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CREDIT CULTURE: HOW TO CHANGE A BANK'S CREDIT CULTURE (PART 4 OF 8)

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Implementing a New Credit Culture

The first step in changing a bank's credit culture is getting top management's commitment to the change. The decision to change the credit culture has to be made by senior management, anyway, but there remains the commitment to follow through on the change. Senior management must be committed not just to change but also to the continuous reinforcement of the change through communication, actions, and incentives. They must "walk the talk."

The next step is to decide on the desired credit culture. Since cultures are influenced by their surrounding environments, the business cycle's impact on lending behavior is relevant. Henry Mueller observed that lenders respond differently over the four phases of the cycle:

- **Boom:** lenders overly aggressive; past mistakes forgotten
- **Bust:** lenders defensive, chastened by negative impact on asset quality
- **Recession:** increasing liquidity erodes pricing
- **Recovery:** lenders resume new business offensive; institutional memory tested

During booms, optimistic bank marketing plans and budgets overrule detached judgment and prudent underwriting. Booms blind borrowers and lenders to see any end to the boom. Aggravating the collective blindness is the lack of penalties for judgmental errors– no one can make a bad loan during boom times. Worse, during recoveries, the business cycle starts out so low that any slight upward movement is interpreted as a welcome sign of returning stability and the promise of another boom. These swings in behavior bring with it the volatility the market tries to avoid. The bank's credit culture must be prepared to dampen the amplitude of the cyclical swing to produce steady profitability through good and bad times. Asset quality, profitability, and growth must be a balanced set of priorities.

ABOUT BankersHub

BankersHub was founded in 2012 by Michael Beird and Erin Handel, 2 Financial Services professionals dedicated to educating and informing banks, credit unions, solution providers and consultants in the U.S. and worldwide. BankersHub delivers best practices, research insights, opinions, economic trends and consumer views through online web education, virtual events and conferences, live streaming activities, custom training and content development.

Management's priorities influence its credit culture. If management seeks to build shareholder value by long-term, consistent performance based on credit quality and low volatility, then the values-driven culture will emerge. If management wants to maximize shareholder value with superior short-term performance, then the profit plan is the driving force, especially in a soft market, and this priority induces the immediate-performance driven credit culture. During periods of strong loan demand, credit quality floats atop the bubble, but immediate earnings priorities surface as loan demand softens under heavy competition. Production at all costs becomes the bank's battle cry, and high-return lines of business are targeted despite their higher risks. Consequently, credit performance may be more volatile due to surges in credit losses and nonperforming loans during difficult market conditions. Ironically, the bank's leadership becomes reliant on its credit administration functions to somehow manage the volatility in credit performance, usually by beefing up loan review and special assets units. Unfortunately, it is common to fuel production incentives with savings achieved by cutbacks in the backroom and support systems, controls, and credit organization now called into action to save the bank.

A production-driven culture evolves where management chooses to maximize shareholder value by growing to dominate the market. The increase in market share is accomplished by producing loans faster than the market or by acquisition, but aggressive lending to gain market share invites credit problems if the lending process is not properly controlled. In the production-driven culture, just maintaining a small market share can be as dangerous as aggressively pursuing a big market share. The small market share bank must take what is left and often cannot price for the risk assumed.

The result is more volatility and lower credit quality. Further, focusing on loan production alone can lead to portfolio risk, low pricing, and higher expenses as well as a tendency to pursue and expand into riskier lines of business and consequent riskier concentrations. Finally, when management sets incentives, it may also liberalize lending authorities and earn itself a "deal maker" reputation. The potential for significant credit problems is high if credit management is not strong.

Well-managed organizations must promote both production and credit quality in the form of "high quality loan volume," and this potentially contradictory goal requires the credit decision process to be under the control of credit management. Individual lending authorities must be kept low, and transaction risk must be mitigated by adherence to concentration limits, underwriting policy, and tight policy exception approval. Both line and credit must share the responsibility for credit quality.

Despite their presentation as separate, distinct cultures, most banks possess elements and aspects of all of them. The value of the detailed descriptions and discussions of the four credit culture models lie in helping banks figure out what culture they have and what they need to change to get to the desired culture.

Implementation

A straightforward way to move toward the desired culture is to announce it to the organization in a culture statement that communicates management's priorities, risk tolerances, and principles on which the new culture is to be based. Here's a sample to try out in your own bank:

> We seek high-quality, profitable relationships and provide the best service to customers in our market. We prefer relationship banking rather than transactional lending. We operate within our policies to achieve our goals: quality assets, profitable relationships, and prudent growth. To that end, we observe these principles:
>
> - We do not sacrifice quality for volume.
> - We reward high quality loan production.
> - We lend when risks are clearly identified and mitigated to our standards.
> - We diversify our portfolio with conservative limits on borrower, industry, and other concentrations.
> - Lenders are responsible for risk rating their loans and promptly reassessing them when conditions change.
> - We maintain a “no surprises” policy that expects line or credit to identify potential credit problems immediately through the watch list.
> - We never graduate from credit school but will provide up-to-date credit training to all line and credit associates actively involved in credit risk management.
> - We cherish good relationships but exit poor-quality, unprofitable relationships.

Once management has drafted its statement, it should communicate it throughout the organization in writing and in public forums. It should be clear to all line and credit participants that management supports the statement in principle and in practice.

Just writing the statement forces management to decide its true priorities, and the inevitable difficulty in reaching agreement validates the need for the exercise. After all, if management cannot agree on a common set of objectives, their employees have good reason to be confused about management’s direction. The lending philosophy and credit culture statement brings order to the previous state of contradictory messages and serves as the foundation for the additional steps required to change the culture:

- Constantly communicating the priorities to everyone in line and credit, from the top down, so every lender and credit approver knows the bank’s asset quality goals and profitability targets.
- Revising the credit policy to insure better credit discipline, less “should” and more “must.”
- Conducting mandatory, ongoing training of lenders and credit approvers in the desired culture and the credit skills needed to maintain it.
- Tracking variances from policies so that high-risk situations are identified immediately and brought to the attention of the appropriate decision-makers.
- Restructuring the credit organization as needed, starting with identifying a chief credit officer and the respective talent needed to staff the approval, loan documentation, loan closing and booking, policy, and review functions.
- Revising the incentive system and the profit planning process to support the corporate priorities of high-quality, profitable relationships with tangible rewards to those who attain their goals and appropriate penalties to those who fail or refuse to work within the new culture.
- Integrating all the line of business strategies into the new culture’s expectations for asset quality.
- Identifying the relationships consistent with the new culture and prepare remediation or exit plans for those borrowers who do not measure up.

These eight steps will move the bank down the road to the new culture. It is not easy to change. Change of this magnitude is a long-term process – with plenty of time to get ready. Abe Lincoln said the best thing about the future is that it comes only one day at a time.

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