Top Lending Practices

The best lenders create living, strategic credit policies—and stick with them

By Jeff Judy

Among the many factors that go into sound credit risk management decisions, community bankers want to be confident that their commercial customers know where their businesses are going before they lend to those commercial customers.

Well-run community banks know who their customers are. Those businesses learn not to waste energy chasing customers who produce poor returns, who create problems and who demand resources disproportionate to their revenues. They also know which tools and resources to apply to win the business of the best customers, and to work with them.

In other words, community banks' best business customers have well-understood strategic plans that are communicated to their employees and reinforced through management action so that everyone in the company shares a vision of who they serve and how they do it.

Like well-run business customers, credit risk management departments in the most successful community banks operate with clear strategic plans. Those departments know what kind of customers they are looking for and what kinds of loans or transactions are appropriate for them. Then those departments share that vision among credit risk management staff through every level of the organization.

These well-run credit risk departments call their strategic plan the "credit policy," which spells out the standards and conditions on which financial institutions lend money to borrowers.

The senior executive managers and directors of leading community banks know that a well-crafted, well-executed credit policy gives them an edge on their rivals. Market leaders view their credit policy as a foundation of their lending success. Competitive advantage arises from the greater efficiency and productivity of credit interactions with customers in better-run lending operations in community banks.

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The best credit risk managers choose efficient business customers who apply their resources well. A smoothly run business with a consistent vision is always going to beat a rival that flails around without executing a coherent plan.

Every lending institution is under greater regulatory scrutiny these days, community banks not excepted. Examiners are paying close attention to how well actual credit practices reflect official credit policy.

Unfortunately, some banks operate with two credit policies: their official document, and how credit is actually delivered by lending officers, underwriters and other credit staff.

Rarely is this disparity intentional. It is usually a consequence of policy drift, where an official credit policy and actual practices once matched up well but over time gradually became more separated from each other.

Here are five typical reasons

Out of Sight, Out of Mind

When frontline staff rarely hear about credit policy from their managers, they gradually veer off into developing their own credit evaluation practices. In well-run banks, regular communication through the management chain maintains visibility of the credit policy.

Not My Problem

When upholding the credit policy is seen as the job of one or two individuals, the rest of the staff don't pay much attention to it. In market leaders, credit policy is everyone's job.

The One-Way Street

Internal conflicts and operating inefficiencies abound when credit policy communication always flows from "the enforcers" to "the transgressors." In well-run credit operations, communication is a two-way street, with feedback about how to improve the credit policy actively sought from everyone involved in the process.

The Fossil

In some banks, credit policy is a museum piece, never changing even as credit practices adapt to customer needs and market conditions. The most successful community banks maintain their credit policies as living things that are evolving under changing conditions.

The Plug-In

Banks that view credit policy as a burden just want to get it over with. They buy a boilerplate, copy their competitors' plans or basically let the regulators write their policies for them. The best-run banks know that their credit policy has to be unique to them in order to generate success.

A Leading Lender Profile

Successful community banks that lead in their markets share several features related to their credit policies, says consultant Jeff Judy. The best-run lenders ...

- see *credit policy as a tool* rather than as a burden;
- maintain regular, *two-way communication* about policy with all their credit staff;
- *regularly review and update* policy to reflect changing conditions and opportunities;
- *manage exceptions* to an appropriate level rather than seek to eliminate them;
- *distribute responsibility* for following policy across all credit staff, at all levels of the organization; and
- *fit their credit policy* provisions to their unique challenges, opportunities, resources and values.

Now, if a community bank very rarely has exceptions, can we assume that its "two credit policies" are in sync and its success assured? Not necessarily.

Leadership in the best-run banks *expects* a certain creative tension between the credit and sales cultures. A credit policy describes a market in broad terms that don't always match the individual circumstances of particular relationships and transactions.

Credit risk managers seek to meet the unique needs of each borrowing relationship, while a credit policy provides consistent standards and guidelines. That means that a certain number of credit policy exceptions, a certain number of conflicts and a certain number of workarounds are normal. The best banks manage exceptions realistically.

The only path to perfect compliance with a credit policy at all times is a policy so loose that "anything goes." Some banks hope that such policies will make it harder for regulators to find instances where policy has not been followed.

Those banks are vulnerable to tumbling in the marketplace sooner or later. They are headed for a lot of poor credit decisions and weak portfolios, and their wide-open approach to credit policy won't fool the regulators for a minute. IB

Jeff Judy, a frequent ICBA seminar instructor, is the principal of Jeff Judy & Associates, a community bank consulting firm in Bloomington, Minn. He recently released the white paper "Is Your Credit Policy Working?" Contact him at jeff@jeffjudy.com or at (952) 903-0113.

Commercial Lending Seminar This November

ICBA has scheduled this year's Commercial Lending Institute for Nov. 1-6 in Phoenix, Ariz. The in-depth seminar, led by community bank consultant Jeff Judy, will help commercial lenders hone their skills to maintain and manage a commercial lending portfolio.

For more information, visit the education section of ICBA's Web site, *icba.org*, or call (800) 422-7285.