CREDIT CULTURE REBOOT, PART IX: WHY BANK CREDIT CULTURES DRIFT OFF COURSE

When—and how—can a bank be like a brontosaurus?

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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, Part Seven, and Part Eight.

–The Executive Editor

Do banking companies deliberately set out to undermine their credit culture?

I don’t think so, but it may happen more often than we’d like to think. What are the circumstances or tendencies that make such a “drift” possible? Or even likely?

Factors that can set credit culture adrift

1. A company can grow faster than its human and systems infrastructure.

This happens in times of rapid organic growth and may be accompanied by a change in management or control. Culture drift may also happen where companies have grown by acquisition. The last ten years or so have seen a rapid increase in the average size of banking companies, while the number of companies has continuously shrunk due to persistent acquisition activity.

The risks of undermining culture in a “growth by acquisition” mode are significant and they are not necessarily readily apparent.

First, rapid growth produces size and scale that may be out of proportion to the individual and collective experiences of the management group and perhaps beyond their skill sets. In other words, bigger body, same brain.

Bigness does not automatically imply experience in managing larger and more diversified operations.

Second, even apparent extensive lending experience of the staff may not have occurred within a context of shared experiences. What each lender knows is often conditioned and modified by his or her individual experiences in a variety of lending environments prior to a merger of institutions that no longer exist. These lending environments may have varied widely relating to formality, product line, internal controls, staff support, training, and human development.

Are we making too many assumptions about the collective and individual experience of our lending colleagues?

2. A company’s leadership and its front-line troops can fall dangerously out of step with each other.

There is often a conflict between the stated goals of an organization—the values espoused in the mission, vision and values of the company and the operational values—and the day-to-day practices of its staff and management.

A certain amount of drift is hard to avoid in a fast paced, expanding environment. What we say we do and what we actually do may be different. This can be so even if the disconnect is unintentional or unconscious.

3. A company can get caught up in the “high performance star” trap.

There has been the tendency in recent years of some banks’ emphasizing maximum financial performance. FDIC may have had something like this in mind in the Summer 2009 issue of Supervisory Insights in the article entitled “A Year in Bank Supervision: 2008 and a Few of its Lessons.”

Here’s a direct quote from that article:

“[F]inancial firms engaged in a competitive relaxation of credit standards and risk tolerance to gain and maintain revenue growth. . . . To some banks operating in such an environment, traditional lending standards can appear an unnecessary impediment to revenue growth.”

This is a harsh judgment, particularly coming from the largest of the bank regulating agencies.

Perhaps this is somewhat of an overstatement applying only to a few institutions and their behavior in recent years. But it may reflect evolving financial goals and expectations where high performance in both absolute and relative terms is expected, demanded, and liberally incented.

The drift away from a conservative credit culture can occur incrementally in such environments and extend over several years.

There’s nothing wrong with high performance.

In fact, sustainable, high performance is the ultimate metric of an environment of low operational risk.

Ah, but the controlling idea here is “sustainable.”

Applying lessons to credit culture

Directors, owners, supervisory agencies, and the banking public should all prize sustainable performance. Sustainable means levels of risk and operating practices that can deliver consistent performance quarter after quarter and year after year. Banks operate with accustomed levels of financial leverage exceeding prevailing standards of most industries that routinely rely on bank credit. That means that loan assets reflecting high levels of financial risk (financial leverage) must be diligently managed.

There are several categories of risk that are monitored by bank supervisory agencies but as credit people, we are primarily concerned with credit risk and liquidity risk.

• Credit risk is the risk to bank earnings and capital of loans that cannot perform according to their original terms.

• Liquidity risk is the risk to bank earnings and capital that the bank cannot meet its contractual obligations to its deposits or to its borrowers.

This is not to say that weak performance is an acceptable alternative to either type of risk. Banks can still perform to high external standards with the right blend of internal controls and appropriate practices and attitudes toward how credit is solicited, underwritten, and overseen.

There’s no room these days for inaccurate or outdated assumptions on the real state of a bank’s credit culture.

It is what it is by collective human behavior shaped and modified by individual as well as collective attitudes of the lending staff, executive management, and the directorate.

Anecdotal evidence abounds in recent years of how difficult it is in practice to meld the cultures of different institutions that one day find themselves merged and under single ownership and management. It’s hard work to shape a culture but it’s not particularly difficult to define the current state of an institution’s culture.

Time for self -examination

Here’s a short list of questions to that end:

1. Are the values of the combined organization clear and consistent?

2. Is there congruence between the company’s stated goals and the operational goals?

3. Are the company’s policies consistently applied and observed to a high degree?

4. Is there a discernable level of tension or conflict between the volume of loan production and portfolio credit quality?

5. Is earnings performance reasonably predictable during periods of moderate economic downturn and therefore reasonably sustainable?

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A bank should never expect to perform better than its customer base.

In depressed economic times, everyone suffers, including the bank, to some degree.

But no bank’s performance should be subject to sharp swings in fortunes relating to credit quality.

That’s a failure of the credit culture—and credit culture should be one of the abiding constants in our business.

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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