



Building Success. Together.

Credit Policy and Culture



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What we will cover

Part I. Primary Credit Policy tenants at a community bank level

- A. General considerations while crafting a policy
- B. Common sections to be covered
- C. Recommended process for policy approval or changes

Part II. Credit Culture

- A. What's your "real" credit culture
- B. Strengths and weaknesses of different credit cultures
- C. Are your culture and policy working in concert or opposition

Transitioning credit culture and integrating credit policy

Policy Perspectives:

"We will extend credit to all borrowers who will pay us back without argument after they legally sign over all business and personal assets in advance in case they do not."

Credit Analyst view of Lender's Perspective:

Since loans are scarce we should treat all loans like they may be the last and therefore we should grant credit to all who:

- 1) Can pay us back.
- 2) We think might actually do it.
- 3) Only have a few blemishes in their past.
- 4) Allows me to hit my quarterly goal and get a large incentive check.
- 5) Are social acquaintances or belong to the same clubs I do – because saying "no" to them...well that would just be awkward.

Lender view of Credit's Perspective:

Since loans are abundant we should cherry pick only the very best loans and therefore we should only make loans to those who:

- 1) Can pay us back.
- 2) Can empirically prove they will through exciting ratios and charts—that aren't really exciting.
- 3) Have a perfect credit history and background.
- 4) To those who don't actually need it.
- 5) Agree to all our terms with unconditional love and support because everyone wants to borrow from us.

Credit Policy – Key reasons for its existence

1. IT IS REQUIRED
2. Defines the Board approved risk appetite of the Bank
3. Provides direction for managing the Bank's Asset Quality
4. Communicates consistent expectations across departments
5. Promotes an atmosphere of fair dealing for credit clients

Credit Policy Should Define

Who

- Is responsible for each aspect of the credit cycle
- Has the final say for credits
- Is the ultimate accountable party within the bank

What

- Characteristics are desirable and undesirable
- The Bank considers to be acceptable and unacceptable risks
- The Bank will require, track, and report upon

How

- The bank will evaluate and monitor credit risks
- The board of directors defines approval authorities
- The bank's considerations for non-performing assets



The Importance of Clarity and Specificity



Lines of Business to be covered in Policy

Commercial

- Small ticket commercial credits
- Commercial and Industrial
- Commercial Real Estate
- Agriculture
- Soft credit exposure for Treasury Management services and swaps
- Participations and Syndications
- Commercial loan pools
- Commercial deposit account overdrafts
- Market or Bank specific credit exposures

Consumer

- Secondary market or mortgage division
- Portfolio residential conforming and non-conforming
- Consumer installment loans
- Unsecured loans and lines of credit
- Credit cards
- Indirect lending programs
- Consumer loan pools
- Consumer deposit account overdrafts

Lines of Business to be covered in Policy

Specialized Lending

- Private banking
- Oil, Gas, Coal, other mining/drilling
- Specialty healthcare programs
- SBA, USDA or other government programs
- Yachts, house boats, barge, passenger cruise ships or any other water transit
- Luxury Items such as recreational vehicles, leisure boats, ATV's, etc
- Highly specialized or customized equipment
- Thoroughbred, equestrian or other show horses
- Aircraft
- Municipal loans or leasing

Operational Issues

- Loan approval practices and designated approval authorities
 - Employee loan requests
 - Lending requests with potential Regulation O or W impacts
- Approval, Tracking, Monitoring and Reporting of Credit Policy Exceptions
- Portfolio management, monitoring, tracking and reporting requirements
- Compliance with all Federal and State Regulations in all states covered
- Loan Review and Annual Reviews (internal or external? Both?)

Concentration Definition and Management

- “Subprime” concentrations
- Out of Market
- NAICS Codes
- Exposure to single employer
- Exposure to common repayment sources: Walgreens, CVS, FedEx, Amazon, GSAs
- Exposure to common participants or agents: IndyMac, Lehman Brothers, National City Bank, Wachovia, Colonial Bank, Guaranty Bank

Example Concentration Reports

A great report, but anyone catch the “obvious” challenge within it?

