Is *Your* Credit Policy Working for *You*?

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Developing a Credit Policy that Achieves Better Outcomes for Your Bank

A White Paper from

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Executive Summary

Your bank may be performing substantial credit policy revisions, or crafting a new credit policy, because:

- a merger or acquisition forces you to address multiple credit policies;
- inefficiencies and conflicts related to credit policy have become a serious drain on your business;
- dramatic changes in markets, systems, or business practices need to be reflected in your credit policy;
- bank examiners have specifically mentioned deficiencies in your current policy, with recommendations for addressing these flaws.

Whatever drives you to develop or revise credit policy now, you want to craft a policy that truly contributes to your success as a business, and that won't need serious repairs, or lead to problems, in the future.

My associates and I have spent decades in the credit arena, consulting with many institutions on a range of issues. In this white paper, I distill key themes we have encountered again and again:

- the appropriate role of credit policy in your business;
- key players and responsibilities associated with credit policy;
- the *two* credit policies that guide your credit business;
- why these two versions of your policy often diverge from each other, hurting your business results;
- how you can point your credit policy in the right direction;
- where to seek input, from internal and external resources;
- why an explicit communication/revision plan is crucial to an effective credit policy;
- what your policy development team needs from bank leadership to produce long term benefits from your credit policy.

I conclude with a summary of next steps you can take to develop a credit plan that truly helps, rather than hinders, your business.

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Good Policy = Good Business

What do I mean when I say that your credit policy can drive your banking business?

I have worked with healthy institutions where an effective credit policy is a secret to their success, and with struggling organizations where their policy has become no more than a necessary, irrelevant evil -- and perhaps, just a secret!

Let's look at it this way: *if your bank were a car, what part of the car would be analogous to your credit policy?*

Many bank employees might say that credit policy provides the *brakes* for the car. Their organizations use credit policy to slow them down, to *prevent staff from doing things.* Credit policy is there mainly to give approvers a way to say "no" -- and to affix blame when credit relationships run into problems.

Does credit policy drive your credit business . . . or just put on the brakes?

If that's the view in your organization, you may find it hard to believe that I work with many other organizations where *credit policy is much more like the steering wheel*, than the brakes. Policy isn't there, in these successful institutions, ***just*** to stop them from running off the road and going over a cliff.

Credit organizations that apply their policies effectively use them not only to stay on the road, but to make the right turns, to find the most efficient routes to their destinations. Credit policy is about aiming credit practices in the right direction to achieve optimal outcomes. **It is a tool you use to proactively manage expectations for banker behavior.**

In the best run credit operations, in fact, credit policy plays a major role in efficiently reaching the organization's goals. It acts not only as a steering wheel, but as a GPS system, speedometer, traffic cop, and maintenance schedule, all in one.

When I review (or help construct) the credit policy at one of these well-run organizations, it includes:

- **Explicit and up-to-date information about target markets.** The policy highlights the kinds of customers, and appropriate structures, the bank will pursue, and not just what to avoid.
- **Standards for performance *combined with* clearly defined performance measures.** The policy tells you how you will know whether you are on the right road, or whether you are lost. Effective managers know that they must measure the things they want to manage, including adherence to policy.
- **Responsibility for "wrong turns" and "crossing the line."** When individual actions and decisions fail to conform to the credit policy, who has to know about it? Who must take action?
- **Consequences at all appropriate levels.** What response is appropriate when a loan officer or credit analyst strays from policy? How should the Board of Directors and executive team respond to trends and patterns, in lending practices, that stray from the "map" documented in the credit policy?
- **A clear "maintenance schedule."** When will the policy be reviewed? What mechanisms ensure that information needed for "course corrections" flows to the appropriate parties? What events, external or internal, will trigger an "off schedule repair," a review and update of the credit policy?

Credit policy is your Strategic Plan for your credit business

There is a lot more to success, in business, than simply *avoiding failure*. *Credit policy is nothing less than a strategic plan for your credit business,* your business vision for a critical element of your enterprise. Over decades of consulting work with banks of every size, in every market, I have seen just how powerful a properly crafted, appropriately implemented credit policy can be in driving any bank toward greater success.

If almost everyone in the organization views your credit policy as a hindrance or an obstacle to a more successful business model, you are at a *competitive disadvantage*. You and your staff are spending a lot of time and energy working *around* your credit policy, when your more successful rivals are leveraging their policies to lead them to better results.

That is probably not your intention. So how did your credit policy become a drag on your business?

When Policy Hurts Your Business

In many institutions I have worked with, credit policy is seen as a *burden* on daily business activity.

Credit policy can become so detached from, or even opposed to, the business vision of the organization that it leads to significant problems. At the very least, customers may be inconvenienced, employee morale in credit operations damaged, and mediocre results produced, to the disappointment of shareholders.

And at the worst, policy and practice may be so disparate that industry regulators step in and put things right.

