Why do we need credit culture? In July 2002, Fed Chairman Alan Greenspan spoke of the “infectious greed” that had gripped much of American business, a greed that ultimately pushed such companies as Enron, Global Crossing, and WorldCom into bankruptcy. In reporting on Mr. Greenspan’s latest addition to the American business lexicon, The Economist (July 27, 2002) observed that infections are spread by an organization’s culture—the set of rites and rituals, symbols, and signals that give it its unique character. Culture is “the way things are done around here.” Although many business leaders have difficulty with a concept they consider too soft to be managed, a corporation’s culture determines how people behave when they are not being observed.

These observations should not be lost on bankers who place great trust in and decision-making powers on people who are often beyond immediate observation. Bankers rely on their institutions’ credit cultures to keep everyone honest. Does credit culture matter in financial organizations replete with loan review units, internal auditors, external regulatory examiners, and outside accounting firms? Who can stray off the straight-and-narrow path when there are policies, procedures, guidelines, regulations, checks and balances, and debits and credits to keep us honest?

These questions form the basis of a three-part series on credit culture. Part I defines credit culture and examines its determinants; Part II evaluates four types of credit culture; and Part III explains what it takes to change a credit culture.
**PART I: DEFINING CREDIT CULTURE**

A bank’s credit culture is the unique combination of policies, practices, experience, and management attitudes that defines the lending environment and determines the lending behavior acceptable to the bank. More broadly, credit culture is the system of behavior, beliefs, philosophy, thought, style, and expression relating to the management of the credit function.

The banking community applies a verbal shorthand when distinguishing one bank’s philosophy toward risk from another’s. A strong credit culture permeates the organization from top to bottom; it is felt rather than defined. It is more “how we do things around here” than what is spelled out in policy and procedure. For obvious reasons, the regulatory community favors an institution that has a well-developed culture, takes a long view, has clear policies that delineate its risk tolerance, practices risk discipline, and has committed resources to support sound risk management.

Defining a credit culture can be as difficult as depicting a mirage. Some observers argue that when an organization feels the need to define its credit culture, the culture is probably nonexistent or needs considerable improvement. With this kind of definitional flexibility, banks have ample room for staking out credit cultures of considerable variance. Even if they do paint a credit culture in their own perceived image, what is the point of it all?

Citicorp’s legendary chief lending officer Henry Mueller provided a good answer when he declared that a credit culture’s purpose is to build the right risk foundation for good banking: A credit culture is made up of principles that need to be communicated. A credit culture is rooted in corporate attitudes, philosophies, traditions, and standards that require administrative underpinnings. The role of a credit culture is to create a risk management climate that will foster...good banking....

It is no coincidence that a good bank has a good credit culture. A profitable, well-run bank that enhances shareholder value consistently and predictably relies on a disciplined credit culture to make it happen. In contrast, bad banks have lousy credit cultures plagued by the undisciplined, the self-interested, and the wrong-headed, who collectively make these banks fail at profitability and shareholder value.

Even worse, sometimes two good banks combine into something less than the positive sum of its parts. In this era of merger and acquisition, cultural collision accounts for much of the pain behind the assets of combined financial organizations. For example, financial institutions that have acquired investment banking organizations have discovered how hard it is to impose commercial banking’s centralized tendencies and orderly salary grades upon investment bankers’ entrepreneurial looseness and Wall Street bonuses. The cultural differences were too much for 100 investment bankers who left Montgomery Securities after its 1997 purchase by NationsBank, now Bank of America.

The pain and suffering plumbed agonizing depths in the recession of the early 1990s, when so many troubled banks were merged into their surviving partners. As a consequence of this activity, many of the introspective, groundbreaking observations on credit culture were written during this period. In turn, the comments in this series draw heavily on those resources because their observations are still relevant to this decade with its continuing bank consolidation and resulting credit culture clashes.
If a culture is not supportive of an organization’s goals, the organization’s ultimate success is already in doubt. Many of America’s down-fallen companies—Tyco, Global Crossing, WorldCom—were hastily bundled amalgamations that lost their distinctive ways and found nothing to replace them. The interplay between credit culture and bank strategies runs deep, and assessing one’s organizational attributes, especially credit culture within banks, is key to embarking on new strategies. The effort involves identifying the existing credit culture, determining which culture works best with management’s goals, and ensuring that the appropriate tools are in place to implement and maintain the desired credit culture. So where do we begin?

