WHATâ€™S CHANGED IN COMMUNITY BANK LENDING TODAY, AND HOW IT COULD CHANGE AGAIN AS CONGRESS TINKERS

Credits that could pass muster at most community banks 18 to 24 months ago cannot pass muster today. This is because community bankers have become very cautious due to the precipitous decline in business activity, while examiners have taken a strong but probably deserved stand on credit quality during recent community bank safety and soundness examinations. Could community banks have anticipated today’s malaise? And what does today’s trouble bode for future lending practices?

QUESTIONS TO ASK

One compelling question is whether community bankers could have anticipated the current financial malaise. The answer here is not clear and contains a complexity that the question doesn’t address. While the OCC started warning of potentially unhealthy commercial real estate concentrations of credit as long as two years ago, both practitioners and examiners did not, and probably could not, have reasonably foreseen the extent of the collapse of business activity.

What seems to have stunned bankers particularly is how widespread fraud and other abuses were in the home mortgage origination market. While much of the toxic product was originated by non-regulated industries (mortgage banking seemed almost like a “cottage industry” not too long ago), the volumes were large enough to represent a systemic risk to asset quality for the banking system as a whole. While the volumes of toxic assets largely escaped placement in community bank portfolios, the market’s reaction to the extent of the problems negatively impacted all players. The seizing up of the credit markets represents a loss of public confidence that’s unprecedented over the last 75 years.

As bankers come to grips with current realities and assess the weakened quality of their portfolios, it’s time to seriously assess or “vet” the credit culture of all banks.

* Did credits currently criticized slip through a vague and inadequate credit policy?

* Or was it a failure of enforcement that created the credit rot?

* Was your loan review on its toes in spotting credit weakness in a timely enough way to mitigate some of the negative impact of such underwriting?

* If we don’t have a strong sense about the answers to these and related questions, how are we to prevent such a thing from happening again?

THINKING ABOUT CREDIT POLICY

I don’t believe that any credit policy can reasonably anticipate every eventuality. One cannot anticipate every situation or describe every “opportunity” in detail before the fact.

However, bankers should evaluate how well their credit policies have served them in the last two or three years, and make such changes as events suggest to what degree recent events could have been reasonably anticipated.

A place to start would be to evaluate every criticized loan in the loan portfolio. See if the weaknesses identified by examiners or the shortcomings in performance were identified in policy. Next, were they identified in the credit approval write-ups? If these bad loans are loaded with exceptions that created or materially contributed to the criticisms, then corrective action is obvious. If the policy is “observed in the breach,” then it could be said that the bank really has no policy at all.

What about those problems that policy could not have reasonably detected? Corrective action probably is needed—but not a retooling of the credit policy. What should you do and where do you start?

The next obvious suspect is the level of surveillance that outstanding credits get after the loan is funded, even if the borrower has a long standing borrowing relationship with the bank. If this does not appear to be a fruitful area for corrective action, the problems will be more difficult and intractable. Maybe the answer resides with the set of assumptions the lending staff makes about the economic health and vitality of its lending trade area. To say that such assumptions were (or even still are) overly optimistic somehow fails to capture the essence of the problem. A better way to think about this is to analyze the bank’s collective attitude toward risk. This is why a healthy concern about concentrations of credit and the overall composition of the loan portfolio by type of loan product may be a fruitful place to start.

Community bank portfolios have a certain inherent concentration risk to them. In some cases they are extreme and obvious, such as oil and gas drilling and production located in defined geographical areas such as West Texas or Oklahoma. Other communities where particular industries are predominant are susceptible to concentration risk that is essentially unavoidable just because the bank is located in proximity to these sources of economic activity and employment. What I’m talking about are concentrations of credit that don’t fit comfortably into a ratio of capital sort of matrix.

This is where the bank’s collective attitude toward risk is important to evaluate. It’s hard to do objectively because the benchmarks are frequently subjective. More tangible common equity is a partial answer but in a competitive environment such as our national economy, banks have to earn reasonable returns on equity to attract and maintain equity capital. To say that it’s hard is not the same as saying that it’s impossible.

CHANGES OF VIEWPOINT

One place to start is to make lending into an activity that is principles driven rather than solely rules driven.

* We can return to an old-fashioned idea that credit extensions should be for useful, productive purposes that result in increased opportunities for employment and profitable operations.

* We can train our people better (and continuously) and eliminate the tendency to curtail training budgets at the first sign of stresses and strains to our net income account.

* We should remind ourselves that we’re in a cyclical business. Our customers are impacted by normal business cycles. We should never expect to do better than our customers, taken as a whole, should do in our local marketplace. When they do well, we should do well; when they slow down, we should slow down too.

REMEMBERING OLD-FASHIONED IDEAS

There’s another old-fashioned idea that’s coming back into vogue and we should pay attention to it. A half a century or more ago, lending money was considered to be a reliable way to generate and sustain core deposits.

We’ve gone quite a distance away from that idea in 50 years and the clock isn’t likely to be turned back to any significant degree. We’ll continue to rely on non-core funding sources to a greater or lesser extent for the foreseeable future. But the principle remains—lending money should generate core deposits. When it doesn’t, then we probably need to take a closer look at our customer base. That links back to the productivity principle of each loan. If a loan by purpose doesn’t satisfy the community’s need for credit and contribute to employment and an increased level of community affluence, then we’re not doing our jobs. Some of this can be addressed in loan policies. But so much more of it is in the attitudes toward business development; lender recruitment; how lenders are incented, trained and retained; and our attitude toward risk taking.

When each of our banks were newly chartered and opened the doors for the first day’s business, we had a choice. We could make a particular loan or not and develop, loan by loan, customer by customer, the character and nature of the bank. That’s much harder to do with an established business as one incremental loan does not materially change the composition of the loan portfolio or its risk profile. We need to re-establish a sense about the sort of business we want to attract with the same formality and purpose as we recruit the staffs we hire.

Any industry that is capable of giving back in one year nearly the aggregate profits of much of the current business cycle is in need of some serious retooling. It’s time to do that now with a thorough review of our internal controls to be sure that they are up to the job. We should combine this with a new and serious look about the sort of bank each one of us would like our bank to be. This requires some thinking, some introspection and lots of training and reinforcement to sustain. National attitudes toward risk taking and the very nature of lending are changing. It’s time to claim our industry for ourselves and not cede control to those who have lost their way or do not share our commitment to our communities and our values that have served us so well.

QUESTIONS FOR THE FUTURE

Congress and the Obama Administration are considering extensive changes to the way banks and other financial institutions are regulated and financial risks are administered.

The very largest banks, those generally described as “too big to fail,” are likely to operate differently in the future, perhaps as downsized entities or with different (increased) capital requirements.

These developments will have direct implications for how community banks conduct their business, fund themselves, and administer risks.

Here are some of the questions we need to get a head start on addressing:

* How can we improve the way we view, measure, and monitor risk?

* How do we change old ways of thinking? What are the likely agents of change?

* How competitive is community bank lending likely to be when economic activity recovers?

* Has the borrowing public’s appetite for debt been permanently reduced or is this just a temporary slow down due to economic fears or uncertainties?

* How intrusive is the federal government likely to be in our industry’s day-to-day activities? Are our current business models already obsolete?

What are your answers to these questions?

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.

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