

GETTING YOUR ATTITUDES IN SHAPE FOR 2012

Ready yourself now for deposit building, credit concentration, and other challenges

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All things considered, we're in a more positive environment than we've experienced in a while. Question is, what will we do about it?

There are still mixed signals, but the economic recovery that started some months ago is gaining traction. And we can look to the Federal Reserve's commitment to hold rates low to assure a positive net interest margin for the industry.

But what can we as lenders do to improve our own situations locally? Are we to be passive at this phase of our industry's recovery? Actually, proactive steps taken now will pay off later.

Time for positive action

Several urgent strategic questions should be on lenders' minds now:

1. As loan demand returns, are we absolutely sure that we are not compromising our credit standards at the expense of generating interest income?

2. What long-term steps are we taking to preserve liquidity?

Banks are generally awash with deposits as we became convenient and safe places to house customers' underutilized liquid funds. These deposits can and likely will flow out quickly enough in search of better returns. Our current rates on certificates of deposit will not hold back the outflow.

3. Finally, what are we doing to reorient the attitudes on core deposit retention of our lending staffs? These are the same folks who have been largely occupying foxholes since 2008.

Let's take a closer look at these issues, and their interplay.

Credit quality: Let's get it right and keep it right

First and foremost we must be sure that we are not backsliding credit wise.

Bankers as a group have to relearn certain lessons every generation or so. It's just seems a fact of banking life.

What is certain this time around is that the credit risk cycle has been much briefer. Consider that our lending rates are at all-time historic lows and therefore rate is not a sensitive barometer of relative credit risk. When our principal product is priced so cheaply, it's hard to imagine just how precious credit can be at different points on the economic cycle. We can be fooled, especially those who have very short memories--or even selective amnesia--regarding relatively recent circumstances.

Raising and retaining core deposits will bring enormous challenges, the likes of which we have not experienced in a very long time.

And bankers will be doing it with a new wrinkle in the market: interest-bearing business checking accounts. So far, only a handful of players have done much with this. In time, this new wrinkle, brought about by the Dodd-Frank Act, will bring additional pressure on rates and therefore spread management.

I've said before that there's an old-fashioned idea (well more than a generation old) that lending is a reliable way of attracting deposit business. We need to build deposit retention into our strategic thinking--indeed, we ought to keep it top of mind.

How long will today's "easy" money last? That's uncertain--probably a year or more. But one day, there will be a profound shift in the market and we'll have plenty of loan demand but an uncertain supply of raw material.

Your ALCO managers are worrying about this now (or should be) though it's not pressing as lenders go about serving their customers today. Those institutions who figure out the right retention model will be enormous winners.

How have young lenders fared in the post-crisis industry?

As 2009 was beginning, many senior loan managers were concerned about how younger lenders, those who had not been through difficult lending times before, would adapt to the new reality of problem loans and negative loan growth. Would their ingrained optimism and the natural enthusiasm of youth be damaged, perhaps permanently?

Three years later, the consensus seems to be that lending staffs, both the young and the not so young, have adapted reasonably well and met the challenges of the sharpest business contraction in 75 years.

However, many managers are now concerned about the opposite problem: How will lenders who have grown excessively cautious and conservative in the last three years make the transition to growth and relationship building?

Changing their perspective presents a valid concern and is linked in lockstep with the issue of whether credit standards are eroding as business improves. Lending managers will be severely tested at times in coming months with the size and scope of this challenge.

Credit concentrations and Machiavelli's The Prince

Have you ever read the medieval classic *The Prince*, by Machiavelli. The main character of this story is a pragmatic nobleman who engages the world as he finds it and shrewdly adapts it to his own ends and purposes.

By the standards of our day, that nobleman ranks as a classic cynic. Here's one of the Prince's prescient observations that I associate with overall credit risk:

When a problem is difficult to see, it's easy to fix.

When it's easy to see, it's hard to fix.

Let me explain for those who don't immediately see the connection to the loan review function.

The occasional tendency to cut corners in underwriting standards or to under-appreciate a particular type of risk often comes early in the credit cycle. At this point, it's unlikely to be prevalent or habitual. By the time it is so, then it's embedded in the portfolio and therefore visible to just about everyone. At that point, it's very difficult to fix.

The classic example of this in the last business cycle is concentrations of real estate credit.

We are all sensitized to concentrations of this type so the chances are it'll be some different sort of concentration that will disturb us in a few years.

Whatever its source, it's probably beginning to show up now in low doses and is not very visible. That's why this phase of the business cycle should be a period of high vigilance for all lending managements and loan review. Today, it's a matter of much greater urgency compounded by a combination of lender inexperience with differing business conditions and the very low rate structure that implies relatively low credit risk.

Apropos of this, the Comptroller's Office published a revised booklet on concentrations of credit in mid-December. It discusses the relatively familiar topic of concentrations but with a perspective more aligned with supervisory concerns about enterprise risk management. I recommend that you take a look at this, which can be downloaded [here](#).

Our credit risk issues are all at their heart forms of concentration risk-too many exceptions, too many loans to businesses in the same industry, too many loans secured by a common type of collateral. These are not new to any of us.

What's different this time is that we have a much keener sense of what to look for and with the growing appreciation and discipline of enterprise risk management we have better ways of seeing the problems early.

The time to be looking is right now.

Resolve to aggressively get it all right

And while we're at it, let's figure out how to do a better job of hanging onto our core deposits. When I was the annual metropolitan drive chairman for the United Way in Albuquerque a few years ago, I used to tell my customers, "I don't have a United Way view of developing your business. I don't want fair share, I want it all."

That seldom failed to produce a chuckle. But I was serious and they found out I wasn't kidding.

It's time for that sort of view today if we as a community banking industry are to preserve our funding for a prosperous future. It's not too late to add these things to your New Year's resolutions list.

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. O'Leary's website can be found at www.etoleary.com.

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