Déjà Vu All Over Again

As the banking industry rebounded from the recession of the early 1980s, it stumbled into another, more serious recession at the end of that decade as it staggered into the early 1990s. The problems of those times do not seem so very different from today’s:

- Management overconfidence.
- Aggressive underwriting and lending to marginal borrowers in risky lines of business.
- Loan concentrations in borrowers, geographies, lines of business, maturities, or types of loans.
- Inadequate pricing for risk.
- Lack of credit discipline evidenced by lending outside of areas of competence.
- Inadequate policies, procedures, systems, and controls.
- Erosion of core earnings.
- Wider bands of volatility in earnings and asset quality.
- Poor transaction management caused by aggressive underwriting, over-lending, ill-defined sources of repayment, incomplete credit information, and poor documentation.

One ironic blow to the myth of big-bank superiority is that these problems seem to be concentrated in the largest institutions thought to have the best policies, procedures, internal controls, lenders, and credit approvers. What happened? Blame the poor economy and distressed borrowers for some of it, but the remaining problems point to a breakdown in credit discipline. The finest written policies in the world are useless if they are neither read nor enforced, especially when senior management aggressively pursues loan growth to boost current-year earnings and expand market share while suspending underwriting policies and overriding turndown decisions.

Examples of credit discipline breaking down under the stress of loan volume and market share campaigns can be seen all around us. Imagine the confusion in a bank when the credit approval officer initially declines a loan request because of negative cash flow repayment ability, insufficient collateral, and lack of adequate guarantors, only to discover that senior management has overridden the turndown. The lender senses either a suspension of or breakdown in the rules, and the credit officer perceives a loss of decision-making power and competence. Neither consequence is healthy for the organization. Along with discipline should come the flexibility to adapt to changes in circumstances. Disciplined action is typically aimed at achieving a desired result and being good at what you do.

Mueller offers 20 self-evident essentials of good banking that are fostered by a strong credit culture:

1. Continuing commitment to excellence.
2. Logical framework for day-to-day decision making.
3. Sound values system that will not break down under change.
4. Uniform and consistent approach to risk taking.
5. A common credit language.
7. Supremacy of the bank’s objectives over individual profit-center goals.
8. Candid and frank communication at all levels.
9. Awareness of every transaction’s effect on the bank.
10. A portfolio with integrity and few exceptions.
11. Individual accountability for decisions and actions.
13. Respect for credit basics.
15. Encouragement of independent judgment over the herd instinct.
17. Realistic approach to markets and budgeting.
18. An understanding of what the bank expects and the reasons behind its policies.
19. Credit system with early-warning capabilities.
20. Expectation that problems are identified early and that no tolerance for surprises exists.

If we can generally agree that these essentials of good banking are worthwhile, then we can begin to identify the components of a strong credit culture that foster and shape good banking, and how a strong credit culture promotes sound risk management.

As they set their performance goals, banks are trying to enhance shareholder value. Today’s markets reward those organizations that generate predictable, stable earnings and punish the institutions that perform erratically and uncontrollably. Rising revenues and declining expenses create a winning situation, and as banks game the possible options, lenders typically assume responsibility for the revenues path and credit risk managers are held accountable for minimizing risk expenses.

Tension between line and credit increases as management pressures the lenders for more loan volume and higher earnings; higher profits, of course, are the reward for taking more risks. To keep the profits coming, the bank’s management must decide how much risk it can afford to tolerate.

A high return on equity depends on revenue generation at a reasonable cost and at an acceptable risk. The senior lender and the chief credit officer must share the same goal of high-volume, high-quality loans and act as a team to support their CEO’s goal of enhancing shareholder value by means of predictable, rising earnings. After all, shareholder value is ultimately the present value of future earnings and dividends, and the current market price is a common measure of the team’s progress toward building shareholder value.

The unforgiving market expects shareholder value to be stable and predictable, growing steadily throughout the business cycle by means of earnings growth during expansion and earnings stability and quality during recession. The credit risk strategy needs flexibility to execute shifts between growth and stability; both flexibility and discipline are anchored in the credit culture of the bank.

Notes

Contact Strischek by e-mail at dev.strischek@suntrust.com