

## ARE GOOD INTENTIONS ERODING YOUR FOUNDATIONS?

Risks exist that Loan Review and Internal Audit may never see, because they arise between people

\* \* \*

Is there someone in your bank who, with all the good faith in the world, is undermining your credit foundations?

And is this well-meaning person somehow flying under all your radar?

Mismatches in your bank

Stated values are what we say we do. Operating values are what we actually do, whether they match our stated values or not.

Sound familiar? It's just another way to say that we should "walk the talk." We often don't, and it's frequently apparent to anyone watching closely.

Commonly, this sort of disconnect appears most blatantly in bank Mission/Vision/Values statements.

You know the kind-your bank probably has one. They often feature rhetorical flourishes from Marketing, and beg comparisons with the actual level of customer service that's available in our branches.

In many banks these two are seamless-what the bank says and what it does are highly aligned.

But sometimes, they aren't...

Any banker who has ever picked up the phone to find an irate customer on the other end of the line knows how jarring such experiences can be.

Such disconnects are not confined solely to "gaps" in customer service expectations.

Credit policy versus credit behavior

Sometimes, what we think our credit culture is and how some lenders actually behave don't match up too well.

We may think we have a sound and thorough lending policy. Perhaps we do.

But are our lenders trained to the standard necessary to maintain credit quality?

Do we enforce our internal rules with the same enthusiasm and consistency that we extol our credit integrity?

A strong and effective credit culture should be demonstrable over time through the quality of the results of our lending activity.

A few soured loans may be an unavoidable consequence of lending money. But a portfolio of troubled or problematic credit is quite another matter. Unfortunately, there have been a lot of results that haven't matched our expectations or our rhetoric during this credit cycle.

Optimism doesn't breed success

Only a few years ago I read and graded a number of credit-related extension problems for a national banking school. Community bankers from many states were asked to write about their banks' credit culture and the internal controls that supported and sustained favorable results. Prominently mentioned in most of the papers was the belief that credit policies were sound, tested, and thorough. The bankers believed these measures would keep their banks out of trouble.

I recall my reaction that the expectations of so many were probably unjustified, given the late stages of a long and "frothy" credit cycle. Unfortunately, my skepticism was better founded than the writers' optimism.

What did I know that these active, mid-career credit professionals didn't?

In my experience with working with problem loans and bankers charged with administering them, there is sometimes a critical weakness in the credit extension process that is nearly impossible to detect.

An easy way to think of this is in terms the level of credit and collateral exceptions. We can measure these and most banks do. Boards of directors have come to understand the corrosive effect of exceptions and examiners have been particularly vigilant since credit quality collapsed at so many banks.

Yet there may be procedural lapses in common-sense internal controls that have little or nothing to do with credit standards as typically enumerated in written lending policies. These often entirely escape the scrutiny of Loan Review or Internal Audit.

Introducing your unintentional enemy within

One type of internal control where violation can have deadly consequences is that of the actual sequence of funding of a loan.

Imagine a process where exceptions are recorded and documentation is checked for completeness before funds are advanced.

The loan officer in this scenario is experienced and relatively senior. Maybe he (or she) enjoys a decent-sized individual lending authority and a well-deserved reputation for developing and administering his business with flair and finesse.

Imagine too that he is also a "charmer" and one who can often convince co-workers to do him a favor. Or cut him a little slack in the occasional rush to get a loan funded for an important customer.

Do you recognize this fellow?

What is possibly missing at funding is a piece of documentation that is basic to the deal—a note that the customer is taking home for his spouse's signature or getting a signed "power" for negotiable collateral. These may be simple things that we infrequently do to accommodate a good customer and things that an accommodating staff person may do for a hard-working or perhaps sometimes overworked lender.

No exception is noted (or, if it is, it doesn't become a "show stopper") if the lapse occurs beyond the point in the process where either the exceptions are noted or funding is denied.

And maybe the intended followup never happens...

There's no substitute for vigilance

A strong credit culture where operating values and stated values match requires three things:

1. A top-down commitment to do things right—everything right, big and little.
2. A an explicit set of standards
3. Ruthlessness in enforcing the rules.

Making this happen is often difficult to enforce, because the consequences seem occasionally harsh.

It sometimes means saying "no" to the lender who is busting his or her butt to help the customer.

Or perhaps it's a "no" to a large and long standing customer.

(Maybe the customer is also a director.)

This might be where a good culture fails to be a great culture.

It's in the reluctance to do what we know we should do, regardless of the consequences.

Sure, we all make the occasional exception.

But a lapse at funding often has a great deal more risk attached to it than, say, a missing financial statement of a contingent obligor or hazard insurance coverage on an item of collateral.

Before the lessons of this current credit cycle are forgotten, I urge each of you to think about the role of internal controls in your specific credit process and whether you and your management have the internal fortitude to do everything necessary to minimize loss.

Do your stated values line up with your operating values?

This is much more than a marketing question.

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](mailto:etoleary@att.net). O'Leary's website can be found at [www.etoleary.com](http://www.etoleary.com).