Examination of a wide range of circumstances and consequences, surrounding credit policy in a broad spectrum of institutions and markets, points to a few key themes that arise again and again. Most of the time, when we see an organization that is working *against* credit policy, when policy is *hurting* the business, we will find one or more of the following situations:

When your credit policy is hurting your business, or just holding you back, it is usually for one of these reasons

- **The credit policy has become irrelevant.** Markets, goals, strategies, resources, products and services, and systems have evolved over time, and the policy has not kept up. Credit policy has little to say about the everyday, real world, front-line activities your bankers are engaged in with your customers.
- **The policy leans to one extreme or another, on one or more key policy dimensions.** Much of the guidance contained in credit policy addresses a range of potential conditions, or a spectrum of standards. But your policy may be too far to one end of the universe to be effective.
- **The policy has no place in the mindset of the staff who have to implement it**. In other words, employees who play roles in the lending process have largely forgotten about the credit policy, except to the extent that they are forced to pay lip service to it.
- **The policy has no teeth**. Even the most detailed policy might as well not exist, if no one is paying attention to how it is applied. If there are no consequences to violating policy, nor any response to ongoing trends of repeated exceptions, the policy is no longer a living document that plays a positive role in

the business. It is simply something that generates a lot of extra paperwork.

What Goes Wrong

Let's take a moment to examine each of these common credit policy flaws a little more closely.

Is Your Policy Relevant?

Nobody sets out to write a poor credit policy

We have worked with plenty of banks in the area of credit policy and process, and *none of them*, I am happy to say, *set out to write a credit policy just for the sake of writing a policy*, ignoring their standards, values, market conditions, and operating constraints.

In other words, in each of these banks, the credit policy was spot on, exactly what they needed -- *at some point in time!* Unfortunately, for too many institutions, *that point in time is well in the past*, and the way they do business has drifted far from the description in their credit policy, because:

- the credit *business* has moved on, responding to changing conditions, while . . .
- the credit *policy* has been left behind, gradually becoming irrelevant to daily credit business in the bank.

How can your credit policy get so out of touch with your real world credit business?

Many a bank once had a great credit policy, that gradually became irrelevant

- **Lack of a maintenance schedule**. Failure to maintain your vehicle on a regular schedule can invalidate your warranty. Failure to review and update your credit policy regularly will erode the protection it affords you, as well as reduce the performance of your credit business. It takes an explicit review schedule to keep your credit policy alive.
- **The "all no" approach**. In some institutions, policy is all about what *not* to do, all about the "brakes". It is a list of forbidden fruits, and little more. But a policy that contains only negatives does not truly guide anyone's business behavior. It simply

degenerates into a checklist that your staff will work very creatively to get around.

- **For specialists only**. In some organizations, the only people who are expected to know and care about the credit policy are specialists. They may be credit analysts, credit review or audit staff, or others in credit administration positions. A policy that has meaning only for the experts sets up a cycle in which the bankers push the envelope, the specialists reign them in, and a pattern of delay, hide and seek, and confrontation inconveniences customers and wastes bank resources.
- **The copycat approach.** The policy is based on a purchased boilerplate, or closely follows another bank's policy (possibly a rival's). Too bad the policy you copied is not relevant to *your* goals, strategies, target market, resources, or conditions.

Whatever the cause, an irrelevant credit policy simply sucks up resources. By contrast, a credit policy that is closely connected to ongoing, routine decisions and actions of front-line credit staff helps them see opportunities, reduces time tiptoeing around land mines, and improves the overall efficiency of the credit business.

The connection between credit policy and daily, routine lending practices is the test of its relevance

Has *your* credit policy become *irrelevant*? Ask yourself:

- What does our credit policy have to do with the routine work of your bankers today?
- Are items discussed in the credit policy also addressed in typical conversations with customers and prospects?

Answers to these simple questions can uncover a credit policy that was once good and effective, but is now irrelevant to the way you do business. Unfortunately, of course, when your business falters, and perhaps even attracts the attention of the regulators, your policy, good or bad, will once again be *very* relevant.

The Search For The Silver Bullet

It is a sometimes inconvenient fact of the credit business that lending decisions are judgment calls. And at a portfolio level, each individual organization has to make its own, subjective decision about where they want to position themselves.

Do you want to pursue more business with a certain industry or type of business operation, or do you want to avoid them? Should some products and services get more attention than they do now,? Are some products and services more appropriate for your goals and your market and resources, and others perhaps less useful? Are there structuring approaches that you can handle more successfully than your competition, and others that you should be cautious about, even though they may work well for someone else?

Let's face it: *life would be a lot easier* if questions like "What is the right structure?" or "Whom should we be doing business with?" each had a single answer that was right for *everyone, everywhere, every time.* It is human nature to look for the "magic pill" or "silver bullet", a miracle solution you can a drop into your credit policy document for an instant solution to your lending dilemmas.

