

WHAT'S IMPORTANT AND WHY WE WORRY

REMARKS BY

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SEMINAR

THE LIFE CYCLE OF A BAD LOAN

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~~We at the Federal Reserve Bank of Kansas City certainly appreciate the opportunity today to help sponsor this seminar on~~

Loan quality. ~~this~~ is a fundamental, important topic of considerable concern to regulators as well as to lenders, borrowers, investors, and members of the legal profession.

→ ~~to~~ FARMERS CASE. ←
Though litigation involving problem loans is not often front page news, we do see headlines every day that chronicle bank failures, or rescues, or related problems. So long as these problems remain on the front burner, so to speak, I think that there will continue to be diminished public confidence in our financial institutions and fears about the stability of the overall financial system. Stability and public confidence are the linchpins of a sound financial system and they are, therefore, matters of great concern to us at the Federal Reserve.

Loan quality is right up front among the key elements of banking stability. As we see it, credit decisions of individual lenders impact directly on bank safety and soundness, and ultimately influence the stability of the whole banking system. Stability of the system is important to the Federal Reserve for two major reasons.

One reason is that as a supervisor of banks and bank holding companies, the Federal Reserve is concerned that institutions do not take on unwarranted or uncompensated risk. Such risks endanger the safety and soundness of these institutions, exposing not only investors, but depositors, the FDIC, and the Federal Reserve to potential loss.

But a broader and more fundamental reason for our concern is that monetary policy and other economic policy decisions cannot be made in a vacuum. Because monetary policy is implemented through the banking system, the willingness and ability of banks to extend credit and the stability of the banking system in carrying out this function influence the effectiveness of monetary policy. Thus, policymakers must always be concerned with conditions in the banking system. And as we all know, the health of the banking system is directly and significantly related to the quality of its assets.

In one sense, the sturdiness of the banking system's foundation is the strength of its loans. At individual banks, the loan portfolio is built loan by loan, decision by decision. Good loan administration--written loan policies, loan approval processes, loan monitoring, loan review, and loan workout--along with sound credit judgments by loan officers, ensure a quality portfolio free of significant loss. Good loan administration helps bolster individual banks and adds strength to the entire banking system. In contrast, institutions with weak lending direction and administration eventually will deteriorate, weakening the foundation of banking as a whole. In the Tenth District, our experience confirms that most of banking's difficulties can be traced to loan problems.

Before taking a closer look at some of the lessons we have learned from monitoring Tenth District banking in recent years, I want to comment about economic activity and lending. We live in a free-market society. Individuals are encouraged to seek out

and take advantage of opportunities for economic gain. Depending on the market, individuals succeed or fail. I strongly believe that this open and free process of market-driven success and failure has helped propel our country forward.

Bank lending is a central element in this process: lending supplements the resources of successful ventures, allowing them to exploit their success; in times of tight liquidity, lending provides the cushion that carries firms through to better times.

Against that background, let me move now into the lessons of our experience at the Kansas City Fed. A major lesson is that lenders must use care to temper credit decisions with reality forged from the instruction of history. We have seen how every nation, every region of the country, and even each industry can enjoy expansive boom periods. And we have also seen realism turn to optimism and then shift to onrushing euphoria, all the while laying the groundwork for future problems. For example, reflect on the economic events of the last 20 years: we have seen booms in real estate investment trusts (REITs), and in developing nations, agriculture, energy, and real estate. As we all know, these booms faltered, and what were good credits at the time provide today's "spilt milk" stories.

While on this topic, let me diverge a bit. I must confess to some uneasiness about commercial real estate lending in Kansas City. The rapid expansion of the last few years is slowing and signs of weakness are appearing. Vacancy rates, once below the national average, have doubled since 1981 and now stand above the national figure. Without a rise in office demand, the completion

of buildings under construction will push vacancy rates higher, bringing perhaps increased loan problems as some investors find their cash flows inadequate to service debt.

By no means do I suggest that you abandon commercial real estate lending. Good lending opportunities remain. But caution suggests that in evaluating these opportunities, changing conditions should be factored into the loan decision if risks are to be controlled.

Another lesson from our experience is that banks should be alert to avoid simple arrogance and careless provincialism. Believing that "our bank is different" can lead to unsupportable expectations and a weakening in loan administration that invariably results in loan losses. Too often a bank's management and board of directors fail to adopt or force adherence to sound, fundamental principles of strong loan policy. Thus, a bank might operate with few guidelines on the types of credit it would extend, to whom or where it would extend credit, or to whom credit granting authority would be given. Without these guidelines, a bank can make loans that should not be made. Moreover, if policies are not set and followed in normal economic times, it is almost axiomatic that policies will be ignored in boom periods.

