THOUGHTS ON THE CHALLENGE OF MANAGING THE CAPITAL ACCOUNT

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Many community banks today are cautious about the lending environments in which they are operating. A turnaround in our national economy is not yet evident, not in a broad- based way. And many regional economies are clearly distressed, with no clear sense of when overall business conditions may improve.

Banks also face a difficult earnings environment. While management of net interest margins has become easier, at least temporarily, because of the actions of the Federal Reserve, loan volume growth, the typical engine of bank profitability, has stalled. Indeed, in many markets, loan growth has been in a significant decline in recent months.

Many industry observers believe that this lays at the root of why banks are not doing a brisk lending business.

In one sense, capital appears to be adequate to support more lending activity than appears to be happening nationally. This is in spite of the TARP money that has been infused into the balance sheets of many banks during the last six months.

But not all banks qualify for TARP assistance, and, furthermore, there is a growing cadre of them who do not want it and the perceived government intrusion into their day-to-day activities—such as lending, compensation, or paying dividends.

Where capital is scarce, or may become so, bankers become cautious. They lend less or are pickier about the deals they are willing to do. They also tend to preserve capital by not aggressively charging down problem loans. Rather than charge down quickly with the expectation that they will recover the proceeds later, they manage the charge down process. For example, if an appraisal of collateral doesn’t mandate a charge off or a charge down, then the recognition of loss is deferred or delayed.

The implications of this tendency or practice are potentially important. First, bank balance sheets become less conservative and begin to reflect a degree of optimism that may not be warranted over time. The liquidation of troubled assets, especially real estate assets, are retarded, as a bank is less willing to accept a stiffer write down today at a price that would otherwise free the bank of the problem asset. Finally, the practice truncates subsequent recoveries, potentially exposing the bank to further erosion of values over time.

Community bankers should carefully consider the manner in which they manage their capital accounts—manage both actively and passively. There should be a continuous internal dialogue about the temporary versus long-term impacts on the health and prosperity of the organization.

Some questions for you to answer:

In circumstances where a charge down or a charge off of a credit asset is discretionary, is your bank's charge off activity influenced by the degree of capital available?

Would you describe your bank's attitude on taking charge offs or charge downs as "conservative?" If so, why?

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.