CREDIT CULTURE REBOOT, PART VI: ARE CREDIT POLICIES THE WEAKEST LINK?

Credit policies would seem to be a cornerstone of credit culture. And yet, a new report from FDIC calls that into question.

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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, Part Three, Part Four, and Part Five.

–The Executive Editor

Last week we defined credit culture as the set of shared attitudes, values, goals, and practices that characterizes an institution, organization, or group.

Just this week, as I was setting out to follow up on my last column, the FDIC published its Summer 2009 issue of Supervisory Insights. It contained an article dealing with bank supervisory lessons learned during 2008. Several causes of the recent financial turmoil were cited, including practices at banks of lax underwriting standards; excessive reliance on financial leverage by individual borrowers and by the financial system as a whole; and significant concentrations of risky or illiquid assets on bank balance sheets.

Each of these contributing factors to the financial turmoil usually receives considerable focus in any bank’s credit policy.

The question indirectly posed in FDIC’s article is whether credit policies truly address the inherent risks being placed on bank balance sheets. It appears the answer inescapably is “no.”

Credit policies have failed, by omission, to adequately identify such risks. That, or management has failed to observe its own policies, deliberately or by willful negligence.

By inference, this suggests that credit policies do not represent the cornerstone of credit culture at many banks.

If the credit policy does not adequately state credit standards, or if management permits numerous exceptions to the policy, then where or what is the foundation of the credit culture?

Have there been no guiding principles other than of the unimpeded growth of revenue?

As our industry prepares for a protracted period of less-than-satisfactory credit quality due to the deep economic recession, and as the Obama Administration releases its banking supervisory and regulatory reform proposals, what should prudent managements and directorates do for the sake of damage control? How should they rebuild the internal culture without the mistakes, failures, and omissions of recent years?

We should recognize that while credit policies should embody the best credit standards, human behavior in the pursuit of a specific firm’s economic goals can be misdirected or aberrant. We may say that credit culture begins with a policy, but it certainly does not end there. What other components are appropriate safeguards to the interests of stockholders, depositors, and the banking public?

There are two types of internal controls: those that are active (or proactive) and those that are essentially passive.

Active controls include loan approval processes, such as credit committees where credit principles can be taught and reinforced through discussion of appropriate structures and analysis aimed at limiting or controlling risk. The overall bank attitude toward business development and competition is also an example of proactive leadership by senior management and the board that has a direct bearing on credit culture.

Passive controls are those activities that assure compliance with stated policies and that address matters of audit and compliance concerns.

In recent years, the Sarbanes-Oxley Act is a preeminent example of how audit and compliance programs were instituted to curb excessive risk taking or to detect aberrant behaviors of rogue officers and employees. These are important activities. That’s because noncompliance with stated policies on a widespread basis suggests the absence of any policies.

The real heart of a bank’s credit culture lies in the attitudes and day-to-day behaviors of the officers and staff who solicit, underwrite, book, and administer credit.

In other words, the active guidance and input of the leadership and experience will be decisive. No policy can cover every contingency nor anticipate every risk or possible outcome. But human behavior can be observed, conditioned, and predicted.

Questions to consider

Here are some questions on my short list that any credit culture review should consider.

1. Does the bank’s senior leadership respect the existence of established policies and related internal controls?

2. Is there consistency in the approach to risk? Is there formality in the way that each credit extension is underwritten and documented?

3. Are exceptions rigorously documented and reported regularly to the board of directors?

4. Are exceptions considered truly “exceptional”? Or are they seen and handled as more or less routine?

5. Are comments and criticisms by internal or external auditors carefully considered—and acted on?

6. Then there are four key questions to ask about staff:

a. How are lenders recruited and trained?

b. Is there a sense of what each lender is expected to know?

c. Is there an inventory of skill sets that are considered necessary for successful lending and the ongoing supervision of credit?

d. How formal is the continuing education of lenders and lending staff?

Credit culture can be either strong and ingrained or fragile and superficial.

Unfortunately, we’ve seen too many examples of internal cultures not living up to the demands placed on them during this credit cycle.

In coming columns, we’ll consider what sorts of specific activities are the hallmarks of proactive management of the credit culture.

Meanwhile, what do you think the immediate steps to remedy deficiencies and strengthen the fabric of your bank’s credit culture should be?

Comment on this instalment below. Suggest future topics in the series to Ed O’Leary at 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. O'Leary's website can be found at www.etoleary.com.

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