
MIX UP POLICIES AND PROCEDURES, AND YOU'RE BOUND FOR COURT

A new debtor gambit pins lender liability claims on bankers confusion of two distinct disciplines

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There has been considerable creativity by the plaintiffs' bar in the range of litigation activity against banks during the current business cycle.

Perhaps some of this is an inevitable consequence of size. Large-dollar deals make attractive targets for borrowers seeking to avoid the ultimate consequences of their actions.

But today it is also the creative way that plaintiffs are asserting issues that seems to gain some occasional traction with judges and juries.

Whatever the causes, the risks for bankers have increased. We have got to be more careful of controlling the environment in which we do our business and the way we establish our rules and processes.

Lender liability risks grow and morph

This column in recent months has talked about lender liability-the growing body of case law that exposes banks to the consequences of arguably arbitrary behaviors toward customers. Admittedly, some behaviors have been found to be arbitrary and harmful. But lender liability as a defense against such practices has in part been a manufactured issue, on the plaintiffs' part, to create additional hazards for banks.

The practical effect has been making the ultimate collection of principal more difficult to accomplish.

There are anecdotal reports from the field that a new line of attack by delinquent borrowers is taking shape.

This involves alleging that banks have not been exercising appropriate due diligence in the origination and administration of borrowers' deals and that such omissions in more grievous instances have resulted in unnecessary losses to the bank and ultimately to the borrowers.

The "hook" on which these arguments hang involves the difference between policies and procedures.

Policies, procedures, and lender liability

The way this occurs is familiar to me as one who lived through the economic crises of the 1980s and 1990s. Twenty and thirty years ago, examiners were busily encouraging bankers to improve their lending policies in the degree of formality of underwriting loan transactions. Bankers responded by writing formal rules, replacing oral traditions of policy and procedure covering virtually every aspect of lending.

The result was often confusion by the bankers, managers, and, in some cases examiners themselves in what was policy and what was procedure.

The differences are of much more than passing interest.

Policy is often defined as a definite course of action selected from among alternatives and in light of given conditions to guide and determine present and future decisions.

Related to the lending function, policy guides the way a bank conducts its lending business. Facets include: types of loans by purpose and collateral; the manner in which loans are underwritten; acceptable standards of due diligence; and the manner that loan assets of the bank are administered, consistent with safe and sound practices.

Lending policies fall into the area of governance which is the control or influence of the outcome of an activity in a predetermined and acceptable way. Governance is the responsibility of the Board of Directors. And it is for this reason that lending policies of banks are policies of the board, not the management.

Procedures, on the other hand, are the prerogative management and are established to provide a certain uniformity of activity of the staff.

Procedures are very useful in providing guidance and assistance in processing the administrative details of the lending function consistently and in an auditable way. But they are not usually subject to the review of the board. They deal with procedural, routine matters and are not intended to articulate standards by those responsible for the safety and soundness of the organization.

However, when the lines between policies and procedures blurs

When two disciplines leak into each other

Many bank managements, under the urgency of rewriting new loan policies, got "carried away" with detail.

Policy manuals grew in size and scope to contain procedural statements as well as policy standards.

The practical effect of this was to create loan policies that could not clearly distinguish so called quality issues with quantity issues.

Procedures were combined with policy, labeled as policy pronouncements and implemented with a sort of "one size fits all" mentality.

Where that created difficulty for bank managements was in subsequent safety and soundness examinations where examiners, critical of the banks' lending practices, cited violations of policy that were really simply matters of procedure.

Yet to a director, an alleged violation of policy is much more ominous than an alleged violation of procedures. This created considerable tension between examiners and bank managements and boards-and it was largely avoidable.

Board role versus management's role

Management has the responsibility for guiding the day-to-day activities of the bank. This often requires formal training programs; manuals providing specific direction to the staff; and occasional oral and written directives of supervisors and management.

The directorate has the requirement of articulating lending standards but not training manuals or detailed guidance of routine functions. Whether debit and credit general ledger tickets are red and yellow or white and blue, respectively, is hardly a matter requiring the attention of the board. Contrast this example with the board's appropriate role in determining what the bank's collateral standards are and what constitutes the appropriate trade area.

Keep the lines sharp and bright!

Policy, in other words, is considerably more substantive than procedure.

Yet we as practitioners tend to confuse these terms daily.

Even if we really do understand the difference, the term "policy" is often combined with the term "procedure," creating confusion in distinguishing one from the other. We need to be more discriminating in our language and more precise in our descriptions.

Alleging violations of loan policies is considerably more serious than inconsistencies in the application of procedures. It's not that the latter isn't important. It is.

Rather, it's the degree of culpability that may be laid at the feet of the board of directors by a jury convinced by a colossal misunderstanding of the difference that the bank was in chronic violation of its policies when in fact this was not the case.

I urge all lenders and management to be more careful in how they describe what is policy and what is procedure. We need to be sure that we are clear on which is which and act accordingly. This is an old problem coming back in a new guise. We can deal with it but we have to be aware of the dangers first.

In a future column, we'll explore how policies can be written in ways that express principles and standards, rather than simply creating more rules.

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- About Ed O'Leary:

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