

## O'LEARY'S ESSENTIALS: SHOULD DIRECTORS BE MAKING LOANS?

Don't confuse oversight with hands-on involvement

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How many readers work for banks where outside directors are directly involved in the approval of credit?

Bank directors have the role of ultimately overseeing the activities of the banks they direct, including lending. But ...

- &bull; Does that include a specific role in the extension of credit?
- &bull; Is there a right answer to the question of whether directors should exercise actual credit authority?

Loan authority versus lending ability

Ultimately, directors are expected to approve the extension of credit.

But this is normally done as an after-the-fact ratification of the actions of management and the various structures constituting the "delegated lending authorities" of the board. The board members' authority is original in that it is initially vested in them, but it is delegated to the credit professionals within the organization. Credit is extended by virtue of the authority invested by the board and consistent with the policies that they have approved.

Yet many community banks routinely operate with loan committees populated by a combination of outside directors and lending officers.

And regional banks' directors are often represented on Director Loan Committees that have originating authority over very large loans--typically those over the house limit or a relatively high ratio of the bank's legal lending limit.

Interest shouldn't equal involvement

Are these roles appropriate? Let's consider the reasoning behind what we see out there.

- &bull; Whose money is it, anyway?

I think that if I owned a significant portion of a bank's equity capital, I might feel very proprietary about how risk is evaluated and want to be part of the process of approving and renewing credit. This would especially be so for the large-dollar deals that represent significant exposure to the bank's capital.

That probably accounts for the attitudes of directors who serve on loan committees. And it's understandable.

- &bull; Whose rear end is ultimately on the line?

If a bank is under an administrative agreement with its principal supervisory agency, the directors will have a relatively more structured and intrusive role in the administration and oversight of credit.

The point of such agreements is largely to focus the board's attention on its oversight duties and the performance of management in this critical function of any bank. But consider that a more structured role of oversight is not the same as immersion in the processes of extending credit.

A bank's credit health is the product of a combination of factors--policy guidance on what is considered acceptable risk and then the application of internal controls that monitor conformance to those policies.

Directors have to know if their policies are effective and followed to a high standard.

This means a level of due diligence on the process of monitoring--but it doesn't have to mean that directors exercise lending authority in a before-the-fact sense.

What should directors be doing, then?

Directors can be very helpful to community bank management by being eyes and ears in the community. They hear things that lenders might not and move in business circles that are not necessarily open to lenders and other bank officers.

This is a very valuable role, not one to be dismissed.

I vividly recall a director of my bank in Orlando speaking up during a discussion of a new credit request from a new customer.

We were a relatively new de novo affiliate of a large state-wide banking company and were trying to break into an established banking market where the competition was well defined and long entrenched.

The young lender presenting the credit was understandably enthusiastic about the loan.

But one director, a 30-year veteran of the local business community and owner of a successful local small business, noted, "That company is 60 days late with me, and I'm ready to put it on a cash basis."

The silence around the table was as profound as any I've ever experienced at loan committee.

Our prospect was "slow in the trade" and we didn't know it. It's not that we should have necessarily known that, but the director was of great help in supplying this critical piece of information. It was information we needed to know just as it was painful to learn it quite that way.

Even directors of very large institutions provide outside input that's often very helpful to lenders. They frequently represent expertise unique to a specific industry or have broad experience in assessing business conditions on a local or regional basis.

### Rethinking board involvement in lending

My primary concern with directors as voting members of loan committees that preapprove credit comes down to ability.

Many lack functional expertise in the backgrounds. They are not in a position to always lead by example and their ability to analyze Capacity, the second-most important C of credit to me, is usually seat of the pants rather than formal and structured.

In this age of liability, they potentially become attractive targets of regulatory lawsuits for their lack of formal training.

Note that I'm not saying that they don't have valuable expertise to lend to a committee in its deliberations--but advice is not the same as a vote.

I'd prefer to rely on the former than suffer the potential consequences of the latter.

### What about your bank's board?

Many community bank directors serve with distinction as voting members of the loan committees of their banks. Should this continue?

- &bull; If you have directors exercising original credit authority and want to continue doing that, I urge you to consider arranging formal training for these people.

FDIC has programs for outside directors germane to their specific responsibilities. There are also many ways that functional training can be arranged and conducted for board members' benefit over a period of time.

You owe it to those directors to lower their profiles as targets of regulatory litigation and enhance the overall credibility of the credit extension function as viewed by the regulatory authorities.

- &bull; Be particularly vigilant against actual or potential conflicts of interest.

Some of your directors may be borrowers at your banks and have a heightened level of potential interaction with other borrowing customers with an increased potential for conflicts. Be proactive in alerting them to such dangers to their reputations and structure your credit approval process in as transparent a way as possible.

It's hard being a commercial lender today and it's not getting any easier.

Directors have key roles to play in the process and there's nothing that says that they either should or should not be part of the actual decisionmaking process.

But it's primarily up to management to help them stay out of trouble as they exercise their duties and obligations.

**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.

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