

## TWO LESSONS FROM THE HEADLINES: CREDIT CONCENTRATIONS AND CORPORATE GOVERNANCE

A large bank and an international church, both in the news

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Concentration concerns bring up history and controversy

Moody's Investor Services this week expressed concern about Wells Fargo's expansion of its investment banking activities with its just-announced large credit participation in the Heinz leveraged buyout led by Warren Buffett's Berkshire Hathaway, Inc. The bank, along with JP Morgan Chase, has agreed to provide \$14.1 billion in financing to accomplish the deal.

Moody's observed that the financing is probably a larger amount of credit than the bank would likely grant to any customer of its commercial lending function. The implication, of course, is that this will result in increasing concentration risk and thereby contribute to expanding the bank's overall level of credit risk.

Is Moody's on target?

This strikes me less as a concentration issue, though dollar size of the transaction probably qualifies as a valid element of concern, given the sheer size of the commitment. No, I think what we have here is more to the point of an overall reduction of commercial lending standards in the face of strong banking competition. It's a battle being waged now over price and terms.

A recent time the mega banks were doing a lot of syndicated financing was in 2008. Many deals committed to in the summer and early fall of that year were ultimately at "below market" pricing, due to perceived risk characteristics by the time it came to close the deals at yearend.

The banks found themselves having to go to closing on deals then "out of round" with market conditions or risk significant liability for reneging on multi-billion dollar commitments.

They then had to mark down to market their unsold inventories of many of these deals, as interest rates had run up unexpectedly at year end. To make matters worse, since the loans were part of inventory rather than the permanent lending portfolio, mark to market treatment was obligatory and immediate and the losses hurt.

In actuality, the Wells and JP Morgan participation is a continuing facet of the "too big to fail" dialogue that all of us have been engaged in for the last several years. Press reports on the Wells involvement in the Heinz transaction also noted that Wells Fargo has been expanding its bond trading operations and ranked fourth in U. S. syndicated loans in 2012.

Bond trading and syndicated finance are two areas that would have not been permissible under the Glass-Steagall Act that was repealed in 1999 by passage of the Gramm, Leach, Bliley Act. A big bank is getting bigger and while that may not be troublesome per se, given the strong balance sheet and operating performance of Wells, the matter of TBTF continues to be largely unresolved in the practical sense.

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#### A corporate governance lesson from Rome

The forthcoming Conclave of the College of Cardinals to elect a successor to Pope Benedict XVI has some practical similarities to the governance of any significantly sized institution in our contemporary world.

While I'm not suggesting that the Church is a business (it's a Church, after all, though it must operate according to an overall "business" plan) there are some strikingly similar issues to the governance of any truly large enterprise.

I remember cutting my teeth as a lender in the New York environment of mega banks. The Bank of New York was a relatively small "giant" among its largely New York-based peers in the 1960s though it was still a huge company in comparative terms of the day. Those of us in our apprenticeship period in lending were reminded that we were joining the lending line and were being fashioned and shaped into an elite type of banker known as a "commercial lender."

Early on we were reminded that there is line and there is staff and the line is where the action is. The sachems could also have noted that the line was also considered a more direct and reliable route to the top of the house.

Some years later after tours on the line as well as significant chunks of time as loan review and then as head of credit administration for a regional bank, I realized that both line and staff had unique and in some respects exclusive roles to play in building a strong franchise.

By franchise I mean the way any bank addresses its market and how it organizes itself to get the particular job done. Neither line nor staff could do a really effective job without the other and that's a tendency that's expanded, not contracted, over the last generation.

The cardinals probably already see themselves individually as line or staff without perhaps ever thinking expressly in such terms. The Curia constitutes the central bureaucracy while the diocesan bishops are the line. The College of Cardinals is divided about evenly between line and staff and has been for generations, an organic and deliberate sharing of influence.

Our secular institutions face great challenges, as do our state and national governments and other great world institutions.

In this day of banks of previously unimaginable size and concentrations of resources and wealth, change has been visited upon all participants. Are big banks too big for the safety of the system? Do foreign-based companies enjoy an unfair advantage over domestically based businesses? Are the politicians too involved? Are they not involved enough or in the most constructive and productive ways? Will the next CEO of your bank or mine be from the line or from the staff?

So many questions.

The list is seemingly endless. And there is a striking similarity across the panorama of institutional size and function. As we watch the Church go through another transformation of leadership in its long history, let's hope that it shows our age that leadership and organizational realignment can be a seamless process. The business structures of civil society and its governmental entities face the same sorts of challenges in the months and years just ahead.

#### 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 e-mail him at [etoleary@att.net](mailto:etoleary@att.net). O'Leary's website can be found at [www.etoleary.com](http://www.etoleary.com).

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