Call Report #	Description	General Ledger Balances +	Undisbursed Amounts =	Maximum Commitment	% of TRC	Board Cap % of TRC	Allocation Available
GROUP 1 - Land, Construction and Development (C&D)		<i>Regulatory guidance suggests a cumulative Group 1 limit at 100% Of Capital.</i>					
RC-C 1a1	Residential Construction - Personal	\$6,328 +	\$9,795 =	\$16,123	7.7%	12.5%	\$ 10,077
RC-C 1a1	Residential Construction - Builder	\$4,817 +	\$11,014 =	\$15,831	7.6%	12.5%	\$ 10,369
RC-C 1a2	Residential Construction - 5+ Units	\$7,105 +	\$7,265 =	\$14,369	6.9%	5.0%	\$ (3,889)
RC-C 1a2	SBA Construction - Non Residential	\$16,770 +	\$6,676 =	\$23,447	11.2%	15.0%	\$ 7,993
RC-C 1a2	Construction - Non Residential	\$5,938 +	\$10,515 =	\$16,453	7.8%	15.0%	\$ 14,987
RC-C 1a2	Commercial Land Development	\$8,387 +	\$2,584 =	\$10,971	5.2%	10.0%	\$ 9,989
RC-C 1a2	Consumer - Land Only	\$3,495 +	\$0 =	\$3,495	1.7%	7.5%	\$ 12,225
GROUP 1 - C&D TOTALS PER CALL REPORT		\$52,841 +	\$47,849 =	\$100,690	48.0%	75.0%	\$ 56,512
GROUP 2a - NON-OWNER OCCUPIED (NOO) COMMERCIAL REAL ESTATE (CRE)							
RC-C 1d	Multi-Family Investment Real Estate	\$32,411 +	\$1,856 =	\$34,267	16.3%	50.0%	\$ 70,534
RC-C 1a2	SBA - NOO Non-Residential Except Land - Hospitality	\$4,203 +	\$0 =	\$4,203	2.0%	5.0%	\$ 6,277
RC-C 1a2	NOO Non-Residential Except Land	\$98,927 +	\$4,698 =	\$103,625	49.4%	80.0%	\$ 64,056
NON-OWNER OCCUPIED CRE LOANS (EX. NNN)		\$135,541 +	\$6,554 =	\$142,096	67.8%	135.0%	\$140,867
TOTAL GROUP 1 AND 2a NOO CRE		\$188,382 +	\$54,403 =	\$242,786	115.8%	210.0%	\$ 197,379

13

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NAICS Code Concentrations

NAICS Code	Naics Title	Max % of T1 Capital + ACL	NAICS Code	Naics Title	Max % of T1 Capital + ACL
11	Agriculture, Forestry, Fishing and Hunting ^T	300%	11	Agriculture, Forestry, Fishing and Hunting ^T	300%
21	Mining, Quarrying, and Oil and Gas Extraction ^T	0%	111	Crop Production ^T	100%
22	Utilities ^T	15%	112	Animal Production and Aquaculture ^T	100%
23	Construction ^T	75%	113	Forestry and Logging ^T	0%
31-33	Manufacturing ^T	300%	114	Fishing, Hunting and Trapping ^T	0%
42	Wholesale Trade ^T	15%	115	Support Activities for Agriculture and Forestry ^T	0%
44-45	Retail Trade ^T	300%	53	Real Estate and Rental and Leasing ^T	300%
48-49	Transportation and Warehousing ^T	25%	531	Real Estate ^T	300%
51	Information ^T	0%	532	Rental and Leasing Services ^T	25%
52	Finance and Insurance ^T	50%	533	Lessors of Nonfinancial Intangible Assets (except Copyrighted Works) ^T	0%
53	Real Estate and Rental and Leasing ^T	300%	72	Accommodation and Food Services ^T	100%
54	Professional, Scientific, and Technical Services ^T	25%	721	Accommodation ^T	100%
55	Management of Companies and Enterprises ^T	300%	722	Food Services and Drinking Places ^T	10%
56	Administrative and Support and Waste Management and Remediation Services ^T	100%			
61	Educational Services ^T	100%			
62	Health Care and Social Assistance ^T	300%			
71	Arts, Entertainment, and Recreation ^T	100%			
72	Accommodation and Food Services ^T	100%			
81	Other Services (except Public Administration) ^T	150%			
92	Public Administration ^T	100%			

