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Getting from Here to There

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CREDIT CULTURE: FOUR TYPES OF CREDIT CULTURE (PART 2 OF 8)

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Stuck on Credit Culture

Last time credit culture was defined as "how we do things around here." It reflects the bank's approach to underwriting, managing and monitoring credit risk. Credit culture is the glue that binds the credit process and forms the foundation for credit discipline, and every bank has a credit culture although the glue may vary in its fastness. The culture may be formally defined by senior management, or it may have evolved informally over time. The culture may be unified or diverse.

An institution may have multiple cultures or subcultures, and sorting out all these facets starts by asking some defining questions:

- What is the dominant culture?
- Is it suited to achieve the priorities established by senior management?
- Are the subcultures consistent with the dominant culture?

Traditionally, diverse cultures evolved from loan approval and loan management processes built around transaction management. Many banks still struggle with balancing the dual roles of its lenders as sound, conservative underwriters and as business development officers.[2] So where credit culture has grown from the bottom up rather than being defined from the top down, management will have to synchronize the culture with its corporate priorities.

Synchronizing Culture and Priorities

Corporate priorities must be supported by the credit culture, and one approach is the following 4-step process:

1. Establish Corporate Priorities. Successful credit risk management of individual loan portfolios or a bank's loan portfolio is measured by consistent and predictable earnings and credit quality over the business cycle. Successful credit risk management must then balance priorities for:

- Profitability
- Asset quality
- Growth and market share

2. Choose the Credit Culture. Once the priorities are set, they become the foundation of the institution's credit culture, and there are four basic types of bank credit cultures:[3]

- Values driven
- Immediate-performance driven
- Production driven
- Unfocused

We will examine these in more detail shortly.

3. Set the Credit Risk Strategy. Identification of the credit culture is critical to setting the credit risk strategy. A bankmay choose a risk strategy that is inconsistent with the underlying culture of the bank. For example, a values-driven credit culture is not likely to be supportive of an aggressive risk strategy.

4. Implement Risk Controls. Finally, the bank must implement risk controls that identify, monitor, and manage assumed risks. Among the tools that maintain credit discipline are: loan policies, approval process, risk ratings, loan administration, loan review, and portfolio monitoring.

Matching Corporate Priorities and Credit Cultures[4]

Corporate priorities can be matched to the types of credit cultures needed to support them:

Corporate Priority	Credit Culture
1. Asset quality; long-term consistent performance	1. Values driven
2. Immediate earnings, stock price	2. Immediate-performance driven
3. Market share, market domination, loan growth, volume	3. Production driven
4. No clear priorities	4. Unfocused

Each of these cultures reflects priorities established by senior management. The driving force may be a long-term approach based on corporate values or shorter horizons set by the annual budget or the latest market penetration plan. Credit environments may range from strong to weak in leadership, policies, and systems. Policies may be written or unwritten, spoken or unspoken. Some more detail on these four types of credit cultures may help in understanding the culture-priority relationship.

Short Descriptions of Credit Culture Types.[5]

The four types of credit cultures differ in their top priorities, driving forces, credit environment, hidden or informal policies, and success factors:

1. Values Driven	
Top Priority:	Long-term, consistent performance
Driving Force:	Corporate values and market consistency
Credit Environment:	Strong credit organization with few policy exceptions and excellent communication
Hidden Policy:	Not a factor, consistent with written policy
Success Factor:	Balance between credit quality and revenue generation, avoids tendency to over control lending function

2. Immediate-Performance Driven	
Top Priority:	Current earnings, stock price
Driving Force:	Annual profit plan
Credit Environment:	Generally strong emphasis on credit quality when economy is strong and not much difference from values-driven culture; however, in periods of weak loan demand, there is a tendency to enter or increase riskier lines of business
Hidden Policy:	Conflicts with written policy during soft loan market periods as lenders become confused over management priorities
Success Factor:	Credit risk management must be strong enough to resist lender pressure to enter riskier markets in a down cycle

3. Production Driven	
Top Priority:	Market share, loan growth, and loan volume
Driving Force:	Commitment to be the largest
Credit Environment:	Well-managed, market-driven banks have strong systems, controls, and good credit leadership, but as lenders are pressured to produce, line and credit will be in conflict over priorities; in very aggressive banks, credit approvers find themselves increasingly limited in their influence on loan decisions as they are directed to "find a way to do the deal"
Hidden Policy:	Lenders understand their job is to produce loans regardless of written policy
Success Factor:	Credit risk management must control the loan approval process, keep individual loan authorities low, and resist production pressure

4. Unfocused alias Current-Priority Driven	
Top Priority:	Tends to change frequently
Driving Force:	Changes as priorities change; management is reactive
Credit Environment:	Line units may have their own views of credit quality; credit risk management tries to respond to frequent changes in direction
Hidden Policy:	Lenders confused by inconsistency and shifting priorities
Success Factor:	Credit quality can be maintained if credit risk management policies, systems, and leadership are strong

A very competitive banking environment tends to focus individual banks on immediate performance. A bank may say credit quality is its highest priority, but earnings pressures in a highly competitive environment with few high-quality lending opportunities can push an institution away from a values-driven culture toward an immediate-performance culture. The result may be a hybrid culture with characteristics of both values-driven and immediate-performance cultures.

The immediate-performance culture tries to balance credit quality and loan production to achieve consistently good earnings. Stressing credit quality is easy in prosperous times when good lending opportunities abound. The challenge for this culture comes when loan demand is weak. The push for earnings, especially in a recession, means tolerating higher levels of risk.

No one intentionally picks a strategy lacking clear priorities or deliberately announces the pursuit of immediateperformance priorities. Instead, management may decide to pursue market share, market domination, loan growth, or volume targets that conflict with common sense advice to know one's customers, to be prudent in extending credit, or to avoid big participation shares in syndications.

Movie producer Sam Goldwyn was legendary for his Byzantine decision-making style, "I'll give you a definite maybe." But bank management must be decisive in a strong credit culture. If there is not clear, consistent communication, relationship managers pursue behaviors that are rewarded regardless of policies and procedures. Consequently, management can't predict credit performance anymore, and corporate portfolio management of asset quality fragments into individual line managers' priorities and capabilities.

[1] Ibid. p. 20.
[2] John Grafstrom, "Seven Characteristics of an Effective Credit Risk Management System and How to Test for Them," The Journal of Lending and Credit Risk Management, December 1996, pp. 55-60.
[3] John McKinley, How to Analyze Your Bank's Credit Culture, (Philadelphia: Robert Morris Associates, 1990).
[4] McKinley and Barrickman, op.cit., pp. 20-21.
[5] Ibid. p. 22-23.

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