

CHANGING NATURE OF SMALL BUSINESS CREDIT AND COMMUNITY BANKS' FUTURE

First of a series: What do we stand to lose? And what do we stand to win?

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One very intriguing question is how small- to medium-sized businesses will access commercial credit in the years to come. What has gradually come into stark relief are the evolving and very different business models of commercial banks, largely driven by their relative size.

How commercial lending evolved away from its roots

It's not surprising that size tends to drive the business delivery models of banks. Many years ago, size differences largely were often expressed in the relative degree of formality in the lending process. Large banks had elaborate loan policies and they were always in writing. Smaller banks were less formal, and while their standards were usually precise, they were often unwritten or were much less well-documented as to both policy and procedures than their large counterparts.

When I arrived as the newly elected CEO of First in Albuquerque nearly 20 years ago, we were typical of large community banks of the day. The "big loans" were negotiated at the main office, while loans to smaller business borrowers were typically done at one of a half a dozen of the bank's largest branches, where staffing included commercial lenders and branch managers with considerable small business lending experience.

In the intervening years, the industry has gradually evolved to the point where in many multi-branch retail systems, the contact point for commercial lending has become the branch. The difference today is that branch managers, especially at banks with large retail systems, are increasingly less likely to have formal commercial lending experience. The large banks led the way to making all but large commercial loans a branch product in terms of both access and delivery. The primary objective was to reduce the human costs of lending by increased use of credit scoring and centralized underwriting, and by streamlining the gathering and processing of information.

What banks gained ... and what they lost

The effort has been quite successful in terms of reducing costs. The customers, however, are not necessarily satisfied.

What's being lost is the direct and personal contact with a local lender who understands both the geographical market and the business of the customer. Lending is losing its personal touch as the human contact and interfaces are being replaced with lower cost alternatives or where the lending contact is at some physical distance (perhaps even hundreds of miles) from the customer.

One way of looking at this is to ask, from the bank's point of view: "So what?" So long as the customer is getting his loan approved, what's the problem?

But there are three relevant perspectives to be addressed in this question. One is the banks', another is the customers' and the third is the community's.

The bank's perspective is that credit is available to worthy borrowers and is being provided on a cost-effective basis.

The borrower gets a market rate of interest and the bank has a more cost-efficient delivery method. This means the employment of extensive labor-saving technology coupled with risk management systems that can be implemented on a portfolio or product-line basis. The branch is the contact point for this activity and represents a sensible way to utilize its fixed assets more effectively.

The customer often sees this differently.

No longer is the principal contact at the bank on lending necessarily an experienced credit person. Increasingly, this is now a contact person knowing little of the credit underwriting process, however skilled in the collection and assembly of information he or she may otherwise be. The credit decision is less personal and less based on hands-on, face-to-face contact and direct personal interaction.

Some of this is due to a series of legal actions beginning two decades ago where banks were deemed to have given poor or inappropriate business advice and delivered it in a manner deemed to have amounted to inappropriate control of the customer's affairs to the direct detriment of the customer.

In a phrase, "lender liability."

As a consequence, bank counsel became very cautious in its advice to lenders and this discouraged banks from giving anything that could be construed as business advice. My own experience was formed in this environment and the consequence, in my opinion, has been a long-term dearth of reasonable business input from the banker to borrower. The real loser here has been and will continue to be the borrowing public. The bank has lost something, too in the diminishment of a "value-added" feature for dealing with the local bank lender.

Community bank's future role in credit-and community

The third perspective--and the one that cries out to be addressed by bankers, regulators, politicians and the general banking public--is the future role of smaller- to medium-sized independent banks, the so-called community banks that populate the industry today, in granting credit to small- and medium-sized business.

There is much in the public discussion about the increases in regulation that are squeezing bank profitability. The inability to earn an appropriate return on stockholders' equity is seen to be driving industry consolidation and eliminating small banks from the market place.

Banking is a business of scale and size has always mattered. It always will. However, we are losing one of the essential elements of community cohesion as our smaller banks disappear and are merged. Our cities and towns are losing local boosters, and sources of contributions of financial and human resources for the public good.

Though the regulatory authorities have so far seemed to be unresponsive to these developments, at least these issues are entering the public discourse.

Cause for optimism

Increasingly missing in the marketplace and in all discussions of the future is the long-term access to credit by small- to

medium-sized businesses combined with and delivered through the business experience of a local professional lender. There is less business and human interaction between borrower and lending officer, with the result that a valuable community resource is withering away.

This, to me, represents both a problem and an opportunity.

The problem is that there is less productive lending based on the affirmation of character and first-hand knowledge of the business environment.

It probably pinches to a degree the flow of credit into a local economy. The community is the ultimate loser and in a way, this basically undermines the fundamental intent of Community Reinvestment Act activities.

The opportunity is that independent banks, those that pride themselves in not subscribing to the "empty suit" business loan development model, have a new and powerful niche to explore.

We'll talk about that in coming weeks and how the glass may be more like half full than we have been thinking.

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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