
O'LEARY'S ESSENTIALS: 6 WAYS TO MAINTAIN YOUR LOAN COMMITTEE'S EFFECTIVENESS

Final installment: Keeping on track takes vigilance

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Loan committees are one of any bank's principal internal controls on credit quality, as well as constituting a major communication and training vehicle for lenders and support staff such as Credit Administration and Loan Review.

As community and larger banks rationalize their business models in a dynamic macro business environment, it seems increasingly likely that loan committees in coming years will often be the principal drivers in preserving and promoting an acceptable credit culture in a business environment that is contracting by numbers of participants and must meld the best of former cultures into the brave new world of independent banking.

What should the committee look like in its composition and how significant a role should it have in the prior approval of credit?

My comments are from the perspective of a lifelong lender-presenter and in later years as member and chairman of the committee process at two large (in their day) regional banks. Good outcomes are not necessarily assured and so the components and inputs should be examined and updated from time to time to be sure that they still serve and will continue to serve the needs of the enterprise.

Here's my list of components that I think should be revisited every few years.

1. How much individual loan authority should officers exercise on their own?

The last few years have surfaced much anecdotal information on this subject. I'm suspicious that we have not rooted all the cowboys out of the business and until that distant day, loan committees with shared loan authority are essential.

My own bias is that no individual should have the legal limit of the bank or anything remotely close to it.

How many times have bank CEOs or senior lenders found themselves at the "Nineteenth Hole" of the country club and been drawn into credit discussions that were overly specific, but under analyzed? It's just dumb to allow senior people or the institution to be placed in that sort of context.

How about no one having more than \$25,000 unsecured, or \$50,000 secured (as that is defined in the loan policy) of individual loan authority?

If you think that clips the wings of your premier lenders, then I suggest you examine your tolerance for risk. It might be higher than you imagined it to be.

This is not meant to be a rigid, ridiculously low number that clutters up the channels with small dollar deals. If \$25,000 is too low and some relatively more generous number suits your bank better, then choose higher limits.

But remember that in sloppy credit cultures, individual lending authorities, especially relatively high ones, are the equivalent of testosterone injections. If you think I'm kidding, just listen carefully to lenders when they start enumerating bragging rights at banker meetings as the cocktail hour extends.

I'm not suggesting that every small credit should be in committee for consideration.

How about a "lending ladder" where two or three officers can collaborate on credits in amounts that are significant but not excessive? "Excessive" needs to be defined in the context of each bank but the objective should be to keep the small stuff away from committees and put the big stuff under the collective microscope.

2. Is there an aggregate commitment level that deserves committee scrutiny?

What about the committee looking at everything that, say, represents 65% or 70% of the bank's aggregate loan commitments?

There's no magic level. But I'd be striving for a relatively large coverage while not burdening the committee with small-dollar (and hopefully low aggregate risk) deals.

3. Who should be at the table and who should have voting authority?

I have two distinct biases here.

One is that those with voting authority should be senior and experienced.

Second, those attending should have a proximate need to be there and share in the information. There's no need for the voting members of the committee to "play to the gallery." That's not what loan committees are about. And to me, no one not exercising credit authority should be a voting member.

4. What are the specifics of the vote?

Is it a straight up or down, a consensus? Or does anyone exercise a veto?

I think that each credit decision should be definitive and self-contained so I would personally avoid any one person exercising a personal veto. In previous columns I've expressed a preference for consensus, as I think that builds a collegial sense of risk exposure. On the other hand, you can make any structure work among people of good will and reasonable motives.

5. I think the committee process should be reflected in the credit file. Were there any dissenting votes and if so, who and why?

These can be very informative over time and should encourage anyone sharing committee-based credit authority to speak up.

This is one area where anyone's opinion should be considered. I don't think we need to give special attention to a narrow minority view. But the committee members are entitled to the current thinking of anyone who shares in credit granting authority. That should be respected and encouraged, at least to some degree. But you may have to work at it.

6. Loan policy provisions and requirements should be emphasized.

This means that exceptions should be listed in the minutes but it also means that senior officers should use the committee discussion to emphasize "teachable moments" to all present. These should include examples of credit policy non-compliance as well as those items of an internal control nature that are not necessarily components of the formal credit policy. Exception reporting (and tracking) should be important components of approval discussions as banks undergo mergers and meld credit cultures.

The directors should be able to look to the senior loan committee process for confirmation that their policies are in force and effect.

No place for amateurs

I've seen lots of crazy stuff over the years. I remember an affiliate bank president bringing in a customer to help make the case in a loan committee meeting. I'd never permit that any more than I think that directors should be involved in the pre-approval process of extending credit.

Credit is a part of the bank's basic function that should be left to the professionals. If a bank doesn't have many (or enough) of those, then there's something important lacking and maybe there's insufficient expertise to be lending any money in the first place.

These items are a partial listing of what we should be thinking about in coming quarters as the industry begins to rationalize its size as the number of banks contract. It's going to be a hard job.

The loan committee is one place where the rubber will consistently be hitting the road.

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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