5 RULES FOR MAINTAINING PROPER CREDIT CULTURE

Like those who won't learn from history, lenders who won't learn from a crisis are doomed to more of them.

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Talk to most lenders today and you'll get the strong sense that everyone is busily engaged in rebuilding the credit quality of his or her bank. That's important and indeed necessary for a true restoration of a safe and sound banking environment. But are we actively involved in understanding the root causes of the problems?

"Root" has an interesting etymology (the derivation of a word). It is expressed mathematically by the radical sign. In other words, any process that gets to the root gets to the cause. Many banks need radical solutions and there's nothing wrong with saying that this way. Here's my short list of "radical" ways to avoid certain problems of recent years and reset the compass of loan portfolio quality.

1. Avoid the tendency to "go along to get along."

This is a problem that's particular susceptible to happening where credit authorities are exercised in a lending ladder rather than a committee context. Not all credit analysis is equally good. Nor are all conclusions that are ultimately expressed in terms and loan structures necessarily sound and effective.

If you feel strongly that a colleague or perhaps the loan committee is on the wrong course, say something. It's in its own way what we're hearing in the news today in connection with the domestic terrorist activity in Times Square: See something, say something.

2. Eliminate "cult of personality" behavior that can subvert internal controls.

The best way to do that is to be sure the internal controls work the way they are intended to work. In previous columns this past year on credit culture, I emphasized the need to be sure that controls are in place to enforce both the letter and the intent of loan policies.

We've all met the lender who can seemingly charm anyone into doing things his way, even if internal controls and checks are occasionally overridden or ignored.

3. Don't shortchange the due diligence process.

You might even want to make it an absolute requirement that lenders are prohibited from lending on anything or to anyone that has not been the subject of an adequate due diligence process. Part of the mortgage collateral issues in the current credit cycle fall in the area of due diligence that was simply not done adequately-or not done at all.

4. Understand what your credit and collateral exceptions are telling you.

My basic assumption is that all banks monitor and track exceptions. Are the exceptions individually material? Are they material by cumulative number and dollar, especially by type of exception? Are they by their frequency such as to undermine policy? Or, worse yet, can it be said that the bank in a particular sense has no particular policy at all?

A policy provision that is not enforced can hardly be called a policy at all to most examiners, auditors, and loan-review personnel.

One of the best credit men I ever worked with used to say, "You can make an exception to any loan policy provision-but when you do, you'd better be right."

We all see the sense in this statement, both from the view of internal politics and credit soundness. But do we consistently act like we do? I think the credit quality issues of the current business cycle show where the truth lies.

5. Be a bulldog in watching for concentrations of credit within the loan portfolio.

In over 40 years in the business, I firmly believe that concentrations are the most insidious threats to a healthy portfolio. Concentrations hide themselves within and in the shadow of normal and often proper extensions of credit.

Too many real estate development loans, for example, though properly made and in full compliance with the bank's underwriting standards, can be harmful to credit quality if the local trade area suffers a moderate to severe business contraction.

Too many large loans present a possible concentration hazard to bank capital if two or more should suffer from credit weakness at the same time.

This is where the "truth" lies in the old statement: "In lending money, you've got to be right 99% of the time, as the other 1% is the loan loss reserve."

Concentrations can lurk in the form of purpose, business type, collateral type, size, and structure. No one loan is the issue but rather the danger is often found in the number of loans where one or more common elements can become problematic.

You've got to be ruthless in identifying and watching them.

Learn now, or suffer again and again

A sound credit culture requires two things:

Management commitment from the top

Internal controls that clearly set forth expectations and monitor and prevent unwanted behaviors.

We're all busy with recalibrating our credit direction these days.

Let's hope we get it right and remember the real lessons.

Rahm Emmanuel's famous and savvy advice comes to mind: "Never waste a crisis."

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 free audio 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.

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