KEEP THE HAIL MARY PASSES ON THE GRIDIRON

Consistent basic blocking and tackling do better than occasional heroics

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For a dozen years or so I've done an on-line course for ABA called "Analyzing Bank Performance." It's largely an effort to focus analytically on a bank's performance metrics and to identify ways to improve performance based heavily on information contained in the bank's Uniform Bank Performance Report. There are other tools used as well but the foundation is to know how the bank has performed recently and through the use of peer data, ask questions like "why?" or "why not?"

Part of the process is to inspect the UBPR for evidence of risks: credit, liquidity, market, capital, and operational. There are other forms of risk that are very real but they don't often come with metrics that permit quantification or that suggest any predictability.

The present business cycle has directed the spotlight toward the area of operational risk.

Parsing operational risk versus other risks

Operational risk is the risk to earnings and capital of inconsistent or undistinguished performance over time.

What bankers mean by operational risk has been evolving lately. Would you be surprised if I linked credit risk and operational risk as different ways of looking at the same sorts of long-term performance issues? Is it possible that operational risk has become in some banks one of the most pervasive but least recognized risks in our business today? You disagree? Well, keep reading.

I remember attending a series of informational meetings as an executive officer of my bank in Oklahoma City a number of years ago. The topic was disaster recovery, certainly a major subset of what we call operational risk. It was a major push of the Comptroller's Office that year and boards and executive managements were called to account for inadequate preparation for major business interruptions.

When my bank failed in Midland during the trough of the oil and gas price collapse, I gained a whole new appreciation of the value of consistent performance. Several years of robust performance were followed by a disastrous year. We could have survived one or maybe two of those but the problems in our concentrated marketplace were worse than could be contained in a couple of calendar years.

So, consistency of performance began to enter the thinking of the entire industry and its regulatory structure. This gives us additional insight into credit and liquidity risk and it needed a different label as it is not the same thing and should not be confused as simply another way to label an old and recurring issue.

But the pervasiveness of the "consistency of performance" imperative is perhaps best understood in the context of credit risk. We are an industry that is not heavily capitalized in the equity sense. We fund much of our lending with insured deposits so our risk appetite is appropriately constrained to larger questions of the public good including the integrity of our domestic money supply, which, after all is largely on the balance sheets of commercial banks in the form of deposit liabilities.

As independent, free market enterprises, we need to attract and retain equity to support our business enterprises. We can't operate entirely on borrowed money. No business is entirely risk free.

This demands a performance consistency--the ability to earn an appropriate rate of return on equity over time. And perhaps we should consciously strive to be in the upper quartile of performance metrics.

Banks are a collection of businesses built on years of sustainable performance and not on a series of "Hail Mary passes." We are rewarded by sustainable returns on equity but that means that we consistently hit singles and occasional doubles rather than trying to build a winning season out of triples and homers.

Where bad performance springs from

It's a variant on an old saying, "Lending's hard by the yard but a cinch by the inch." We are not called to be flashy or flamboyant. We are called to be conservative and consistent.

Anything that detracts from or creates a modicum of doubt around our ability to perform satisfactorily and consistently satisfactorily becomes a component of operational risk. Yet, we never seem to wholly overcome our collective ability to do dumb things in the credit sense:

- • Unrecognized concentrations of credit

- • Documentation lapses due to violations of internal policies and perhaps overriding of internal controls

- • Dilution of sound underwriting standards

- • Concessionary pricing practices.

- • Unmoderated growth

- • Insufficient training of staff

Each point represents a facet of credit risk. However, I submit that over time they are manifestations and facets of operational risk.

They negatively impact our ability to be consistent.

Inconsistency looms as today's community banking enemy

It's time we stopped thinking about "having a good year" and concentrated on putting our efforts on having a good decade or at least one complete business/credit cycle where we don't give all or most of the gain of the front years back at the reverse end.

This has been our historical pattern--or the results of enough banks anyway--to make investors and stockholders cautious about our long-term ability to conduct our business consistently well.

The very large players will always enjoy access to the equity markets. Community banks and the smaller regionals are the players who will be squeezed out by inconsistent performance.

As lenders, we ration credit to the best borrowing risks. But are we prepared to be on the short end of the rationing process of the equity markets as consequences of inconsistent performance?

We are called to be the best we can be--every year and not just this year. It's fun to see a Hail Mary pass, but when you think about, they are pretty rare.

Let's concentrate instead on the basics of the business. Controlling operational risk--and that means all of it in all its various forms however labeled--is the best way to assure our long-term survival and prosperity.

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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