

HOW A NEW BUBBLE GETS CREATED

Don't let "income anxiety" mess up your bank's future

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Every credit person is taught that to make money, you've got to keep the action going.

When a business manufactures a product, it creates a potential gross profit on that product. Then the product is sold and a receivable is created; when the receivable is collected in cash, the cycle is complete. But it requires a succession of "turnovers" (manufacturing/inventory/receivable) to make the complete journey in terms of generating cash. That is why "turnover management" is so important--and faster is always better.

We have all learned much the same thing in basic economics. The faster the money supply circulates (velocity), the higher the level of economic activity.

Bankers are once again coming to keenly appreciate a similar lesson in our net interest margins and the size of the liquidity pools that are accumulating on commercial bank balance sheets.

Net interest margins continue to deteriorate due to monetary actions of the central bank. While loan-to-deposit ratios decline for lack of loan demand, that only serves to whet banks' appetites to increase the levels of commercial lending to overcome this shortfall. We are looking at pools of relatively idle liquidity and want to get them working productively.

Are tomorrow's problems being booked today?

In a prominent article last week in The Wall Street Journal, the headline trumpeted that "Business Loans Flood the Market."

Ordinarily that would be good news.

But maybe we need to stop and consider whether we are reading the tea leaves correctly in terms of the current business cycle, which began its tortuous path to recovery nearly two years ago.

The progress in returning to levels of pre-recession lending activity is impressive--but the causes of the improvement look like sources of future heartburn.

The basic capitalistic ratio is Return on Equity (net profit divided by shareholders' equity). It's what the owners of the business get paid for risking their equity. (Perhaps we could describe it as how they expose their resources to the turnovers inherent in the cash-to-cash cycle of any and every business).

Banks take in deposits, make loans, and collect them plus interest. Manufacturing companies buy materials, manufacture something, sell it, and collect the cash. It's similar everywhere and at its heart it's a "turnover" of cash in a series of processes specific to a particular industry or business.

The logic of the ROE ratio is that more risk deserves compensation in the form of a bigger return. Safe or less risky investments (or uses of resources) appropriately earn smaller returns.

This is the fundamental logic of risk in the banking system and indeed in our economic system taken as a whole. Bankers take reasonable risks with depositors' money and earn an appropriate return for the risk taken. Considering that our capital structures are somewhat top-heavy with debt, compared to those of most of the customers we serve, it means that not all risks belong on the balance sheets of banks.

We are not entrepreneurs in our risk taking and therefore we don't earn "outsized" returns on equity.

It's safe to say that the returns on equity for most commercial banks during the last few years have not been particularly impressive. They were much better in the several years before the current recession hit in 2007 than they have been since.

Does anyone see a significant change on the horizon? Is monetary policy about to significantly shift toward higher market rates of interest? Is business anticipating future quarters of robust economic activity?

The numbers of late don't seem to show much optimism in a resurgence of economic growth sufficient to move the needle of market rates of interest very much. And the Federal Reserve seems content with its current course of actions for the moment.

Time to buy Nexium

So where is the "flood of loans" described in The Wall Street Journal article coming from? What's the source of the demand?

The heartburn I mentioned is the almost certain probability that bank lenders are lessening their credit standards to stimulate loan demand. After all, it's expensive in the opportunity cost sense to keep large pools of liquidity on the sidelines.

And we have all grown weary of the "save our way to prosperity" attitude that has been imposed on our business models by directors, shareholders, and regulators since 2008. It's time to get back to doing what we do best or so the prevailing logic goes.

Bankers instinctively understand the link between credit quality and liquidity. Lose the public's perception that credit quality is sound and liquidity is the immediate casualty. Could that be something we're inadvertently sowing into our loan portfolios today?

Easing credit now, making future workouts harder?

What are "limber" credit terms?

Rate is certainly one of them and anecdotally there's lots of current chatter about how banks are offering fixed-rate loans at remarkably low rates, at least in historical terms.

Loan covenants are another sign of how competitive (limber) banks are willing to be. Are you or your competitors easing restrictions on minimum levels of working capital, stockholders' equity, or collateral advance ratios? Do you still require the personal guaranties of the principals (or at least the main principals) like most all of us did not too many years ago?

Now here's the key matter: If you are in fact granting some concessionary terms today, are you being compensated for it? Will you improve your net interest margin this way? Are you improving your bank's prospective ROE?

If the answers are all yes, then ask whether your anticipated improvement is due to the leverage on your own balance sheet or whether it's primarily because you are getting a higher level of gross interest income.

Could a new "bubble" be forming?

I suggest that we may be entering a new "bubble phase" of lending.

It's an old problem in a new suit of clothes.

The regulators know it by the elegant phrase "anxiety for income."

We know it as loan demand--but we may be guilty of confusing overall loan demand with our own views of the degree of market competition. Our stockholders may remember the coming days ruefully as a return to volatile earnings and unsustainable returns on shareholders' equity.

There's not much new in our business.

So why are we so casually taking on familiar and predictable old fashioned problems?

Don't we know better?

Doesn't anyone remember?

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.

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