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## COMMON SENSE PRINCIPLES FOR GOOD ETHICS AND GOOD LENDING

Principles, not rules, guide good choices and sound credit

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Ethical behaviors in business are still newsworthy items after all the years have passed since Enron burst into the public consciousness. The awareness did not start with Enron nor will it end with the last example of poor behavior by any business figure.

I've said before in this blog that a "rules approach" to ethical good conduct is not particularly effective.

Why? Rules give people a false sense of comfort. "Just follow this list and you'll be OK" is no safe harbor and probably never really was. Good behaviors (those which we consider ethical) are rooted in principles, not lists.

There is a lesson here for the credit function, too.

Don't lose principles amid volume

It's not that lists aren't helpful. What bank does not have its procedures to guide staffs and produce an trail of activity that can be audited?

How many of you have ever had the responsibility of writing a credit policy?

I've done it a few times and I've got a handful of tips for any of you who might ask. If you've been there, think back through what needed change and recall whether the old policy even considered the problem(s) you were trying to fix.

If it didn't, then your old policy was more akin to a list of do's and don'ts than a statement of principles.

A common failure of many policies is that they are too cluttered up with procedures to be clear statements of policy (principles).

Consider the principle that's found in most credit policies: a prohibition on bank funding of unproductive loans by purpose.

What do we mean by "unproductive"?

Does the reader of the policy expect a definition or a description by way of an illustrative example?

If you proceed with writing a definition, I can guaranty that you'll miss something and that unproductive lending will climb in over the transom.

Do you consider lending for speculative purposes to be unproductive? Why or why not? It may not be a subject for extensive discussion in the loan policy but is complete silence on the subject appropriate? I single this particular example out as it is already making a stealthy return in one form or another in some banks.

Commodity prices are on the way up. Some customers may wish to anticipate increases in raw materials and stock up now. Some of that behavior is built into the thinking of all our customers. But I remember the inflationary environment of the early 1980s and the horrendous increase in market rates of interest that it took to tame the inflationary expectations of nearly everyone in the economic process.

How many increases to credit lines did I process in response to borrowers' wishing to anticipate rising prices and stock up now, rather than pay more later? Should bank funding be used to buy inventory solely in anticipation of significantly higher prices?

Note that I'm not talking about commodity or materials shortages. Prices are the key to this discussion.

How do you write "unproductive purposes" into the list of types of loans that should be avoided? It's hard and probably a good example of why some things shouldn't be left totally to the written word. Emphasizing principles in a variety of venues will tend to force the staff to have to think about what they are doing. Senior credit people need to use a variety of venues to drive home key points-loan committees, ALCO meetings, training sessions. and the like are all appropriate channels.

Beyond the credit function, principles should rule

Behavioral principles are not just appropriate to the loan policy.

All banks today have a prohibition on staff members stepping into conflicts of interest and guidance to employees is appropriate. Rules have a definite place here by, for example, defining a dollar limit on what may be accepted from a customer without producing a conflict of interest.

I've been in these situations many times where a conflict by accepting a customer's gift created an actual conflict solely by reference to the gift's value.

I recall when Coors Beer began to be marketed in selected territories beyond its original home state of Colorado. One day a customer came in to see me in Orlando with a 24-can case of Coors on his shoulder. He marched right over to my

desk on the open bank platform and proudly presented this rare "prize" to me.

I can't recall what the value was in those days nor the dollar threshold of our policy. But I guess I sensed at the time that it was a close call.

So what did I do?

I profusely thanked him for his gift and after he left, shared the contents of that case with everyone in the loan department. If I had two cans to take home that night it was a lot.

Sure, I could have refused the gift and embarrassed that man in a very public and an almost cruel way. So I had to diffuse the issue and I don't pretend that my solution was necessarily the right one or the only possible one.

A thinking man's rule

One customer told me of his company's rule that's worth sharing here as it's not stated as a dollar amount:

"Never accept anything of monetary value that you are not in a position to reciprocate with something of equivalent value."

Now there's a common sense rule, expressed in the form of a principle. If my wife and I are entertained for dinner by a customer and his wife and I can reciprocate in an equivalent way, then where's the conflict?

I suppose in this age of Sarbanes-Oxley many bank auditors won't like such a rule so maybe it's not right for all banks. Just the same, though, there's a simplicity and balance to it that makes sense.

A tougher call-personal standards

Another memorable behavioral principle gleaned from a customer's conflicts of interest policy was the admonition to staff that one should never commit a public act that would embarrass the company.

I certainly don't disagree with that rule. But in this day, where employees don't start their working careers with a commonly shared set of behavioral standards, I think it's probably too risky to make important assumptions about employee choices.

At times I am reminded about how standards have evolved over the last 30 years or so.

How many of us may have accepted the use of a customer's lake house for a weekend?

Some things that were more acceptable years ago or in some environments are simply not acceptable today. These require careful and sensitive consideration and expression, as we don't want to create confusion among our staffs nor convey a tolerance of an excessively permissive culture to our customers.

Some purposes are just not the right place for funding with customers' deposit as some work place behaviors are just inappropriate to a bank's culture.

How do we say such things to our coworkers?

These are not new issues but I think they are more urgent now than they have been at any time in my working life. No wonder that rules and lists are so durable yet are so difficult to administer and enforce.

About Ed O'Leary:

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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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