

---

## DARK SIDE OF LOAN GROWTH, AND ITS WARNINGS

Now is the time to avoid planting new seeds of destruction

\* \* \*

Anecdotal as well as statistical evidence is accumulating, and documenting that credit demand is reviving up. The bankers seem to be responding. This is good news-except that on close examination it has its dark side in two ways.

Exploring the dark side

What's on the "dark side"?

First, banks have differing abilities to fund an expansion of their loan portfolios.

The large banks are doing fine-and in fact did pretty well in controlling overall problem asset totals and in keeping the loan window open even at the depths of the lending trough. The issue of capacity to lend is often an urgent problem two or three tiers down in the asset-size spectrum of banks. There are continuing and occasionally deep-seated issues at the small regional and large community bank level, where criticized asset totals continue to absorb management time and attention and weigh heavily on the capital adequacy of many participants.

An article in April in The Wall Street Journal chronicled the problems at several smaller regional banking companies and inferred that some will not likely survive the current business cycle. FDIC's problem bank list as of the end of March has grown to 12% of the nation's commercial banks and is believed to be poised to grow longer over the remainder of the year.

Second, many big banks have reported improved quarterly earnings.

Much of this so far has been the return of loan loss reserves to the earnings accounts of many larger institutions.

But a closer look at the press releases of these companies suggests that there is an anxiety about loan demand. The earnings numbers are improving-but the improvements flowing to the bottom line are largely in the category of "one time" events in the context of this business cycle.

The number to watch is top line revenue and that's anemic at best just about everywhere.

Watch out for competitive déjà vu

There is an overall lack of robust new loan demand and that's becoming a matter of concern to industry observers and participants.

New production isn't keeping up with runoff on an industrywide basis. It's concerning because growth must be driven by net new business-increased loan outstandings plus non-interest income-if it is to be sustainable and credible.

Here's what's worrisome: It's an industry urgency, then the seeds are in place for an erosion of lending standards in response to increasing competition for loan business. The lessons so painfully learned earlier in this credit cycle might be undone in coming quarters.

The signs to look for carefully in the next year or two, whether you're a Wall Street giant or a decent-sized community bank in the hinterlands, are the indications of loan growth at your competitors. Thanks to published quarterly call data, banking has become a very transparent business.

Recovery Job 1: Maintaining quality while competing

When Toyota was racking up impressive sales and market share gains in recent years, the other car manufacturers worldwide were saying "How do they do it?"

Absent were any indications of the quality issues that were to plague the company by 2010.

Bankers were saying similar things about their competition four and five years ago. "Where do they find the business? How can they do it quarter after quarter and not show some signs of strain in terms of loan quality?"

The truth of the matter both for Toyota and for many banks was that they couldn't. It wasn't real for the banks in light of the charge offs and renegotiated credit that were evident following this binge; the performance wasn't sustainable for either the banks or Toyota.

Growth has to be solid and built on a proper foundation whether you're a bank or a manufacturing colossus.

How to build quality: It begins with policy ... but doesn't end there

The loan policy is the first line of defense on asset quality issues. But it is far from the only defense.

Just behind policy is the management will to enforce the policy through a variety of controls.

For example, if the portfolio is riddled with credit and collateral exceptions, what can you reasonably say about how the policy is interpreted and implemented?

If the directors think it means one thing but the loan officers treat it as meaning another, there's a problem coming. A strong credit culture rests largely on management will. The time to be sure what you think is in place is in fact there and working properly is right now, before the portfolio becomes riddled with new exceptions and justifications for growth. It's not just the numbers of criticized assets or exceptions. It's the bad habits that create and perpetuate them.

There have been a number of recent blogs on this web site dealing with the likelihood that many community banks will choose to offer themselves up to so called mergers of equals or simply elect to be absorbed by stronger and larger institutions. Banking for the last many years has been a business of scale and never more so than right now as the new regulatory environment inaugurated by Dodd-Frank is fully implemented. Owners and managers who want to assure the best possible environment for their customers and employees in the coming mergers need to pay close attention to the quality of the culture. A slipshod or marginally effective credit culture present in an acquired bank almost assures a back seat and inferior position in the merger(s) to come.

What would an outsider see in your loan files?

As a staff credit officer in Florida many years ago, I participated as a team member performing due diligence on several bank acquisitions. None of these banks were truly large but they were large enough to require careful due diligence and an active sense of what we were buying.

The quality metrics haven't changed over the years. They are the results of attention to credit underwriting fundamentals and an attitude toward account management and oversight. It's not terribly hard to assess those things on a credit file by credit file basis.

Someone may doing due diligence on your bank one day soon. What will the verdict of that external assessment be? Remember that it will affect the price your owners get and the role that existing management and staff will be offered in the ongoing enterprise.

Maybe we can't individually change the inevitable but we can certainly influence the environment. Time and attention to the full range of internal controls whose sum define the overall credit culture will be essential to a good outcome for many community bank employees and their customers.

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 has been 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).

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.](#)