

## CREDIT CULTURE REBOOT, PART VIII: HOW DOES YOUR CREDIT CULTURE MEASURE UP?

Can your bank stand up to Ed O'Leary's Credit Culture Audit?

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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](#), [Part Five](#), [Part Six](#), and [Part Seven](#).

—The Executive Editor

The events of the last 18 months or so have created deep levels of concern in many banks about the adequacy of the bank's credit cultures. There is no single list of absolute rules, practices, or approaches to a sound credit culture, but there are some ways of seeing whether you are doing most of the right things (and doing them well) to keep the credit quality of your loan portfolio within reasonable bounds.

A comprehensive evaluation of how your credit culture is working should include the results as measured by loan losses, consistency of net interest income, and overall bank profitability over a complete credit cycle. There are some things you can and should check on in the meanwhile to get a sense about whether some things might not be quite what they should be.

The following list is not meant to be all-encompassing or exhaustive.

But it is based on experience and the application of the principle, "If it's not broken, don't fix it."

### 1. HOW WELL DOES YOUR CREDIT POLICY WORK?

• Is your credit policy frequently or regularly discussed in the process of approving credit?

• Does your board of directors review your credit policy annually?

• Do you formally track credit and collateral exceptions and report them periodically to your board of directors? Is there any regular follow-up activity as a direct result of the process?

• Does management recommend changes to the credit policy based on changes to the marketplace or to the credit products the bank offers?

• Have the bank examiners recently noted any deficiencies in policies or recommended any changes?

• Do you do a formal review of all charged-off credits with a view to detecting elements of policy weakness or omissions?

## 2. IS YOUR LOAN REVIEW PROCESS TRULY INDEPENDENT?

• Does Loan Review have the "last word" in situations where there is an honest disagreement in an assigned loan grade?

• Does the loan review function report independently of the line lenders?

• In the course of an onsite bank examination, do the examiners seldom challenge or disagree with an assigned loan grade?

• Does Loan Review's scope cover two thirds or more of all credit commitments?

• Does Loan Review report on credit quality trends within an individual loan officer's assigned portfolio?

## 3. HAVE YOU EFFECTIVELY INSTITUTIONALIZED A SYSTEM OF INTERNAL CONTROLS TO SUPPORT THE CONSISTENT APPLICATION AND ENFORCEMENT OF YOUR LOAN POLICIES?

• Is there a centralized funding unit or a control point to assure that each loan is being funded consistent with approval authorities and conditions?

• Are loan officers supported in the preparation of loan documents and the perfecting of security agreements?

• Are larger dollars of credit exposure (relative to the bank's capital position) formally analyzed as to the

borrower's ability to repay?

#### 4. DO YOUR LOAN AUTHORITY APPROVAL STRUCTURES MATCH THE SKILL SETS OF THE LENDERS?

• Are there opportunities for lenders, especially younger or less experienced ones, to access the experience of the more senior people?

• Is there a formal mentorship process for lenders in existence?

• Is the exercise of single loan authority equal to the legal limit of the bank prohibited by policy?

• Do lenders have the regular opportunity for continuing education in credit and related areas?

#### 5. HOW DO EXECUTIVE MANAGEMENT AND THE BOARD OF DIRECTORS COMMUNICATE ITS ATTITUDE TOWARD RISK?

• Are charged-off loans regularly and promptly reviewed for curative processes, including modifications to the loan policy or to internal procedures to abate risk?

• Is there a sense of accountability among the lending staff for lapses in the proper application of credit policies and procedures that create a higher level of risk?

• Is there an institutional sense of formality in the way credit is underwritten, funded, and reviewed on a continuing basis within the bank?

• Are exposures to areas of operational risk relatively rare or when they are discovered, remedied promptly?

• Does executive management appear to be consistent in its attitudes and enforcement of practices designed to create proper checks and balances in the extension of credit?

• Would you describe your bank's attitude toward growth as either balanced or cautious?

• Does your bank appear to value an "institutional memory" that accurately reflects its history over the last several years?

## THE "ANSWER KEY"

If your answers to each of these questions are mostly "yes"; then your bank is scoring well in the credit culture audit. One more "yes"; is needed though and it is to this important question:

"Are you truly objective in your answers to the above questions?";

If you are a member of management or the board of directors, objectivity is critical.

One other closing thought. Do you view the success of a bank's lending function primarily as the application of science or art?

To the extent that you may view each borrower as an individual with unique characteristics, you tend toward "credit as art.";

However, if you view credit extensions as a series of steps and routines consistently applied, you tend toward the view of "credit as management.";

Some weeks ago we began this series on credit culture by defining a culture as a shared set of ideas, principles and practices. These separate views—art vs. management—are not necessarily compatible all the time. So it's important that you "know thyself"; and what it takes to create and sustain an acceptable credit culture.

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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