CREDIT CULTURE REBOOT, PART X: WHEN PRINCIPLES AND PRACTICES ARE NOT ALIGNED

As the Credit Reboot series comes to a close, where do you go from here?

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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, which concludes with this installment, has examined the fundamentals of bank credit culture, and explored 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, Part Eight, and Part Nine

–The Executive Editor

Experienced credit practitioners have seen periods in their working lives where credit principles and credit practices have diverged. Let’s call it “drift,” rather than a deliberate undermining of sound practices, though some of us may have observed that too.

Where did “drift” begin?

First, let’s examine the possible causes of this drift. High on any list during the experiences of recent years must be the highly competitive nature of the commercial banking business. More banks and more competition from non-banking companies has made lending money extremely competitive in many markets. Inexpensive credit tended to diminish the “scarcity value” of debt, and it became available to just about everyone.

Competition for deals led to a gradual erosion of established credit principles. The changes in just ten years are truly surprising, in hindsight. Personal guaranties of the principals are less frequently required. Original maturities of debt extend out significantly compared to historical norms. Collateral margin requirements have been bent or relaxed in the face of relentless pressure from multiple lenders simultaneously pursuing the same deal.

And finally, deal pricing has become increasingly unrelated to risk. The reference point is competition for the deal, rather than an objective assessment of credit risk or costs of servicing debt. To some, this has been the most disturbing development of all.

Also occurring in small business lending were a series of practices that tended to convert the customized crafting of a loan into a commoditized product. Credit scoring, truncated applications, and centralized underwriting tended to diminish the personal factors in the negotiating and extending of credit, making the process considerably less personal. Though the pursuit of standardization has resulted in cost savings to most lenders and created a uniformity of credit product results, many bankers experienced this process with the feeling that small business credit underwriting has been “dumbed down.”

Soft side of deteriorating standards

Our industry has not necessarily distinguished itself in recent years with the quality and results of its underwriting. Here’s my short list of signs of deterioration other than those objective measurements of loan loss and regular provisions to the loan loss reserves:

1. The tendency of some lenders to strive for large individual lending limits.

This is considered by many to be a prestige factor. If that’s the view in your bank, you should aggressively discourage that sort of thinking. Sound credit, especially in significant dollar amounts, is the product of cooperation at several levels within the bank.

It is the effect, not the cause, of a sound credit culture.

2. Forgetting that lending money requires the consistent application of basic principles.

These principles need to be understood, agreed to by consensus, and conducted with the formality that the stewardship of other people’s money warrants—and should command.

3. The uprooting of established standards, which should not change with the current breezes nor be buffeted unnecessarily by competitive forces.

Many so-called high-flying commercial lenders of recent years have been shown to be what they really are—lenders of last resort to borrowers that can’t command the respect of responsible bankers.

Looking forward: What to do?

If you have concerns for your bank’s credit culture due to the outcomes you’ve experienced in recent quarters, here’s what you should do.

1. Review the loan policy to be sure it reflects sound, conservative standards.

If it’s not been revised in a while, then go over it carefully and make the changes to bring it current. Simultaneously, be sure to conform sound policies to sound internal practices. This means activities like gaining control of credit and collateral exceptions. It also means making sure that there are not problematic gaps in the application of appropriate internal credit controls.

2. Undertake a complete review of your loan grading system.

Make it more granular and explanatory of what you and your colleagues consider to be good business credit and how to differentiate better and best from merely good.

My own experience confirms that a bank’s loan grading system is as effective as loan policy in communicating standards to the lending staff. You might also ask other bankers to share their grading systems with you. Most are willing to do that as there’s really nothing proprietary about any of them.

3. Recommit to the long-term process of developing the skill sets of the commercial lenders.

Along with this, do some functionally related career planning and development for all those who exercise lending authority. Remember the quote from the Stonier thesis of the 1960s with which this series on credit culture began ten weeks ago:

“An inexperienced lender is an insecure and unhappy person. At best he or she is a walking tribute to public relations.”

Closing thoughts on ten weeks of cultural cogitating

Our business has experienced a great deal of change in the last several years and much more is coming as regulation and supervisory practices are realigned for the new century we’re in.

But some things don’t change, such as the importance of the character of the borrower and the need to thoroughly understand and analyze the capacity of the borrower to repay a loan through the cash flow of the business.

These principles are as old as the hills and they have not changed much, nor should they.

For some, it’s time to rediscover them, relearn them, and put them back into practice.

For others, it’s time for them and their institutions to be rededicated to the highest level of personal and corporate responsibility in maintaining a superior and effective credit culture.

We can afford no less.

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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