

WHO SAYS LOSSES ARE OK?

Stop and really think about that old saying about losses, for a minute

* * *

The anecdotal evidence that our national business environment is improving is gaining momentum. There are exceptions here and there. But generally, community banks and community bankers are feeling more optimistic and anxious to resume a more active role in lending to their local marketplaces.

Experienced heads are still concerned about the quality (depth and strength) of the recovery and the mental agility of lenders, especially less experienced ones, to pick up safely and prudently where they left off a few years ago.

The latter issue is real enough but how can we address it while not destroying the value of the experience gained since 2007?

What's bugging bankers, part 1

My interactions with bankers over the last calendar quarter suggest that there are two principal concerns or obstacles to returning to a more normal lending environment.

The first is whether the examiners, state and federal, are relinquishing their aversion to credit, especially new deals to smaller borrowers.

These have always been considered the riskier segments of the commercial loan market. If the examiners are negative in general on such opportunities, then the banks are likely to be reluctant to lend and the trough in lending volume will continue for another few quarters.

This is on top of the recent indications of the Federal Reserve to hold interest rates low until 2014 at the earliest. The prospect for improving banks' net interest margins is as bleak as it's been in a long while.

My own view is that the way to fix concerns that we may be taking excessive risks, real or imagined, is to recommit to conservative lending principles and internal controls that credibly mitigate credit risk.

Examiners will be among the first to acknowledge that there is nothing wrong with a loan portfolio addressing business segments that are traditionally considered higher risk. Their issue is the ability of the bank to recognize, monitor, and control that risk.

This will take time but it's not an impossible task nor should it drag on interminably. Needed are a commitment of resources and the internal discipline, consistently applied, to produce consistently good results.

In the longer term, the customers, stockholders, and communities will be better for it. We have all learned just how debilitating a wounded bank can be to the prosperity of a community.

What's bugging bankers, part 2

The other concern, though less talked about, is the attitude of lending staffs toward risk.

Have these attitudes been warped and jaded by recent events in the credit markets? We are conservative risk takers and we must be. But how have our perceptions been shaped (or perhaps damaged) by the recession we've been living through?

All of us will view this dilemma through our own prisms. We've not had a single shared experience but rather thousands of experiences that possess common elements.

I used to work with a very senior lender at The Bank of New York who was fond of saying "Experience is what you get when you don't get what you want."

So as community bank lenders, let's ask the question: What do we want?

We could have a national dialogue on this question alone but in the interests of time, let me try to answer it here from my composite experience as a lender, workout manager, credit administrator, and CEO of a bank laboring under a Formal Agreement:

We want a loan portfolio that produces sustainable, replicable, and financially acceptable performance that reflects reasonable credit underwriting principals and responds to the long-term needs of our communities.

We could all make very lengthy statements but stripped down to essentials, I think that we all know what we want and it's not a portfolio of sour loans that are an embarrassment in hindsight to our judgment and competence as lenders.

Rethinking an old adage that may be worthless

I don't want to take a complicated subject and try to distill it down to a cable news network type of sound bite. But there is one attitude that I've heard freely expressed over my entire lending career that I think exemplifies what may be wrong with our collective attitude. And it also conveys just the wrong signals to our younger lenders at this point in the economic recovery. It's the sentiment, however specifically phrased:

"Show me a lender who has no loan losses and

I'll show you a lender who doesn't make loans."

Sound familiar? It has a plausible and reasonable "ring" to it.

But it's also insidious in its own way. This tells every young lender that some losses are going to occur ... and that they OK.

Wait a second ...

I hope that every lender has the opportunity to learn from his mistakes and from the mistakes of his colleagues.

But how much discipline and effort have you seen in your banks to conduct this painful and embarrassing educational process? In my work lately I've seen more sugar coating of the real truth than illumination in dark corners. I'm absolutely convinced that many lending environments ultimately promote more spin than candor.

1. How about telling the lenders, old and young, that they are expected to make good loans with satisfactory outcomes for everyone?

2. What's wrong with stating the expectation up front that bad loans will not be tolerated?

3. And that charge offs of interest or principal due to violations of bank policies or lapses of common sense and judgment will expose the perpetrator to dismissal?

Internal controls equals accountability

This brings me back to the notion I've often expressed in this space: A commitment to internal controls is the other half of the equation of satisfactory credit outcomes.

Why don't we ever seem to learn this?

We need a good credit policy and most of us believe that our banks' policies are adequate, if not excellent, as currently written. Don't we all see that it's in the execution phase where most of the losses originate?

Albert Einstein is credited with saying that insanity is doing the same thing over and over again and expecting a different result. So what are we as an industry waiting for to make the necessary changes?

Losses are not OK. Anyone who implies that they are doesn't belong at a lending desk.

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.

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