shorter maturities when the market believes that long-term economic activity will be strong. There's more competition for funding for long-term projects that are traditionally funded by a preponderance of debt as the source of the funding.

Anyone who regularly attends his or her bank's ALCO deliberations will relate to the concern that economists voice when the yield curve flattens, or inverts. This has traditionally been a reliable indicator that business activity is headed for a cooldown.

It was in this current recession too.

Our inescapable optimism hangs us again

Banking is a pretty transparent business today. We know what our competitors are doing and Call Reports have for many years provided public information on the size and type of credit extended by the banking system.

This produces, or at least reinforces, a certain "group think" or herd mentality. We all tend to chase many of the same sorts of deals and compete vigorously with each other on product, rates, and terms.

In my many years of experience in different sized banks and in different geographies, I've found contrarian views in the banking business tend to be the exception.

If business is good, we think it will stay good indefinitely. A credit trough is viewed as just as permanent.

Most of us have experienced both highs and lows and we know at some unconscious level that no market condition is permanent.

We rarely seem to act that way, though.

We don't know when to leave the buffet

This leads to my thought that commercial lenders, when acting as a crowd, are usually wrong. It's not that we do the wrong things or lend carelessly. Rather, we don't know when enough is enough. We tend to overdo.

Consider that there have been several commercial bank lending bubbles since the 1970s. I recall the lending excesses in commercial real estate in 1973. I made a lot of commercial real estate loans as a young lender that year ... and then spent the next two years collecting them.

In 1980, I was recruited to Midland, Texas, in the midst of the robust economic climate in the oil patch due to the commodity price boom in oil. Oil prices when I arrived were \$29 a barrel, headed for \$41. When I left in 1984, prices were back to \$29 and headed ultimately for less than \$10 not two years later.

Banks followed the prices up merrily lending on a finite commodity in the belief that prices wouldn't decline.

In the mid-1980s, federal tax law underwent significant revision. The change that created so much heartburn for commercial lenders was the elimination of certain tax breaks in the area of depreciation of commercial projects. The law changed at mid-year to be effective starting January 1 of the following year. That front-ended a lot of real estate building activity financed by the banking system.

As a result, there was considerable overbuilding financed by banks with unhappy consequences that took several years to completely work through.

By the late 1980s, highly leveraged transactions became the lending rage. Many companies deemed to be underperforming were acquired almost exclusively by debt-much of it loaned by banks. While many sleepy, overcapitalized (in the equity sense) companies were reinvigorated, a great many more were saddled with debt they ultimately couldn't handle.

Again, the banks were left with a pile of soured loans.

By the mid-90s, housing was the hot lending area and once again, the banks piled on in considerable numbers. In hindsight it was no surprise that we overdid things. But not many of us saw it for what it was as the bubble developed.

And the true extent of what we had done was impressive by the damage and havoc it caused.

The concentration we've all been missing

In the last 40 years, I've lived through several commercial lending booms and not one of them produced a lasting, constructive result. Instead, it was a repetitive pattern of boom and bust.

In hindsight, some of this was due directly to desensitization to the risks inherent in what we were doing. Or perhaps the cause was hubris-too many bankers thinking that they had it all finally figured out.

There is at least one enduring lesson in all of this.

We don't seem to be able to avoid the extremes. Hence, we should face the reality of that and be more mindful of what we're doing.

Perhaps this is another way of describing concentrations-though not of the credit product or collateral variety.

We as an industry are overly concentrated in the assumptions that we collectively make about our environments. We should find better ways of reading the tea leaves and figuring out our economic environments.

Often the answers are buried in the credit market rather than stock market.

Most of us work there. So we have no excuse for not knowing.

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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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