O'LEARY'S ESSENTIALS: DO LOAN COMMITTEES REALLY WORK?

First in a series: Part of the answer hinges on what you think the purpose is

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Don't miss Parts 2 and 3 of this series, "Getting the most out of your loan committee" and "7 deadly habits that undermine your credit committee process."

And don't miss the concluding blog, Part 4, "6 ways to maintain your loan committee's effectiveness"

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Over the years I've become of two minds about loan committees. Sometimes they work as they should. At other times the process can go badly awry.

I'm not talking about whether the decisions they make are necessarily better than they would be without a committee. (Such methods include "lending ladders," or expanded individual lending authorities.) Rather, the question to me is whether loan committees serve the functions of education, information sharing, and collegiality particularly well.

Considering committees' purpose

There are many forms of concentrations in any typical lending function. What a committee should do is to facilitate the arrival at a consensus about credit and minimize concentrations of risk.

Does a particular deal fit the credit policy, address the risk profile of the bank, and seek to expand the availability of credit to the community on a sound and reasonably equitable basis?

When you think about these objectives, they are quite far reaching. They are anything but simple. Wrong answers produce concentrations of credit risk.

Over the years, I've seen committees devolve into "group think" sessions.

This can happen because of one or a few strong personalities.

Or there may be an unwillingness to displease or "go against" the boss whose views (biases?) may be well known.

Or there may be a simple failure to encourage open and candid discussions about the various Cs of Credit, most often concerning an adequate analysis of collateral and the borrower's capacity to repay.

Superficial discussions on credit are dangerous for the habits they introduce or reinforce--and the misleading sense of comfort they encourage.

Rules to run a credit committee by

Experience tells me that credit committees should have in their charters the following formal functions:

- • Regular and formal communication on local business conditions.

- • Reinforcement of the credit standards of the bank, usually but not necessarily centered on the loan policy.

- • Education and mentoring of newer lenders.

Now, let's look at some approaches to these functions in "real life."

Different banks, different approaches

A bank can institute a joint authorities type of approval system. However, this usually diminishes the best attributes of a committee process. Committees should be organized to produce the effects the bank wants to include the type and format of information regularly presented.

1. A very traditional approach. At The Bank of New York I seldom attended the loan committee meetings. As a very junior officer, I was second fiddle on several credits and there was simply no tradition of encouraging large meetings with lots of non-voting attendees. I think too many "supernumerary" observers comprise an unnecessary "bleachers" section. There's something to be said for limiting people around the table to those with an urgent and specific need to be present. I tend to side with the view of "smaller is better," but do recognize the value of mentoring the newer lenders.

2. A committee morphing into mini-committees. From The Bank of New York, I joined a large regional bank (for its day) in Miami. About the time I arrived, a joint authorities system was installed to replace a formal credit committee process. It had seven categories of authority and so it seemed to me that a single committee suddenly morphed into several smaller committees.

I regularly presented to one or more of these small combinations or groups depending on size of the credit and the type of loan deal. The system seemed to work in the credit risk sense. But it was a confusing and inconsistent way to create an effective communications environment.

3. A committee undermined by poor participation. At Liberty Bank in Oklahoma City, I was a voting member of the senior loan committee for my entire tenure and I served as committee chairman for my last three years. While that environment wasn't perfect, it functioned competently in all its dimensions and purposes that I think it served the bank and its stockholders well.

One occasional issue was the lack of adequate preparation by non-presenting but voting members. This conveyed the wrong signals sometimes to the junior people. Better for the process that any unprepared members skip a meeting for which they have not at least read the material ahead of time. But that didn't always happen.

4. A dysfunctional committee. When I arrived in Albuquerque and assumed the CEO role, the loan committee situation was superficially orderly. But, as I diagnosed quickly, in reality it was pretty dysfunctional. Having diagnosed the problem, I had to come up with a cure.

Fixing a dysfunctional credit committee

First of all, the OCC was critical of some of our underwriting habits. It's not that the loan policy was weak. It wasn't, but the internal controls were not up to the rigors of a first-class credit culture. My new colleagues had heard about that in two successive reports of examination. As bankers, we never want to hear from auditors or examiners the phrase, "As previously noted . . ."

The second problem was that the ownership family did not fully appreciate the value of the formal committee process. As a result, the owners failed to understand and insist upon the "fix" that the examiners were demanding.

The siege mentality that ensued and continued for months prior to my arrival brought out the worst personality traits of a couple of the senior loan committee members. Although I never witnessed those behaviors, I heard anecdotes about how junior members would be ambushed and criticized in their presentations.

Who can learn or effectively participate in this kind of an environment?

It was anything but a collegial process and while it did gratify the egos of some participants, it did absolutely nothing helpful or constructive in any other sense.

The fix was simple enough.

I installed a new committee chairman and made a point of personally attending all committee meetings. I asked plenty of questions and where possible tried to be overtly supportive of the presenting officers.

As a committee we didn't always agree on everything at first but at least the meetings became a forum for constructive discussions aimed at addressing OCC issues, rather than fighting losing battles occasionally resisting correcting sloppy underwriting tendencies.

After a few months, the mood had lightened and the conversations were peppered with good natured comments and occasional laughter. Lending is a serious business but there are lots of funny things that happen with customers and between and among the lenders themselves. The laughter I began to hear was a sure sign to me that the healing process was underway.

Take a hard look at your bank's approach

As our industry gradually recovers its balance from the recent recession, we should take a good look at our credit committees in terms of purpose and results in the broadest context.

What do we want the committees to accomplish?

Communication activities can become like lots of fast food: abundant calories but not much nourishment.

Let's focus on the nourishment in the holistic sense that effective communications can produce and foster.

Our future as an industry largely depends on it.

Talk back! How does your bank handle the credit committee process? Have you made, or are you considering making changes?

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 about workouts here. You can e-mail him at etoleary@att.net. O'Leary's website can be found at www.etoleary.com.

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