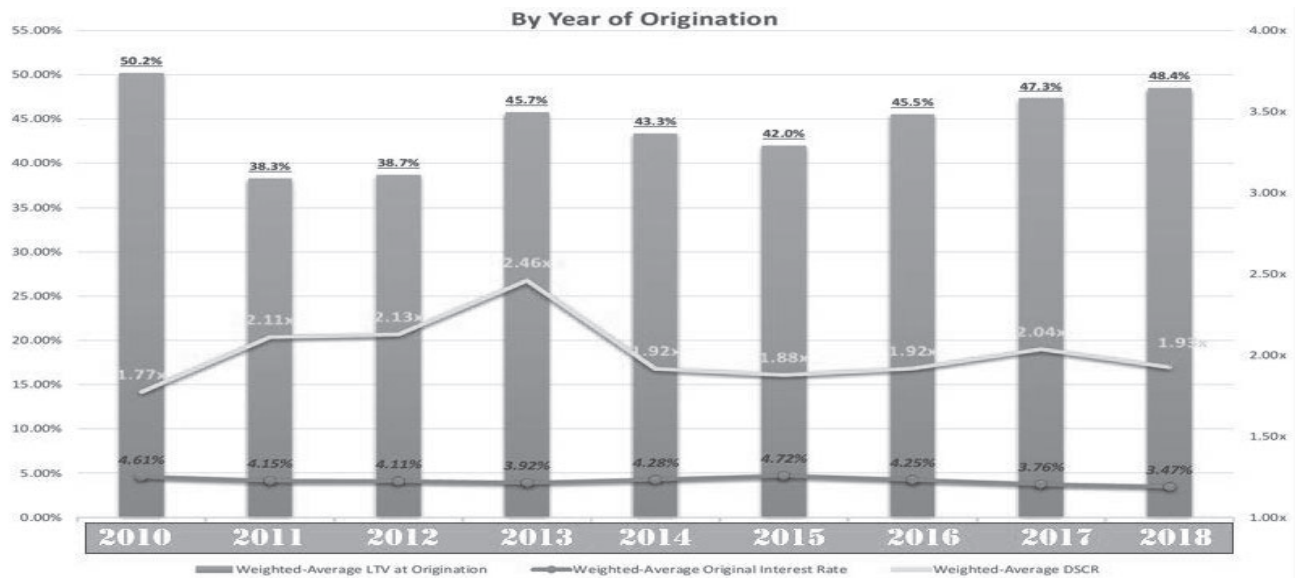
14

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“Underwriting Vintage”



15

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Risk Ratings

- Should accurately reflect the transactional risks of the loan
- Policy defines both the objective and subjective components of the grading system
- Single or dual risk grades and definitions for each grade or component
- Uniform retail risk classification vs. transaction grading
 - Small business loans and leases
- Distribution of credits throughout the risk spectrum
- Will your risk grade be tied into a designated reserve for the ALLL

