# A Talking Credit Essay: Why Community Banks May Come Into Their Own

For the last few years our industry has experienced a “new order” of credit. Traditional underwriting standards were frequently waived, owing to “competitive conditions.” Banks were aggressively generating additional lending opportunities for both real-estate-related purposes as well as leveraged-buyout deals. How much of this so called “new order” will survive and how the new realities of the current economic and regulatory environment will impact the banking industry is not clear. We are in a period of economic and political change and the public’s view of financial institutions and their regulatory context are not yet clear.

But we can begin to come up with a hypothesis of what the future holds, based on current events. And we can see that, in the longer term, there is good news for community banks.

The boom in big

We should first acknowledge that “big” has become the norm and will likely be undiminished into future business cycles: Big banks, big credits, big borrowers. These will largely define the prevalent banking business models and public and political perspectives of our industry.

Second, the very top of the size pyramid has some new players, now, including large Wall Street investment houses and nonbank financial firms, such as GMAC, that became banks for funding purposes.

Competition at this size level has always been robust. But now there’s more of it competing for any available business and related funding sources, in depressed market conditions. The very large multi-national banks have argued and lobbied for years against artificial constraints on their size (total assets, expanded legal lending limits) as a competitive necessity in the worldwide scope of their activities. The new and permanent reality is that there are fewer banks and they are of a larger size than anything we’ve seen in the past.

An “ice age” for community lenders?

There are many interesting industry issues to work through in the next few years. Perhaps the most urgent one is, “What will become of community banks?”

Will community banks, historically the primary credit sources for small and emerging businesses, be entering into a new “Ice Age” (in spite of global warming) where they can no longer prosper as a business model in the new paradigm of bigness?

There could be something to that. There are trends that have been evident for years that tend to threaten a “small” community banking model as defined by the size and scope of the bank. These include the burden of consumer compliance in lending and deposit-gathering functions that have added incrementally and significantly to bank overhead. Risk control processes in the form of loan review and enhanced credit administration functions have been growing since the late 1970s.

In spite of what appears to be an almost systemic failure of these risk management systems in the last year or two, the trend is unlikely to be reversed. In fact, bankers can expect political and regulatory pressures to increase outlays in these systems, although with uncertain results for long-term safety and soundness based on a conservative reading of recent history. The headcount necessary to perform these functions that are now mandated by law and regulation represent nonproductive overhead. None of these positions and the people they represent contribute to revenue.

There is also the long and persistent trend of banks’ sources of funding, deposits, and equity, becoming scarcer and more costly. Bankers understand that it takes as much time and effort in manpower to originate small loans as large ones. It is this same principle of scale applied to the origination of sources of liabilities and equity that will increasingly tend to crowd out the smaller institutions that simply don’t have the economic muscle to compete effectively on the same playing field.

Regulators’ role in rollups

Bank supervisory agencies have been cast in the roll of accelerating the trend toward larger banks. The size of the Deposit Insurance Fund has been relatively marginalized in recent years as banks have expanded total assets by both internal and external growth.

It’s not hard to understand why. Systemic credit risk has in recent years been consistently underestimated by both supervisory agencies and banks themselves. Accounting practices that permitted banks to offload contingent liabilities into entities that were not capitalized on balance sheets was another factor that tended to diminish the perception of the size of the risk in absolute terms. When IndyMac was taken over by the Office of Thrift Supervision in 2008, the institution’s insured deposits exceeded the size of the insurance fund by more than a factor of four.

Clearly, in hindsight, the insurance fund entered the current economic slump significantly underfunded. The regulatory response has been to merge ailing banks into healthier ones to reduce the drain on the fund as well as on the human resources of the FDIC and the OTS. The inevitable result of these collective factors has been fewer, as well as larger, institutions comprising our banking system.

What does it mean for community banks?

For community bankers these factors comprise a dreary list of threats and prospects. But is the future of community banking necessarily bleak?

The behaviors of community banks since last fall have been instructive. While the evidence is still largely anecdotal, it appears that very large banks have sharply curtailed lending activity. Community banks became temporarily hesitant, out of funding concerns, but they didn’t sit on the sidelines very long.

The politicians and the public are excoriating large banks for taking TARP capital and sitting on it, or using it to fund acquisitions, rather than generating loan volume.

But local customers understand what’s been happening as well as, or even better, than anyone.

They know which banks are lending money and which banks are not. From a public relations viewpoint, community banks are faring well through these uncertain business times. [Editor’s note: The upcoming February 2009 ABA Banking Journal includes a roundtable discussion among nine community bankers that demonstrates how lending is still going on, by community banks, in certain markets.]

Large players face harsher regimes

How successful the former investment houses-now-commercial banks will be in earning anything approaching their historic returns on equity is far from certain. They have traditionally assumed risks for their commensurate rewards. However, such risks are simply inappropriate for commercial bank balance sheets and risk appetites. They will not be tolerated with funding sources consisting in part of insured deposits.

During this last business cycle the very large commercial banks have not distinguished themselves as sound stewards of their financial resources. Risk measurement systems failed—or at a minimum failed to sufficiently alter institutional appetites for risk. Examiners have very long memories and are likely to be given additional tools as a new and reinvigorated regulatory environment emerges in the next couple of years.

We are experiencing a severe economic downturn that will at some point reverse itself. With fiscal and monetary stimulation, we will recover. Community banks will lead the recovery for the primary reason that their part of the business is perhaps the one portion where reputations for responsible and ethical business practices remain intact.

It is much easier to lose one’s reputation than to rebuild it. That creates a window of opportunity for community banks to perform well and earn honest and appropriate rates of return that will attract capital, funding, and political support. In fact, the next few years may be the best that the community banks have enjoyed in very long while.

How are things going among community banks in your market?

What is your own bank’s outlook for 2009?

When does your management team think things will turn around?

What steps is your bank taking to help make it through 2009 and into 2010?

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.