

## O'LEARY'S ESSENTIALS: GREAT CREDIT POLICY IS NOT ENOUGH FOR A GREAT CREDIT CULTURE

A followup to last week's take on credit policy

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Last week I expressed my strong conviction that as important as a good credit policy and an effective loan review process are to strong credit cultures, they aren't enough without a top down and almost ruthless commitment to internal controls.

I am referring to the sorts of controls that functionally implement the loan policy, including those that are perhaps not subject to audit verification or to rigid testing procedures.

Bane of exceptions to policy

The biggest "leak" in my experience is in the realm of exceptions.

All of us have heard probably many times "You can always make an exception to the loan policy."

That's literally true, of course. And some exceptions are fully justifiable on a business or a credit risk basis. But how often do we hear the corollary to that statement:

"If you do make an exception, you'd better be right."

This statement frames the point of a credit policy in the first place. It expresses the credit standards of the bank. And each and every statement or norm has a history and a reason for its existence.

Species of exceptions you'll see

There are three categories of exceptions:

- • Those making an exception to a provision of the policy itself, such as lending outside the bank's defined trade area.

- • Those relating to credit quality, such as incomplete or stale dated financial information.

- &bull; Those relating to collateral, such as imperfections in the security interest in collateral or the complete absence of documentation in the first place.

We all understand how exceptions are created, approved, reported ... and cured.

But is there any systemic sense within your bank about the relative degree of risk between and among exceptions?

A stale dated financial statement on an indirect obligor usually represents less credit risk than a glaring error in a security agreement. Where is the sense of urgency between and among the various types of risk that exceptions represent to the bank?

Generally, such a prioritizing doesn't exist in practice. Or if it does, it's not found its way into specific action plans that reflect any differentiation.

How many banks have explicit prohibitions on funding on a note in the face of exceptions? I have seen some banks with a list of "show stoppers," but this is not common.

You've got to allow for the fact that you can't perfectly anticipate every contingency-but when exceptions are made, are these done by the note teller or the collateral documentation clerk?

This is probably a way of reminding us that the bank should expect-and, in fact, demand--excellence in the credit underwriting process. Loan policies can do that but it's what often happens between the loan committee's concurrence and the physical closing on the loan that can make a difference in overall loan quality.

Stuck between good service and "good service"

Busy lenders who are trying to deliver a quality product for the bank while providing outstanding service to the customers are sometimes between a rock and a hard place.

Perhaps they use their title and position to intimidate a member of the loan administration staff to bend a rule ... or make a "temporary" exception.

Heaven knows how much this goes on. Probably some of us have done these ourselves. But we really are doing a disservice to both the bank and the customer. We should just expect (and be expected) to do it properly in the first place.

Should your bank adopt "credit paralegals"?

Sometimes the internal organization of the bank is a component of the problem.

Smaller banks usually emphasize cross training to accomplish a necessary separation of duties. Large banks have both the luxury as well as the necessity to divide the workload into efficient and balanced sorts of job descriptions.

It's the banks in the middle that may not have thought the process through carefully enough or recently enough and may not be providing proper staff to specific parts of the work flow.

For example, is the loan approval write-up done by the loan officer or by someone under his complete direction? The alternative would be to have someone in a junior or apprentice sort of capacity author the write up with a primary reporting relationship to someone with credit experience within the loan administration area. That way there's often a more objective listing of "strengths and weaknesses" of each credit request.

Years ago, law firms migrated to the practice of using paralegals to do much of the routine work on document preparation and research on legal issues. Yet many community banks insist that lending officers to whom they pay relatively substantial salaries perform chores of a routine or almost clerical nature. That seems short-sighted and inefficient.

The lender should be released for the specific tasks best matched to his skill sets and experience.

Many banks have come to this conclusion but I am not surprised, even today, when I hear about loan officers required to take their time performing some very prosaic chores relative to the entire process of building and maintaining a portfolio of commercial loans.

Maybe you need to rethink your whole process

There's a hospital consultant in Albuquerque who was my customer for years, first as CEO of a major hospital and later as a consulting expert. This person stresses to his diverse and national client base that to produce significant personnel savings in any labor intensive process, it's first necessary to completely revamp the process.

He cites his experience with computer systems, that usually produce less than 20% of ultimate savings in any process change. I think this is true with banks too. We are very labor intensive on the credit side of the house and some of our internal routines have not kept up with technological innovations, software enhancements, and compliance needs.

If we are serious about making staff more efficient, it has got to start with the various elements of the process itself. These are not piecemeal changes by their nature but so many banks simply refuse to see or deal with the obvious.

Don't let the bullies push exceptions through

Finally, a cautionary word is in order about job responsibilities and the personalities of incumbents in the credit approval and credit quality management process.

Banks are hierarchical institutions. And very often, loan officers have assertive personalities and the result can be a degree of bullying of back-office loan staff.

Be sure that you are sensitive to this possibility and assure that your bank's processes consider the various ways that the internal controls can be undermined due to personalities.

Coercive behaviors have no place in a respectful and properly functioning workplace environment and they can materially add to operational risk.

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 has been a frequent speaker in ABA's Bank Director Telephone Briefing series. You can hear free audio interviews with Ed

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