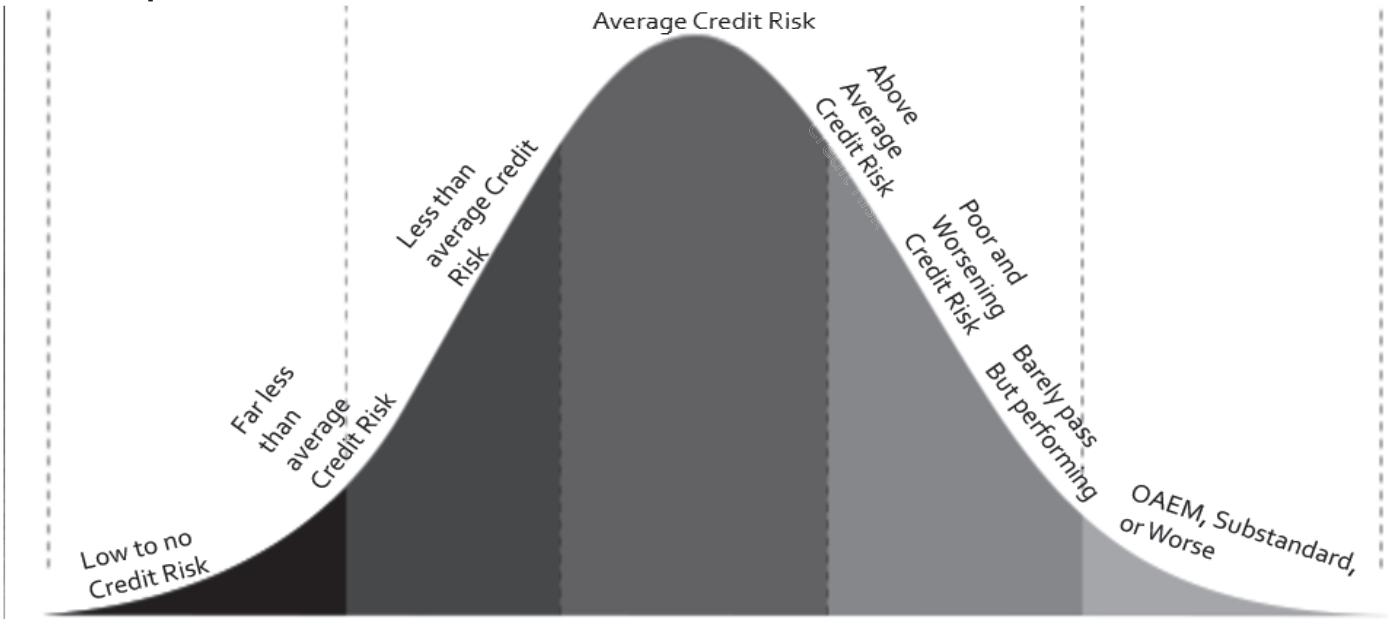
16

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Anticipated Risk Grade Distribution



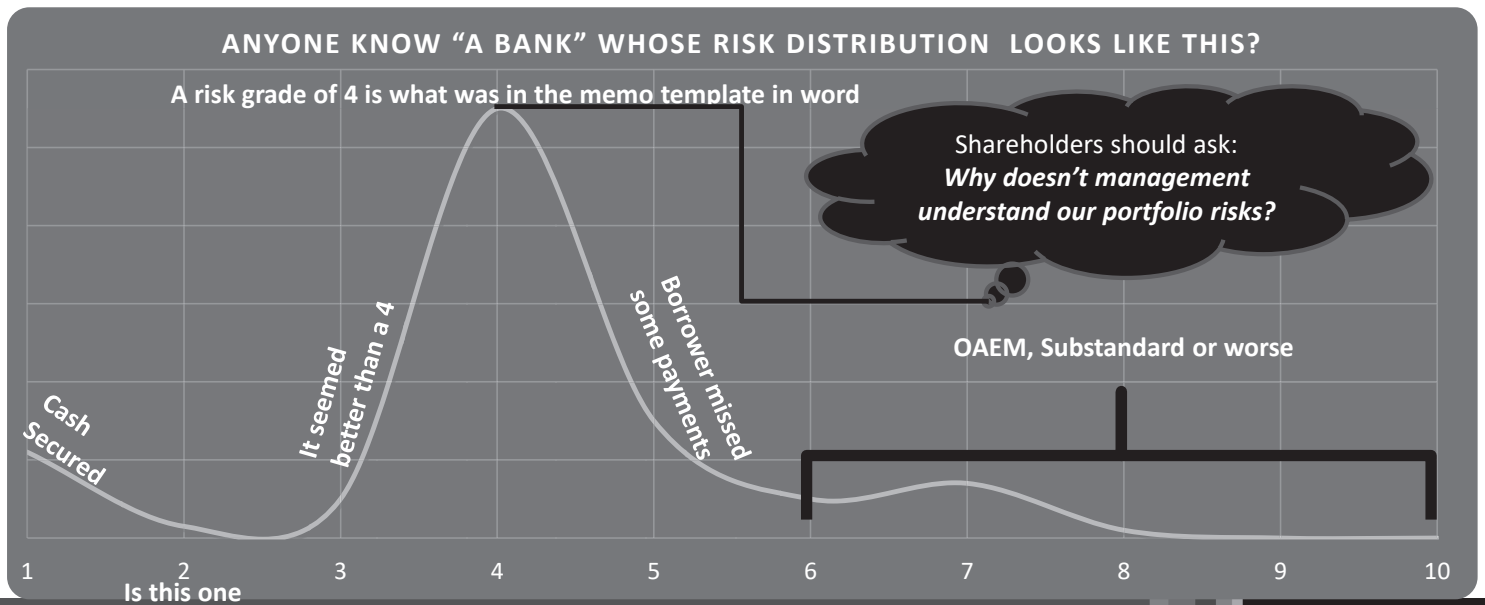
17

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Risk Grades



18

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Special Assets

- Management and oversight of all watch, criticized and or classified assets
- Treatment of substandard vs. non-accrual credits
- Migration requirements for credits that are impaired
- Rehabilitation, timely exit or liquidation
- Reporting elements for the Executive team and the Board of Directors

