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## RULES, POLICIES, JUDGMENT, PRINCIPLES: WHICH WOULD YOU PREFER TO BANK BY?

We can't solve every crisis by slapping on fresh rules

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It seems to be a law of nature, or, at least, Western Civilization, that when someone misbehaves, we make a rule-or lots of them. In thinking back over a long career as a lender, credit administrator, and executive manager, I've seen lots of misbehaviors and cleaned up a lot of messes. I may even have contributed to a few of them. What seems out of kilter today is our tendency to correct actual or perceived behavioral problems with sets of rules.

A necessity, but no cure-all

When the first of the significant post-World War II commercial real estate downturns occurred in the 1970s, banks rewrote their loan policies to tighten up their standards. But that's what they did again in the 1980s, again in the 1990s, and once again in the current credit cycle. This time the regulators are "helping" and the rulemaking syndrome seems to be achieving epic proportions.

Rules are necessary. We need to communicate our expectations and the limits of outcomes and behaviors of what we will accept in most things, ranging from real estate deals to dress standards in the workplace. Some of our efforts have become in recent years "over the top." Consider workplace dress codes. It's one thing to proclaim "business casual" for summer Fridays but quite another to proscribe in excruciating detail what is acceptable workplace apparel for men and women.

The reason that we are moving to an environment of "more" rather than "less" detail seems to be a general lack of judgment on the part of so many workplace participants. And it's not just in the workplace where this occurs. Nor is it limited to matters of personal hygiene or dress.

Why do so many people today seem so "clueless" on what behaviors are appropriate?

Two potential starting points for change

I think we should direct attention and effort in two areas.

First, we need to communicate our expectations more effectively.

Whether we are dealing as employers and managers with younger people who are new to the workplace or business unit managers dealing with customers, there needs to be more deliberate setting of standards.

This is not a singular event. Rather, it's a process that needs repetition, reinforcement, rewards, and punishments. We need to establish by positive and affirmative activity that certain behaviors are acceptable and certain others are not. That's why we have everything from employee handbooks to loan agreements.

Second, we need to express the desired outcomes (and minimize negative ones) by expressing them where we can in the form of principles, rather than rules.

Where principles become too specific and rules too confining is what makes this process so challenging.

This is the difference we talked about in last week's blog between policies and procedures. Policies are the norms; procedures guide the specific "how to."

An example where policy meets procedure

In my own experience it's nearly impossible to write a loan policy without some elements of procedure. If any of you have taken a hand in writing or rewriting your bank's loan policy you already have a sense about what a challenge that can be and how difficult it is to find that balance. But just because it's hard doesn't mean that we shouldn't try.

Here's an example of principles-based policy applied to a common business issue of what constitutes a conflict of interest.

One can list all of the major ways that a conflict can develop and produce a lengthy list.

Or, one can take a very general, open-ended approach and describe unacceptable conflicts of interest in terms of how one compromises the company in favor of another party—customer, vendor, and so forth. Michael Josephson of the Josephson Institute of Ethics likes to say that one pretty reliable test of whether an individual believes that he's acting ethically is whether his behavior would be the same even when no one is looking.

That's operating on principle, not rules.

In writing loan policies, some banks type loans with descriptions such as "prohibited," or "illegal," or "undesirable." These are not necessarily inappropriate, but they are not very helpful in communicating standards without some straightforward means of saying why the bank likes them or why not.

I like policies that articulate standards, such as what the bank considers to be a productive loan. We are, after all, using community-based deposits to fund much of our lending so an appreciation of utilizing local resources for primarily local benefit (such as infrastructure, employment, etc.) is helpful.

Another way to express lending standards is to use qualifiers like "normally" or "generally." Used judiciously, you can express a view or an attitude on types of loans or perhaps underwriting characteristics without the creation or expansion of mindlessly long lists and rules.

"Amortization periods of term loans will generally not exceed seven years" is an example of how this principle could be expressed without necessarily creating a pattern of exceptions.

Rules invite parsing—and lawyers are paid to find exceptions and alternatives.

An angle on rules from the news

There was a fascinating, very public lapse of a Fortune 500 company's code of conduct in the recent firing of the CEO of Hewlett Packard. Mark Hurd, the company's highly regarded CEO, was terminated this past week for violating company rules in his dealings with a female vendor. Though all the details are not necessarily known to the public, there seem to have been no sexual improprieties committed and the amounts of money in question as possibly irregular payments were relatively small.

Is it possible that HP's rules were too specific or that the board was too quick to pull the trigger?

This is a puzzling case and should be considered carefully in the total context of the range of behaviors subject to codes of conduct.

Rules for running companies and, more specifically, banks, is a big topic and is complex at many levels. We need a fresh approach to how we set expectations and form and enforce appropriate standards of behavior. It's much bigger than how we make and collect loans or incent lenders for business development.

But there's a common root to all of this and that is that we are increasingly and excessively rules-driven rather than principles driven.

It's time to reverse that trend.

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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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