

THREE WAYS CONSOLIDATION COULD SOW SEEDS OF CREDIT TROUBLE

Put cultures together, and squeeze. Surprising what pops out

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The other day I found myself being interviewed for an expert witness case where a business deal went sour. What's interesting about this case is that the sour deal is the bank itself.

A relatively small community bank with a largely rural character to its business base was acquired by a considerably larger independent community bank. The issue that appears headed toward litigation is whether the condition of the larger acquiring bank was fully disclosed to the shareholders of the smaller bank at the time of the consolidation.

This case contains the elements of some major issues to be faced by community banks in the years to come, quite apart from the quality of the bank's note case.

Consolidation, the favorite solution for overcapacity

The viability of community banking business models has become a major concern and is caused by two unrelated factors, both of which are largely beyond the control of the industry itself.

While all banks are facing rising compliance costs due to Dodd-Frank, smaller banks are feeling the burden disproportionately as they have only a limited capacity to defray the fixed costs of compliance over a smaller business base of loans and non-interest revenue sources. The increases to staff, most of which are unrelated to the production of revenue, are inevitable and inexorable for all small- to medium-sized banks today.

Community banks are also having great difficulty in expanding loan volumes due to anemic economic market conditions; relentless competition for existing loan business; and regulatory oversight that bankers say continues to depress banks' ability to positively respond to community credit demand. More than anything, it's too much capacity.

The classic response to both challenges is to consolidate and it's been going on for years now at the larger end of the bank size spectrum. It's now a reality at the smaller end of the spectrum, too.

Credit issues intertwine others in a merger

In this specific case, I'm struck by how credit quality issues are intertwined with the broader forces at work in the industry today. There are a wide variety of causes behind the forces of consolidation today but the results may play out identically. So it's worthwhile understanding both the undercurrents as well as what their results are likely to be.

For every business consolidation, there will be "new people" and "old people."

While mergers of equal are often talked about, they almost never exist in the real world. One culture will predominate and

it's usually the one from the larger side of the merger. There will be winners and losers; some combinations will work out better than others.

Second, there will be new business initiatives and deals that will seem out of character to one or perhaps both sides of the combined bank.

Things like "participations purchased" and the extent of the new bank's trade area and breadth and depth of the product lines will be topics of discussion, and perhaps disagreement.

An historical loan-to-deposit ratio in the 70% to 75% range may suddenly become old-fashioned, with the new norm of 90% to 95% (or more) being the new reality.

A combined bank's commercial lending offerings will tend to expand too. While the new may not be remarkably different from the past in terms of industries or product lines, a management group, whether carried over from one or both of the components of the consolidated bank or recruited anew, will face the same sort of opportunities and challenges.

Most new managements will gravitate toward larger transactions spread over a larger geographical territory with more aggressive pricing to help capture a larger market share. Take a good look under the hood of the early wave of size-to-compete mergers and I bet you'll also see more limber credit terms on amortization rates, pricing, and the variety of deal points on the typical deal sheet.

That's how one competes, right?

Darker side arises

What I find ominous is that conservative inclinations by training and experience may tend to be trumped by the imperative of an expanding return on investment.

This is the ultimate capitalistic ratio but it's also the proxy for the risk/reward trade off. More return is better but just increase one and you'll get at least some of the other. Even where credit quality is initially not an issue, new managements will try to show the combined stockholder groups how they can juice up returns on assets and returns on equity. Experience suggests that this will be so.

The risks can come from a variety of sources. Here are the principal ones that I think we'll see.

1. The new bank will likely go after business with aggressive pricing and less-strict underwriting standards.

Old-fashioned logic says that underwriting can be more aggressive in the early phases of the business cycle and can be tightened up later. But when is later?

2. Concentrations of credit will tend to proliferate, but silently and surreptitiously.

We all know about concentration risks but the biggest ones always seem to be the ones you're not looking for. Things like larger trade areas, more of certain types of loans, and even deal size are types or sources of concentrations that don't attract much attention until it's too late.

3. As the memory of the current recession recedes, the job of melding credit cultures will be urgent but may not be recognized as such.

It's easier to be agreeable than to enforce a new credit policy and the related internal controls. Unfortunately, the newly acquired members of the team may not be up to speed by training or experience to the new marching orders. Not every title of "senior vice-president" means the same degree of rigor in one's lending background.

Old challenges in new wrappings

Funny thing: In today's environment, we don't usually associate the evaluation of a consolidation of community banks with the issue of poor credit quality.

But the deal fundamentals, the core merger logic, can sow the seeds of the next credit quality crisis.

There should be enough "experience" among community bankers to last a long while and to keep the industry out of trouble. But I'm not sure the right lessons are being drawn in the right sequential order for a happy outcome.

I don't mean to rain on the parade. But my nose smells trouble.

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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