

## CREDIT CULTURE REBOOT, PART IV: WHAT'S GONE WRONG IN LENDING PRACTICES?

Over the last generation or so, it has become almost an article of faith that a strong loan policy is the ultimate defense against poor loan quality. And banks and regulators take loan policies quite seriously. So where did all these bad loans come from?

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Credit culture needs a "reboot," or at least, a revisiting, in many banks today. The credit cycle's impact has been amplified by some bankers' exuberant belief that there is an acceptable long-term alternative to what blogger Ed O'Leary refers to as a "conservative credit culture." This special "Talking Credit" series will examine the fundamentals of bank credit culture, and explore how management and lender can revisit how they grant credit. If you missed earlier instalments, click here for Part One, Part Two, and Part Three.

—The Executive Editor

What role does a bank's loan policy have in the training and development of a loan officer?

As a rule, loan policies are detailed descriptions of the credit standards of the bank. Among the many facets they contain are: the quality and type of financial and non-financial information required for extending credit; advance ratios on collateral; desirable and undesirable loans; geographical lending territories; board-delegated credit authorities; descriptions of credit product lines; and loan-structuring parameters.

Over the last generation or so, it has become almost an article of faith that a strong loan policy is the ultimate defense against poor loan quality.

Bank supervisory agencies have been diligent and consistent about the quality and consistency of loan policies for many years. Yet we continue to hear recent anecdotal evidence of significant, if not serious, asset quality problems at community and regional banks that have been relatively untouched by the problems of sub-prime lending or residential mortgage loan underwriting.

Perhaps it's time to examine the root cause or causes of what the anecdotes seem to point to. Are the loan policies deficient? Or is it something in the training and experience of the lenders that is contributing to this condition?

If any of us had surveyed loan officers with at least a few years of experience as recently as three years ago, we'd have heard assurances that loan policies were adequate to prevent a diligent lender from getting into any significant credit trouble. Any significant levels of problem credit at most banks were largely unthinkable. (I'm not referring here to an infrequent, honest lapse of credit judgment nor customer fraud in the credit application.)

Yet, given what is showing up in FDIC's industry figures, I must pose the question of how so many lenders underwrote so much credit apparently conforming to policy—yet with problematic consequences for so many

banks?

Are there gaping holes in the backgrounds, education, development, and training of lenders in many community banks today? Experienced lenders are not immune to error, but banks are generally conservative institutions where caution and deliberation are operating characteristics. Are the working environments of many community banks failing to clearly articulate and support prudent lending standards?

A conservative credit culture begins with a conservative, clearly stated, complete, and authoritative loan policy.

If we agree that credit policies alone have not been sufficient to keep community banks from painful experiences in the recent and current environment, what are the companion elements that need to be put in place to assure a high standard of credit integrity?

Most of us can make a list of internal controls that most banks rely on to assure that tasks are performed properly. These include centralized funding, centralized document preparation, independent credit analysis, independent loan review, loan approval structures, and the like.

It's time to look closely and critically at how lenders arrive at their decisions to approve credit and how these decisions should be structured to facilitate repayment over time:

1. Are there ways of viewing or anticipating risk that are not adequately treated in the loan policy or other internal controls?
2. Are there gaps in lender training or experience? For example, what sort of skills do all lenders need to properly assess a borrower's capacity to repay?
3. How is the proficiency level of lenders measured and maintained?
4. How many banks actively perform a detailed "post mortem" on each credit loss? The point of such efforts is to understand what could have been done better at the front end, and during the oversight and administration of the credit.

In other words, are we looking in the right places to understand our industry's less-than-stellar credit underwriting performance over the current credit cycle? Do we understand all of the critical elements that comprise the organizational culture of our banks and the integration of these factors within the sub-cultures, such as credit culture?

Some banks need to make changes. As an industry, we are about to undergo a reshaping of how we do business and how we are supervised and regulated to serve the legitimate public interest. We will have to deal with broad and impersonal forces and they will be powerful change agents.

If we as an industry haven't fully understood how our individual credit cultures work and how they can be

undermined even in good faith, then we are not properly prepared to survive in the long run.

Nor will we have served our shareholders and our banking public very well.

Comment on this instalment below. Suggest future topics in the series to Ed O'Leary at [etoleary@att.net](mailto:etoleary@att.net)

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 a frequent speaker in ABA's Bank Director Telephone Briefing series. You can hear interviews with Ed about workouts here. You can e-mail him at [etoleary@att.net](mailto:etoleary@att.net). O'Leary's website can be found at [www.etoleary.com](http://www.etoleary.com).

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