Cautionary Note:

Don't shoot the messenger alerting the bank to a troubled loan, reward them for doing their job

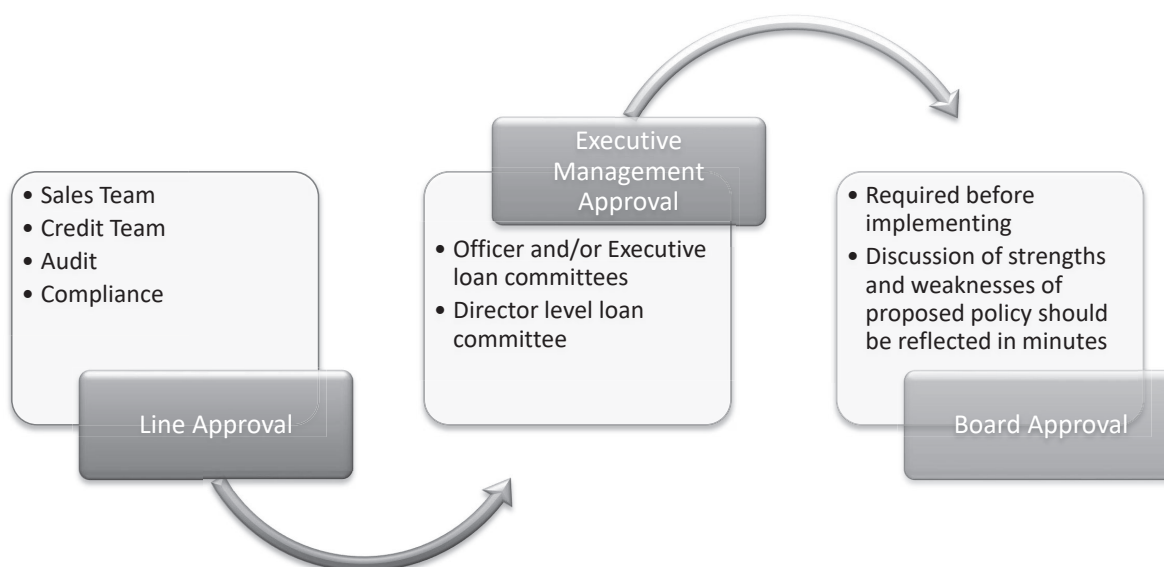
Allowance for Credit Losses (Thanks CECL)

- Which parties are responsible for which parts of the ACL
- How the analysis will be completed
- CECL Requirements:
 - PD (Probability of Default)
 - LGD (Loss Given Default)
 - ECF (Expected Cash Flows)
- Adequacy level of reserves

Note:

Some banks push the accounting functions to their Finance/Accounting team or manage the ACL under its own distinct committee. The Credit Policy should reference and refer to the formalized ACL policy if it is a separately managed policy.

Recommended Credit Policy Approval Process



Policy Changes

- Frequent policy exceptions
- Eliminate, fix, or otherwise restructure bad policy
- Don't feel compelled to change your policy just because the lenders gripe
- Be careful not to set policy requirements that cannot and will not be achieved

Recommended Steps in Policy Adoption

Spend
time on
semantics

Choose an
accessible
location

Train your
teams

Obtain
signatures

Tools Covered so far:

- Loan Concentration Reports by Asset Class
- Loan Concentration Reports by NAICS
- Expected Risk Grade Distribution

- Banker Appreciation Day Video:
<https://youtu.be/QG9odITUUOU>

Jay Clayton, Sr. Chairman US Securities and Exchange Commission



"First, to effectively manage the business of your organization on a day-to-day basis and over the long term, management needs to know what the culture of the organization is today, including the key drivers of that culture..."

Second, over time, whatever the cultural goals for your organization may be, the chances of achieving them go up dramatically if you understand where your culture stands relative to those goals.

In driving organizational culture, it is difficult, if not impossible, to get from A to B unless you have a clear sense of what A is."

The RMA Journal



RMA:

What exactly is the role for boards when it comes to culture?

