
O'LEARY'S CREDIT ESSENTIALS: TWO FACES OF LEVERAGE

You can't understand credit risk without getting leverage—both kinds

* * *

How many of you who are lenders would be surprised to learn that some of our counterparts don't seem to be fully conversant with the concept of leverage?

Would you be surprised if it turned out to be a relatively large proportion of our fraternity?

A much-misunderstood essential of credit

There's little "science" behind my suspicion, but I can tell you that when leverage comes up, I've looked into many blank faces when teaching credit-related subjects in both American Institute of Banking and in-house training programs. Eyes glaze at the mention of leverage. The subject often fails to catch fire with the audience.

Maybe that's my fault. But maybe it's a failure of our industry to really emphasize what we mean by leverage; how we should view its risks and rewards; and how to inoculate our banks and customers from its potentially pernicious effects.

Note that I'm not saying that lenders don't understand leverage at all. Rather, I think we tend to be somewhat superficial about our understanding.

I got to know an OCC examiner pretty well some years ago. He and I often shared a few minutes over a cup of coffee in the cafeteria whenever he was in my bank. I recall how visibly agitated he became one day when he described a relatively senior commercial lender in a bank he had recently been examining in Connecticut who didn't understand the difference between financial leverage and operating leverage. (We'll address that shortly.)

That got me to thinking on banker education. It was at that point in my career that I began to develop an appreciation for what experienced lenders didn't seem to know, but should have reasonably been expected to know, as part of an industry consensus on how to train credit people.

It would be interesting to explore more fully why lenders don't know certain basic things about their trade, especially about the use and risks of leverage. But I suspect there's a combination of lack of intellectual curiosity and a deficiency in the ways many experienced practitioners were trained. I'll address some questions towards that in a postscript to this blog. Now, let's get down to leverage.

A deeper look at leverage

As bankers, we use funds to make loans; acquire investment securities; buy buildings; and invest in operating systems. Our sources of funds are our liabilities (principally deposits) and equity. Equity can come in lump sum investments, though mostly it's that portion of what we retain in the business from our day-to-day and ultimately year-to-year net profits.

Leverage refers to what happens to both owners and creditors of any business when the mix of debt vs. equity in its sources of funds is materially altered. Assuming that a borrower's activities are profitable, the more debt used, the more earned for the owners. This is so because the only thing that the holders of debt get back is principal and interest. The owners get everything else-positive or negative.

To understand leverage you've got to appreciate the difference as well as the similarities between Operating Leverage and Financial Leverage.

1. Financial leverage is a balance sheet concept.

It is the degree to which debt is favored (used) over equity as a source of funds. Its simplest expression is found in the debt-to-worth ratio-the ratio of debt divided by equity. The old-fashioned conservative banker's rule of thumb is that the ratio should not exceed one to one.

In other words, a conservative banker believes that the owners should have as much at stake in the business as the creditors.

I learned that first hand from the head of The Bank of New York's credit department who used to feign horror at any business that didn't display a debt-to-worth ratio of less than one to one. He was an effective performer, to be sure, but he conveyed the standards of the bank in ways, large and small, that could never be adequately explained in a textbook.

2. Operating leverage is an income statement concept.

It is the degree to which earnings are leveraged by the fixed costs of the business. More fixed costs means more leverage. Higher fixed costs means that the business must generate more revenues to cover all its costs. Once that point is achieved, then much more drops down to net income and that's the marvel of operating leverage. It gives a real boost to earnings after a certain point.

Here's the blinding flash of the obvious that so many lenders who are obsessed about the debt to worth ratio never see:

All other things being equal, an enterprise with more financial leverage (higher debt-to-worth ratio) has higher operating leverage. Why? Because interest payments on debt are a fixed cost. In other words, it's not enough to be vigilant about higher balance sheet leverage. When we detect it on the balance sheet, we should expect to find it as well in the degree of operating leverage owing to the fixed nature of the interest costs.

What we really need to be vigilant for in operating leverage is less the absolute amount of reported earnings but rather the volatility of those earnings. Bankers appreciate predictability. Earnings that are leveraged are less predictable over time. They are more at the mercies of economic developments and relatively small operating performance factors, both of a positive and negative nature.

Leverage and risk management

Of course what this discussion describes is the element of risk that leverage injects into the financial performance of a business. Lenders at some level all understand that more leverage produces more risk.

• But why do we often seem so impervious to the risks that leverage produces? Is it that we just don't see it?

• Is it that if our customers want to undertake it then it's not really up to us to discourage them from that pursuit if they are otherwise credit worthy?

• Do we at some point have the responsibility to say to them, "Enough?"

We acknowledge we have that responsibility to our employers. Yet, there's something deficient in the way many lenders are evaluating leverage in the financial statements of their borrowers.

If we are going to chart a happier outcome to the current business cycle that is now beyond its infancy than the one we have recently lived through, then we have to do some things differently.

The place to begin, it seems to me, is with our understanding of and attitudes toward leverage. Could it be that we don't accord enough respect to equity? What do our behaviors tend to show us about that possibility?

We'll continue this discussion next week with a blog that, for now, I'm calling, "Equity Don't Get No Respect."

A postscript from Ed on bank lender education:

Bankers tend to think of education as an event. The young lender, having finished a course on credit, thinks he or she is a fully fledged credit officer, for all the book learning. "Not yet," any old bird like me will squawk. I spoke of intellectual curiosity early on in the blog. Ponder these questions:

• How much is our education worth (or how effective can it ever be) without the intellectual curiosity component?

• How much (or how little) of that intellectual component is regularly on display when we present our credits to our loan committee?

• Does what you see on a regular basis either comfort you or disturb you on the breadth and depth of the intellectual assets of your bank's lending team?

• If we don't fully understand a concept like leverage, then how can we purport to understand how financial statement numbers "work" and how well can risk be detected and identified?

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.

You can get word about these columns the week they are posted by subscribing to ABA Banking Journal Report e-letter. It's free and takes only a minute to sign up for [Click here](#).