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## LOAN REVIEW MEETS LENDING STAFF: A NEW "FOUR Cs"

Second of a two-part look at Loan Review

Loan review seems to have come of age in the current credit cycle.

What steps can lenders and loan review staff--and their managers--take to improve their programs?

To read part 1 of this series, [click here](#).

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Years ago, when cash management was in the relatively early stages of what has become a very sophisticated set of services, I worked with "Fred." Fred sold and delivered these services. We lenders learned our bank's systems mostly by taking Fred along on our calls on likely prospects.

Fred was voluble, immediately likeable, and articulate.

But he also seemed "slick" to some, because he used an arcane vocabulary; talked fast and with considerable assurance; and tended to "under-explain" details that seemed relevant to the rest of us.

Perhaps you know a "Fred." His volume of words was abundant, but the meaning was not always crystal clear. We've all probably known loan officers like this too. The communication that's not materially complete often results in the message being misunderstood.

Finding the right level of communication

As I mentioned in the first installment, lenders are sales people. We are pitching our customers' deals to our employers. People in the bank, our peers and our bosses, form opinions about us from the number and types of deals we bring in.

The opinions are composites, so it's important we understand the components. We are judged on our business development skills and on our abilities as sound credit underwriters.

Yet these are really quite different skills.

A great credit person is not always a great salesman, and vice versa. In our industry, our employers value both skill sets. And a well-rounded banker should be able to do both with broadly comparable finesse.

As sales people, though, we may be inclined to tendencies to under-report or over-report on details. One result can be as detracting as the other. Too little information and we may understate the risk, or be too "generous" on pricing. Too much detail, and we can overstate the risk or produce "credit committee fatigue";

We should strive to accurately represent risk. Precision rarely exists in the extension of credit, so accuracy should be our primary objective.

#### Administering solutions to real-life lenders' tendencies

Very rarely in my experience have lenders deliberately misstate specifics of credit with intent to mislead. Yet our communication styles can be hindrances to full comprehension, just as Fred's style was between him and some of the lenders.

Sales people often see opportunities more quickly than problems. It's our nature, our training, and what makes most of us good sales people. To counter that tendency, we have a series of internal controls including loan authorities; credit committees; loan policies and procedures; and loan review systems.

An effective loan review system relies on a lender's candor and the accuracy of the information presented. Loan Review, on the other hand, has to fit into the culture of the bank in such a way that it aids risk management and credit grading, but that neither dominates nor is compromised by it.

#### Checklists to improve by

We should start any assessment of loan review with a simple checklist, about Loan Review:

1. Are the loan review officers competent to do the job?
2. Are they truly independent of the lending line?
3. Is the coverage of the dollars of exposure large enough to be representative of the loan portfolio as a whole?
4. Does the function operate in an atmosphere of mutual respect, relatively free of adversarial overtones?
5. What do your bank examiners think of Loan Review's work?

What often can be overlooked are the behaviors and inclinations of the lenders, the bank's main credit sales force. Here's a checklist for the lenders:

1. Have loan write-ups been done completely?
2. Do the write-ups accurately reflect the quality of the credit?
3. Do the files contain all materially relevant information on a particular credit risk?
4. Are all exceptions managed to the board's standard of acceptability?
5. Does the institution's culture foster an environment of candor when and if problems develop in the administration of a credit?

#### Performing a "4 Cs" review

Credit risk is the paramount risk in the long-term prosperity of community banks. Credit risk management requires a rigorous assessment of loan underwriting, a process driven by the skills of the lender plus the collective wisdom and internal control mechanisms of the bank. This process runs on information—accurate information—and trust.

Let's assume the culture of the bank appropriately protects against excessive credit risk. To become really comfortable that it does—and continues to do so—I urgently suggest that you perform an assessment of institutional candor.

Start with the lenders and impose a "Four Cs Review." This means credit information, oral and written, that is:

1. Correct
2. Clear
3. Comprehensive
4. Candid.

Now, let's put some flesh on the bones.

Correct means to a high standard of accuracy both in what is said—and what might remain unsaid.

There's an old maxim that teaches "A half a truth is a whole lie."

Clear means that everyone can understand the language and that it is free of flip phrases or jargon.

Comprehensive means that each credit is contained in a story told in an appropriate context without material omissions.

Candor means that if there's a problem developing, the loan officer (who is normally in the position to see it first) brings any credit deterioration to the prompt attention of loan review.

Loan Review and bank examinations

Our credibility as individuals and as an institution is on the line during every safety and soundness exam.

1. Do we know our credits?
2. Are loan grades appropriate and cumulatively reflective of the degree of credit risk in the portfolio?
3. Are the stockholders and directors protected by a loan loss reserve that is adequate and appropriate?

What I'm describing is a process, not an event. It has to be worked at and worked on, and, in the modern history of banking, it's never been more important to the success of our industry and our individual banks.

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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