The results of such lax lending practices are, quite frankly, devastating, in our experience. Before a bank becomes a supervisory problem, examiners' comments frequently focus on poor loan documentation and technical exceptions. Moreover, poor loan documentation, tied to a sometimes careless disregard for prudent

procedures and policies, is the most frequently cited cause of bank failures in this region.

A related lesson from our experience is equally instructive. We sometimes find that loan decisions are based on a borrower's reputation rather than serious investigation into the borrower's financial condition or the nature of the project for which the loan is to be made. Two examples illustrate this point.

In one case, a bank made a loan to a real estate developer collateralized with development land and constructed houses. In its analysis, the bank failed to investigate the management abilities of the developer and his skills as a builder. Nor did it consider the possible effects of an economic downturn on the marketability of the homes in the development.

The consequences of these oversights, however, were small compared to those of an overlooked engineering report indicating that the development was to be built on unfit land. As it turned out, the houses built on the land were condemned, leaving the bank with little or nothing to recover on its defaulted loan.

Unfortunately, there is more to the story. Prior to learning about the land problem, the bank implemented an aggressive workout plan, getting power of attorney from the borrower and, with the developer, marketing the homes. By doing this, they added to their potential loss by exposing themselves to possible lawsuits from home purchasers.

In another instance, a bank made a loan secured by real property. Although the bank monitored the loan carefully, documentation errors caused it to suffer a loss. When the loan

suddenly went into default, the bank foreclosed but found that the collateral for the loan was not a building and its lot but an adjacent vacant lot. Sadly, the bank discovered that the building and its lot were collateral for a previous loan from another bank.

As these examples illustrate, opportunities to make bad loans are, in a sense, endless. No one deliberately made any of the errors I have described, but with some care and attention to detail, many of them could have been avoided.

So, how do you avoid such pitfalls? How do you deal with the problems you already have? How do you survive? Hopefully, this seminar will provide some insights. Before I turn the podium over to the experts, let me offer a few summary principles from the perspective of one wearing a regulator's hat. These are not revolutionary thoughts, but I believe they are worth repeating.

First, look at the downside as well as the upside of extending a loan. Consider the potential effects of a changing economy on your customers. There are no better examples of the downside anywhere than here in this region where several of the key business sectors have experienced a severe economic decline. This has caused financial hardship for many bank customers, causing large loan losses at many of our banks. It may seem a simple principle, but when everything is going well, it is an easy principle to forget.

A second principle, as I have tried to illustrate, is that lending success and loss avoidance is largely a product of solid

loan administration that establishes the guidelines for the lending function. Its importance cannot be overstated. Many supervisory actions taken against problem banks focus on improving and enforcing adherence to loan policies.

A third suggestion is that a lender must always be prepared to act quickly but prudently when a loan begins to go bad. Identify and recognize the problems you have on the books. It's a humbling experience to admit an error, but simply hoping a problem will go away won't start the corrective action necessary to minimize the bank's losses. Bankers who have successfully turned loan problems around frequently tell us that the most difficult step in the entire process was actually admitting there was a significant problem. Once this hurdle was overcome, they were able to take careful, meaningful corrective action.

However, when you begin corrective actions, use care. I recall a bank that made a loan to a jewelry store and logically foreclosed when the loan went into default. In fact, the bank had sold about half of the store's inventory when it discovered that many of the jewels it had sold had been placed with the store on consignment and were not collateral for the bank's loan. Owners of the jewelry eventually sued the bank. The bank incurred legal costs in excess of the original loan amount and had to make restitution to the owners of the jewels. The obvious lesson: do your homework before you act.

My final suggestion is to maintain capital. Strong capital provides a cushion for mistakes. Some of these mistakes may be of your own making. Of course, "to err is human." Other

mistakes or problems may result from things beyond your control. Capital provides time to work through problems. For many banks in this District, it has been strong capital that has sustained them through several years of economic decline and poor banking conditions.

In conclusion, let me emphasize again that the Federal Reserve is vitally interested in the soundness of the nation's banking system. As the central bank, responsible for formulating and implementing monetary policy, we are concerned about how conditions in banking impact the channels through which policy is transmitted to the economy and the ultimate effectiveness of that policy. And as a supervisor of banks, we are concerned that banks are operated in a safe and sound manner and that depositor funds are not jeopardized.

Ultimately, the performance and the condition of the banking system rests with the quality of loans it holds. This quality depends on loan administration and the soundness of credit judgments made by you, the individual loan officer.

Best wishes for a successful seminar!