
HOW SMART ARE BANK EXAMINERS?

Contrasting the 1990s and today

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Just a couple of days ago I read on this website the review of Sheila Bair's book *Bull by the Horns*. Of all the impressions that bankers have about the last three or four years, the most durable are probably about how blindsided many of them felt when the examiners so heavily criticized their loan portfolios during safety and soundness examinations.

We have heard plenty anecdotally about this and the stories continue. But I've not seen any serious discussion of the question of whether the examiners were "more right than wrong." I think this is an important question that can, if thoughtfully approached, give insights to the degree of credit risk present from time to time in all community bank loan portfolios.

Facing examiners in the Southwest of the 1990s

My own experience in this area goes back to the early 1990s when I was the newly appointed CEO of First National Bank in Albuquerque. The OCC had forced a management change and I was brought in from the outside to administer the bank.

The previous few years in the Southwest had been a time of prosperity and relative growth. The community bankers were serving our marketplaces and booking loans at a good clip and at decent rates. But alarm bells must have gone off in some workstations in the Dallas field office of the OCC. There was something in the numbers, and maybe some tendencies noted in prior examinations, that suddenly seemed problematic.

We were the third-largest bank in New Mexico in those days and our principal competitor was Sunwest, also a national bank. Sunwest was examined a few months before us in 1990 and found the examination to be surprisingly unpleasant.

Our turn came next and we were set back on our heels. It was only with a little perspective that I began to appreciate what the OCC saw.

OCC had noted nationally that real estate credit was problematic for the banking industry. We hardly remember now that it was the revision of the tax code implemented in 1986 that closed some tax loop holes favorable to real estate borrowers.

Essentially,, demand for commercial real estate credit was borrowed from future years and put into lending portfolios, in

many cases to take advantage of the changing tax landscape. In other words, a good bit of demand was front-ended, creating a commercial real estate bubble.

I don't know that the OCC saw a bubble per se in Albuquerque. But it was simultaneously finding similar characteristics in the loan portfolios of two of our state's largest banks. By 1990, the agency decided to act on what it considered to be problematic and we felt the pain right along with our across the street competitor.

Taking a hard look at the facts

In our situation, my assessment was that we had gotten a little careless in our underwriting.

The lending wasn't particularly sloppy, but the documentation side of things tended to be at times. And we were not as tight and disciplined as we might have been with our loan structures.

I suspect from what was implied, rather than explicitly stated, was that the same sort of things were noted at our principal competitor. In other words, we knew better but got a bit sloppy.

Our management was expected to produce a continuous flow of earnings to support a dividend payout to our owners. The payout ratio wasn't excessively high but with the bank growing steadily and the growth in real estate credit (though the tax code impacts were no longer a source of demand), the examiners had some level of heartburn about the banking environment in Albuquerque.

When regulators get their leverage

Examiners don't have a lot of impact on management and the board if the bank is earning well and if the portfolio is not judged to be stressed or strained in some material ways by the manner of credit underwriting. Instead, they must first treat the core weaknesses thereby impacting profitability through requiring additional loan loss provisions or by requiring additional capital to abate inadequate capital levels. If their actions are severe enough, earnings are materially impacted and capital calls follow in short order.

The previous management group at First National elected to contest the examiners' actions. What ensued was a sort of guerrilla warfare between management and the examiners. I don't think the directors understood what was happening early enough to avoid the worst of the pain. In relatively short order the dividend was suspended.

That got their attention.

I firmly believe that the impact on the bank was largely self-inflicted. My sense of the credit underwriting process did not suggest that my new colleagues were a rogue bunch of wild-eyed lenders. They were a little "casual," perhaps, in some of their ways.

But they didn't see it that way, and rather than listen, they found themselves in unnecessary confrontations with the examiners that destroyed any possibility of mutually confident and respectful relationships.

Lesson to take from head-butting

The obvious takeaway here is that it's foolish to pick a fight you can't win. But it's even worse to be in a fight and not have the common sense to understand what the issues are. The old management had made the showdown personal and confrontational and had failed to absorb what the examiners were saying. The outcome was perfectly predictable, and it was nasty.

I came to understand this within several weeks as CEO. My job was not to simply address the examiners' concerns. That had largely been done with the Formal Agreement that they put the board under many months before. Instead, my job was to rebuild the confidence that had been lost all around--examiners for management, board for management, management for examiners, shareholders of both management and the board. The mutual relationships between and among every principal bank constituency had been eroded.

Bringing the lesson forward

The bottom line lesson is as simple as it is obvious. The examiners were more right than the bankers. That was certainly true in Albuquerque in 1990 and 1991 and I think it is an accurate description of the situation on a national basis by 2007.

Recall that the joint supervisory agency guidance on real estate concentrations was originally promulgated in late 2006 but was largely ignored by the industry until the problems were obvious to everyone a full 18 months later.

By then, examiners acted out of necessity and with a heavy hand. I suspect that many community banks and bankers would have had softer landings in subsequent years if the examiners' concerns had been heeded on a more timely basis.

Banking is ultimately a business built on trust. Nowhere was that trust more needed--or perhaps more lacking--than between bank managements and the supervisory agencies by 2007. This is the as-yet-underappreciated story of the pain of the last few years.

These are urgent lessons for the future. How will we as an industry remember them the next time around?

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.

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