DAHLGREN:

*"We talk about 'tone from the top,' but what we want to see is actions and behaviors at the top. **It's not just about talking; it's about doing.**"*

- Sarah Dahlgren
Financial Institution Supervision Group
Federal Reserve Bank of New York

Culture Identification

Which of the 5 C's prevails

- Character
 - “Come on – they’re good people”
- Capital
 - “You want how much down?”
- Capacity
 - “Of course they don’t have capacity – that’s why they need the line!”
- Conditions
 - “What are ‘Covenants’?”
- Collateral
 - “You don’t get hurt with dirt, right?”

Risk Philosophies

- Risk Acceptance:
 - Fire and forget
- Risk Management:
 - Approve, Monitor and Manage
- Risk Avoidance
 - “The answer is no. Now, go ahead and tell me about your deal”

Credit Culture and its Impacts

- It is in fact what defines how your Bank actually operates.
- FOCUS – All workers working toward a common goal or vision
- Encourages internal cooperation instead of confrontation
- Reduces the need for costly administrative constraints
- Becomes the de facto Credit Policy if not properly managed

Importance of Clarity in Culture



<https://youtu.be/mndc63w7BB0?si=GPRkH-9Ukar4DoIT>

29

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Culture Assessment

Culture Type =>		Value Driven	Immediate Performance Driven	Production Driven	Unfocused
↓ Analytics	I believe my Bank's credit culture today would suggest (or require) that our:				
Top Priority must be:					
Driving Force would be:					
Credit Environment is:					
'De Facto' Credit Policy says:					
Success Factors must be:					

Therefore, I believe our Bank's Credit Culture would be best described as:

- A) Value Driven
- B) Immediate Performance Driven
- C) Production Driven
- D) Unfocused

30

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Value Driven

Value Driven	Culture Environment Demonstrates
Top Priority	Long term – consistent performance
Driving Force	Corporate values, market consistency
Credit Environment	Strong credit organization with few policy exceptions and excellent internal communication
Hidden Policy	Not a factor as the written policy prevails
Success Factor	Balance between credit quality and revenue generation Avoids tendency to over-control the lending function

Immediate Performance

Immediate Performance Driven	Culture Environment Demonstrates
Top Priority	Current earnings and stock price
Driving Force	Annual profit plan and achieving quarterly production goals
Credit Environment	Generally strong emphasis on credit quality. Asset quality concerns shift during periods of low loan demand
Hidden Policy	Conflicts with written policy during low loan demand periods
Success Factor	Management must provide direction and resist temptation to over reach risk tolerances in down cycles

Production Driven

Production Driven	Culture Environment Demonstrates
Top Priority	Market Share, loan growth, sales volume
Driving Force	Market leadership, Bank's asset size, Maximize short term returns
Credit Environment	Typically have strong systems and controls but line personnel dominate and are under significant loan production and other performance pressures
Hidden Policy	Often over-rules written policy creating frequent and routine exceptions. Lenders do not consider themselves asset quality managers and believe they are paid to produce loans
Success Factor	Loan approval authority should be outside the lending line to minimize "rogue lender" risks

Unfocused

Unfocused	Culture Environment Demonstrates
Top Priority	Uncertain – tends to change with prevailing conditions and could be summarized as "whatever the direction the winds are blowing"
Driving Force	No one knows. Management and line leadership are not working in concert with one another
Credit Environment	Varies across spectrum from strong loan controls to confusing lending guidelines and signals. Exceptions become the rule instead of vice versa
Hidden Policy	Inconsistent, ever changing priorities, lack of clear direction leaves lenders confused and adopting the "see if it flies" approach to credit
Success Factor	Extremely strong leadership who provides exceptional communication to the lending and credit functions

Do your conversations include:

Culture Type => ↓Analytics	Value Driven	Immediate Performance Driven	Production Driven	Unfocused
Does your bank use the following terms regularly?	<ul style="list-style-type: none"> • Quality • Balance • Soundness • Prudence • Ownership • Conservative 	<ul style="list-style-type: none"> • Quality loan volume • Balanced growth • Aggressive • Portfolio Size • Growth-Oriented 	<ul style="list-style-type: none"> • Market Share • Growth Oriented • Loan Volume • Top producers • Aggressive goals 	<ul style="list-style-type: none"> • Creative • Think outside the box • Fluid credit • Be dynamic • Responsiveness

Common traits of top performing banks



Asset Quality and Credit Culture – Management Tools

Who at your bank is responsible for and manages the:

- % of 30 day delinquencies to loans outstanding?
- % of 90 day delinquencies to loans outstanding?
- % of criticized and classified assets to loans outstanding?
- % of non-accruals to loans outstanding?
- % of net charge offs to loans outstanding?

