

Why Today's Headlines Will Impact The Amount Of Lending Banks Do

Recent press reports concerning banking may be telling a story that's different from the way we've been thinking about our industry the last several months. Clearly the leading problem with the banks, especially the giants, has been the massive systemic failure to assess and manage bank balance sheet risk.

While accounting rules exacerbated the problems in the early phases, in my view blaming "mark-to-market" accounting rules at this point doesn't seem warranted. As mortgage delinquencies rose, the underlying value of mortgage-collateralized debt obligations fell. In some cases, the loss in value approached 85% to 90%. Some of these losses represented market uncertainty of true or realistic values of these securities. As a result, demand for them dried up and values fell to "bottom fishing" levels.

Headlines dictate need for remedies

Now, mark-to-market is a blunt accounting proscription for dealing with such problems. But is the right answer, then, to not deal with the problems at all?

Last fall, after the collapse of Lehman, many observers felt that the markets were approaching a valuation bottom in terms of plumbing the depths of the asset-backed bond losses. The sale of Merrill Lynch tended to bolster this notion, as due diligence by BofA, the announced acquirer of the big brokerage house, and other suitors over earlier months of 2008 gave a sense that risk assessment on Merrill's balance sheet had been reasonably thorough. Deal making could once again resume with some comfort that credit losses were ascertainable and reasonably estimated.

The surprising and unwelcome news at this writing that BofA needed additional assistance from Treasury, due to the continuing decline of asset values acquired through Merrill Lynch, removes any such sense of confidence that the markets know where the bottom is.

Meanwhile, there are some indications that our economic malaise is having a continuing and perhaps more pernicious effect on our financial system. Here are some very recent developments that I think point to a continuing downward direction in the current credit cycle:

* Citigroup had to be assisted again, this time with an additional shot of equity and the limitation of some loss exposure in the form of a Treasury guaranty.

* Marshall and Ilsley, a Milwaukee-based medium-sized banking company, announced a very large increase to its loan loss reserve at the end of the calendar year. M & I is a banking company that largely missed any involvement in the subprime problems that were so devastating to larger banks and financial companies. The degree of credit deterioration during the fourth quarter of last year was a surprise and the fact that the company's dividend was cut to a penny a share was also part of this news.

* BofA faced both further asset writedowns and an increase in loan loss reserves. Investors are asking how much more of this may be in store for the company. Fortunately, it's not a question that depositors and vendors are asking (at least not yet).

* The press has recently reported regulatory expectations that the commercial banking industry will report a cumulative loss for the fourth quarter of 2008.

These are just a few of the examples of the concern that I see right now.

Bad news impacts capital growth

It's not just deteriorating asset values of collateralized debt obligations—those securities backed by mortgages that were imprudently or fraudulently underwritten.

What seems to be underway now are broad and persistent increases to allowances for loan loss reserves at banks over the full ranges of bank size and credit product line. This means that the economic downturn is impacting fundamental business activity in substantial ways. The idea that this is having an impact on both the industry's ability and

willingness to lend money and that banking company dividends are subject to reduction or elimination is beginning to take hold in the marketplace.

Some will say "So what?" So what if dividends are cut? How does that impact lending?

The connection comes in the form of the ability of banking companies to raise additional capital.

In an environment of de-leveraging (less debt, more equity), more capital is required to "fund" or support a given level of assets.

If the banks are having trouble earning additional equity due to reduced earnings, then how will they convince wary investors to put more equity into the common stock account of the company?

Consider recent blogging activity in The Wall Street Journal's online "Deal Journal" section. A number of BofA shareholders are expressing concern about the possible (or probable) lack of any common dividend.

Why would investors invest more heavily in a company clearly showing signs of distress, unless the stock is perceived to be a bargain at current levels?

And why would anyone come to the conclusion that BofA stock is a bargain when the company has been unable to value its assets conservatively over the last several quarters?

Consider too that Treasury has also warned banks that have accepted TARP money that excessive levels of dividends will not be tolerated. Who is defining what excessive means? Remember that this is our tax money being injected into these bank balance sheets. How politically popular will it be if a significant portion of this money is ultimately used to pay dividends?

The real problem might be that the worst of the balance sheet deterioration is in front of us in the form of flagging asset quality and higher levels of nonaccruals and actual chargeoffs of loan asset values.

We went into this recession several months ago with high levels, at least in relative historical terms, of real estate lending assets on the books of community and medium-sized banks. The real-estate-related problems have now become the deterioration of commercial and residential real estate values due to a deceleration of aggregate economic activity.

This is the classic problem experienced during all credit cycles.

However, this cycle began with massive losses stemming from sub-prime lending and securitization abuses. Banks started this phase of the credit cycle in a weakened condition as an industry.

The shape of things to come … if

If we can get beyond the mortgage mess, and if we can get the banking public comfortable that we have a clear and accurate idea of the size of the risks in the financial system, then we as an industry will simply do what we have always done. We'll rebuild our portfolio quality a loan at a time, and over the next several quarters, we'll restore our industry's health, in terms of both quality and profitability.

I think that process is now beginning. But it's sad that our risk management systems, both public and private, did such a poor job of keeping us out of the worst of the problems.

Collapse of character—will it rise again?

Another variable that has been at work here is the first C of credit—Character.

Human nature is unchanged since Adam and Eve were ejected from the Garden of Eden. What seems different today is that there are so few restraints on human behavior compared to earlier times. We see fraud and theft everywhere. Perhaps more ominously, in recent years, there is an increasing detachment of responsibility from the consequences of our individual actions.

There is ethical cupidity and ethical stupidity. We are witnessing the consequences of both. Most troubling is how badly we seem to have lost our way. We have to fix more than just the asset quality of our companies.

Some questions to ponder:

How many of us think that answers to this challenge are to be found solely in policies and procedures manuals?

How can community banks best exploit their advantages in the current environment?

How does your bank see its local situation? Are things looking up yet? Or are they still headed down?

Has your bank taken TARP money? What are you doing with it?

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 a frequent speaker in ABA's Bank Director Telephone Briefing series. You can hear 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