BankersHub
Getting from Here to There

Newsletter Article

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CREDIT CULTURE: KEY DRIVERS OF CREDIT CULTURE (PART 3 OF 8)

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Introduction

The previous article described the four types of credit cultures and the alternative management priorities they supported.

Now let's see what key factors influence credit cultures. They include:

- Commitment of top management
- Credit discipline
- Priority-based incentives
- Risk-managed lines of business
- Clear, consistent, and candid communication.

Commitment of Top Management

Senior management must both promote the culture and practice it. All the talk in the world about the importance of credit quality falls on deaf ears if management walks around with a profit plan that rewards lenders for loan volume to less creditworthy borrowers. Part of any quarterly review of the bank's performance ought to include the trend in 30-day past dues, 90-day past dues, criticized loans, classified loans, non-accruals, and net chargeoffs. These six basic asset quality ratios should be calculated for the bank as a whole and by the bank's lines of business — commercial, commercial real estate, mortgage, direct consumer lending, indirect lending, and so on.

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Credit Discipline

The CEO's commitment to credit quality legitimizes credit discipline. Top management's call for credit quality and expectation of high credit quality standards will cause all levels of the organization to participate in and support the standards. A partial list of credit discipline components include:

- Policies
- Risk-rating system
- Credit administration
- Loan review
- Lender accountability

While the policies, rating systems, and controls are integral to discipline, top management must lead the charge to maintain discipline. The credit process may be capable of identifying risky deals, but the CEO must be prepared to tell both lenders and credit approvers that unacceptable risks are not to be approved, documentation and policy exceptions are to be rare, and lenders who close and book loans differently than what was approved will be disciplined.

Priority-Based Incentives

Priorities must drive the incentives, not vice-versa. If raises, promotions and bonuses reward aggressive lending, credit quality will not survive. Ideally, incentives are tied to priorities that reward performance standards for credit quality and portfolio profitability. Stay ahead of the curve by moving forward from punishing nonaccruals and charge-offs to rewarding lenders for low 30-day delinquencies, avoiding temporary extensions, and getting annual reviews and renewals done on time.

Risk-Managed Lines of Business

As banks organize themselves along lines of business for small business banking, commercial lending, commercial real estate financing, etc., financial institutions are using the different risk and profit potentials of various lines of business to diversify their overall loan portfolio. Thus, the choices of lines of business and the rates at which they expand help shape the risk profiles of the respective institutions.

Banks get into trouble when they pursue risky lines of business too hard and exceed prudent levels of concentration. Lines of business goals must be consistent with bank priorities. For example, large exposures in unsecured small business lending, sub-prime mortgage banking, or speculative homebuilder and commercial real estate development construction are typically inconsistent with a values-driven culture.

Clear, Consistent, Candid Communication

Straight talk means positive and persistent communication to reinforce the culture. The credit culture vocabulary consists of words and phrases with universal meanings that convey the bank's lending philosophy and its tolerance for risk. Some examples of common credit culture vocabulary by type of culture illustrate their differences:

Culture	Primary Culture Words
Values driven	Quality, balance, soundness, prudence, ownership, conservative
Immediate-performance driven	Quality loan volume, balance, aggressive, driven growth-oriented
Production driven	Market share, growth-oriented, aggressive, loan volume
Unfocused	Creative, think out-of-the-box, fluid, dynamic, responsive

An organization with a strong culture supports the common language with informal rules of behavior. New lenders receive extensive orientation on "how things are done around here." Discussions may range from the bank's risk appetite, the types of lending desired and less desired, loan policies, policy exceptions, and the importance of credit quality. Lenders learn quickly how the bank expects them to underwrite, structure, and administer credits.

As noted earlier, the credit policy is the primary document for communicating the credit culture, but policy is an effective communication tool only if it is enforced by top management and monitored by loan review. Besides the credit policy, other channels include job descriptions, market strategies, budget plans, corporate goals, credit decision documents, loan reviews, portfolio management reports, and informal credit discussions.

Barriers

If there were no obstacles to strengthening credit culture, any bank could move up to the optimal, values-driven culture. However, the barriers include CEO commitment, the time needed for change, unacceptable relationships, and lack of integration. First, as stated previously, the CEO and top management must be steady in their commitment to credit quality. Any vacillation opens the door for arguments of stretching, bending, suspending, or eliminating policies. Second, it takes a long time to instill a new culture—defining it, implementing the appropriate risk strategy, instilling credit discipline, and then reevaluating the credits originated under the old culture. Third, besides the time needed to sort through existing relationships, there is the pain of exiting old acquaintances, finding suitable replacements, and surviving the blow to interim earnings.

Finally, a new credit culture's success depends on all the machinery working, its parts installed correctly, and everything ready to go on time. Priorities, risk strategy, and controls must be integrated for the credit culture to work properly. As Ernest Hemingway once warned, "Never mistake motion for action." Everybody must avoid going through the motions; everyone must act together to make the culture work.

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.

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