How does your management team respond to your matured loans past due reports?

Do your Credit Analysts and Loan Officers have an equal voice?

If not – who “wins”?

Deadly sin #1 in underperforming cultures – Lack of Awareness

- Infrequent, inadequate, or absence of any formalized internal loan review functions
- Inadequate past due monitoring and management
- Watch lists full of credits that are not being “Watched”
- There are no discussions about concentrations of credit at any level

Petronas Towers



Tourism Malaysia

Would you approve this loan?

- 88 floors in each building
- Owned by Petronas, the national oil company of Malaysia
- Building 1 - 100% leased to Petronas Oil and subsidiaries
- Building 2 - >80% pre-leased with terms of 10+ years in all leases. Tenants are blue chip tenants with space leased to (among others):
 - Microsoft
 - McKinsey
 - Boeing
 - IBM
 - Bloomberg
- **+/- 4,250,000+ SF;**
- **+/- 43,000 jobs**

39

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39

 American Bankers Association

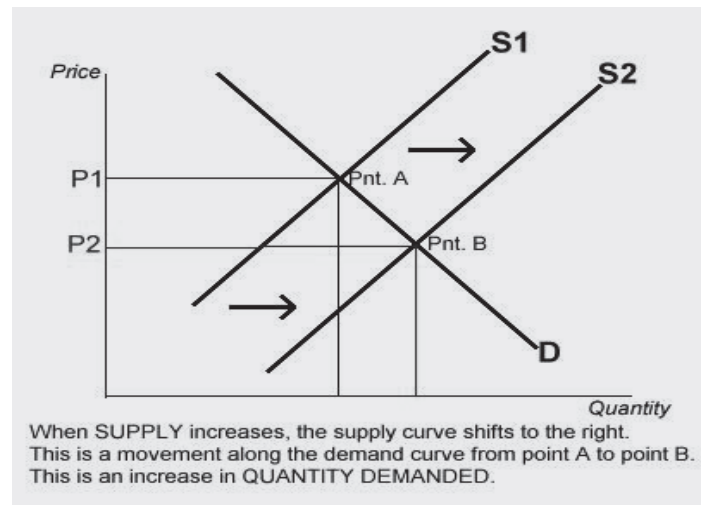
The Paradigm Shift

Loan paid as agreed and Local banks still took excessive losses – why?

Class B Office space vacated to take over the vacancy of Class A/A- which now leased at discounted rates

Class A/A- Office space in Kuala Lumpur vacated to the Petronas Towers

Class C Office space vacated to take over the Class B office space – now leasing at materially lower rates



40

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 American Bankers Association

Are there Petronas Towers events in your community?

- Multi-Family Construction?
- Office Investment Real Estate Post Covid?
- Hospitality?
- Assisted Living Facilities?

Deadly sin #2 in underperforming cultures – Lack of Discipline / Fortitude

- Frequent policy exceptions approved with little to no mitigating factors
- Weak or declining borrower financial conditions ignored or frequently explained away
- Personal friendships clouding the vision of the lender and or credit team
- Recognize the problem exists but refusal to take steps to remedy such as cash calls (right-sizing), amortization of evergreen, or even firing a client when necessary
- Unwilling to enforce the rule because of “who they may know” or “what they may say”
- Good money after bad - piling on additional credit exposure to “buy your way out” of a problem

Culture Transition

When transitioning from one culture to the next, consider the following:

- Who should be involved in the selection of desired culture
- Is the culture you are migrating towards closely aligned with your strategic plan
- Will the new culture enable or distract from the bank's stated long-term goals and objectives
- Will the executive team fully embrace the change and both "walk and talk" the new culture
- Do you have the right skill sets in your existing teams (credit and sales) to make the transition
- Is the message clear to all involved that the change WILL happen

"Implementing risk culture is a journey.

Only through significantly more work can the profile and benefits of risk culture be enhanced."

-Unknown

Tools Covered:

- Loan Concentration Reports by Asset Class
- Loan Concentration Reports by NAICS
- Expected Risk Grade Distribution Graph
- Culture Identification Grid
- Culture definitions



Videos located at:

- Banker Appreciation Day: <https://youtu.be/QG9odITUUOU>
- HSBC “Eels” Ad: https://youtu.be/6_WAmt3cMdk

QUESTIONS?

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