

WHAT MAKES A BANKABLE LOAN TODAY?

5 C's notwithstanding, has it changed?

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Late last year FDIC published its Community Banking Study. Among other things, it explores the questions of what is a reasonable definition of a community bank, while looking at the issues of geography, structural change, comparative financial performance, and balance sheet and capital strategies of community banks.

The report contains much useful and interesting information for anyone engaged in community banking and wondering about the strategic viability of a small bank's business model. This study is available on FDIC's website on this page.

A friend who described his reading of the report as "plowing through the FDIC tome" asked me an interesting question. "What is a bankable loan today? Has the definition shifted over time?"

"Certainly not" was my quick reaction, as I drew on my experiences as a commercial lender with the Five Cs of Credit as my reference point.

But then I went back and reread FDIC's executive summary.

I thought there have been enough changes in the banking landscape to perhaps feel that a more nuanced answer to the question is appropriate.

Answer begins with a definition

The starting point, appropriately, is what size range describes a "community bank" today. The historical view of community bank size has in recent years been most banks up to \$1 billion in total assets. The study found that other factors are perhaps equally important to an understanding of this industry segment--such as geography and a bank's product line.

Community banks hold the majority of deposits in rural and "micropolitan" areas. Customers also associate local ownership, control, and decision making with community banks. There is a clear tie of entrepreneurial activity to community banks. In 2011, community banks held 14% of banking industry assets but 46% of the industry's small loans to farms and businesses.

Product line, particularly among types of loans made, is another distinguishing characteristic between community banks and their larger cousins.

Over the last several years, noncommunity banks have shifted their emphasis from commercial lending toward retail lending, while community banks were shifting toward loans secured by commercial real estate. Unfortunately, data confirms that CRE lending in recent years has been the lowest-performing specialty group of loans by a variety of measures. (That is probably a transient statistic and not necessarily predictive of loan category performance in future years.)

Management's role in underwriting

The study also attempted to explore the role of bank management decisions in the degree of influence exerted on underwriting outcomes.

The results confirmed the importance of a management approach that sticks to the basics, the Cs of Credit, revealing a clear distinction between the imperatives of growth and financial performance. While these are not necessarily mutually exclusive, it often happens that one tends to exclude the other.

We are clearly in a growth mode as an industry and that will probably lead to some underwriting issues that will be revealed when business turns down again--as it certainly will some day.

There are many community banks located within metropolitan centers. What seems to be key to their overall performance as distinguished from their country cousins is a deliberate niche approach to commercial lending.

This is where the true insights of value of FDIC's study may lie for community bankers.

A niche approach means, based on recent trends, an effort favoring not only a richer mix of CRE and C&I lending than is practiced by large banks but also in the approach to servicing loans and tying customers to the bank in a personal and lasting way.

Elements of such a strategy are not without their risk. Failure rates of community banks with heavy emphasis on CRE and C&I lending during the recent recession were considerably higher than the industry averages taken as a whole.

So, is a good loan different?

Thus the question of whether a bankable loan definition has "morphed" over the years suggests that the answer to a degree has changed somewhat. Let's explore this step by step.

While the Cs of Credit are always important, at times growing interest income may receive a degree of priority over strict applications of historical principles, especially during times like now.

The overall business environment is improving.

Banks are profitable (but acutely anxious to build earning assets and net interest margin).

And all the while accompanied by a lessening of regulatory concerns about safety and soundness of the banking system from an industrywide perspective.

A careful reading of the Study (and the Executive Summary is probably sufficient) yields some potentially very optimistic

conclusions.

These mainly include the fact that community banks do some things very well and that by and large, their banking publics acknowledge, appreciate, and enjoy what's special about a community banking relationship.

Second, the sorts of opportunities to be exploited by each segment of the business, the small banks vs. the large ones, are different and will likely continue to be different. This means that niche types of banking strategies, if carefully formulated and well executed, can be successful and produce competitive advantages for the smaller banks.

Third, though not a major component of the Study, the intangible elements of community bank service, such as relationship banking, are simply not a consistent strategy of many large banks.

There are bank customers who want the low-cost provider and there are others who are willing to pay for what they get on a personal service level. This is an article of faith shared by all community bankers.

In the final analysis, consistency of performance is valued by shareholders and customers alike. This is one thing that the principal stakeholders of both small banks and big banks can agree on--and the pursuit by each of divergent strategies will yield certain benefits to each.

Reports of demise greatly exaggerated

The remarkable thing to me in reading this study is how much opportunity for continued prosperity appears to remain in a traditional community bank business model. Geography and product line will continue to provide both resources and constraints impacting future activity and of course an improving economic climate is key to long-term success for everyone.

And yes, maybe the notion of what is a bankable loan is changing and is somewhat more influenced by the business model of each bank than has been acknowledged by current practitioners.

That's always been so to a degree but it's less to do now with the old divide between conservative vs. aggressive lenders.

Now it's more suited to the type of bank its management considers itself to be, its location, and its future aspirations as its managers and owners peer into the future.

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.

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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