It is human nature to look for the one simple solution to any problem

Indeed, sometimes I think that tendency to look for a single, simple solution is even stronger in the credit industry than it is elsewhere.

That drive for the simple solution tends to reveal itself, *often to the detriment of the business*, in a couple of ways:

1. Because it is difficult and messy to manage judgment calls, the bank takes the easy way out and **anchors their policy at one end or the other of the range of possibilities.**
2. The **bank copies an existing policy**, assuming that *someone else has figured out the perfect solution!* Whether using a template, or their knowledge of what other banks have done, they adopt *someone else's* answers to *their* credit questions.

Missing the (Balance) Point

There are several facets of credit policy where the scales can tip wildly to one side or the other, such as:

Some banks try to make policy clear by sharply limiting the options

- **Level of detail.** Some institutions write credit policies so detailed that they leave absolutely nothing to the judgment of the banker, manager, or approver. Other organizations craft very broad, loose policies, saying, in effect, "anything goes." *Neither approach is very efficient or effective*. Extremely detailed policy adds a ton of overhead to the simplest transaction, while a loose policy inevitably leads to problems, down the road, that can require a significant investment of time and resources to fix.

- **Responsiveness**. It is easy to recognize organizations where policy is rarely updated, even as conditions and practices change dramatically. But it is possible to have *too* responsive a policy, one that gets rewritten to handle every new situation. In the first case, exceptions to policy are common, but no one cares. In the latter case, exceptions are quickly handled by revising the policy to eliminate the exception (more common than you might think!). Neither approach provides **proactive guidance** to your employees in lending situations.
- **Monitoring**. What does it take to trigger a policy exception, and who keeps track of it? In some banks, only the most extreme deviations from policy are recorded, while others generate long exception lists by tagging the least deviation from "the letter of the law." And in more than a few institutions, exceptions are *technically* monitored -- that is, they are automatically entered and tracked through the company's technology -- but no human is really paying much attention.
- **Consequences**. When staff deviate from policy and lending practices, *does it really matter*? Is there any difference in how management treats bankers, loan officers, credit analysts, and administrative assistants who tend to skirt around credit policy in their work, compared to those who consistently implement it appropriately? Are the consequences of violating policy *so severe* that everyone is *afraid* to make judgments, preferring to cover their butts rather than pursue good business?

Don't take the (temporarily) easy way out, work to find your optimal position

These are just a few examples where you should seek the *optimal* position in a range of possibilities. We'll come back to some of these "scales" a little later in this white paper.

Your chosen position must match the conditions, values, and standards under which your bank operates. There are *no* "perfect" points on these scales that will work for *everyone*.

Missing the balance point that works for *you* means missing opportunities for a more efficient, productive credit business.

The Copycat Approach

You constantly observe how competitors in your business practice credit, apply their credit policies, organize their processes, and support their work with systems and resources. Besides being basic human nature, this helps you see when you are approaching things quite differently from others in the same industry.

When their solution becomes your solution

Now, those who have been in my seminars, or read my articles (including *Jeff's Thoughts*) will know that one of my pet peeves about the banking business is *the tendency for some organizations and institutions to blindly copy their competition*. They think that whatever is a "best practice" for *someone else* will produce great outcomes for *them*, even though their markets, culture, staff, and goals might all be different. They worry so much about being different from the competition that they sacrifice the opportunity to *differ in success*, that is, to be *leaders in their markets*.

And that's the greatest risk with simply aping practices and policy developed elsewhere, something that often happens when:

There are several ways to get started on your credit policy by piggybacking on someone else's work

1. You naturally **draw on your staff's experience** working for other institutions, or talk to your contacts elsewhere, to learn about policy provisions in other banks.
2. You **purchase a boilerplate**, a template in which you fill in a few blanks and call it your credit policy.
3. You **hire someone to develop a complete policy for you**, that you then rubber stamp as soon as they deliver it.

If you are developing a credit policy for the first time, and really are not sure how to go about it, looking at examples from other institutions, and templates and boilerplates from experts in the industry, can certainly help you get started.

Just make sure you *know the difference* between the **start** and the **finish** of your credit policy development project. These sources give you a starting point, some things to think about. But as a solution, they are based either on generic, average information (boilerplates and templates), or someone's else's solutions to someone else's problems.

Following a credit policy based on this kind of information, rather than your own specific needs and conditions, is like having the Owner's Manual for a Chevrolet in the glovebox of your Lexus. It rarely produces good results:

Gaining perspective and a jump start is a lot different from just plugging in a policy developed under different conditions and needs

- **At best**, even *good* policy content will produce only *mediocre* results. When you copy what everyone else does, you get the same results everyone else does. *You cannot copy your way to leadership in your marketplace*.
- **In most cases**, when policy contents are dropped into place without thorough review and adaptation to your unique requirements and opportunities, *they quickly become irrelevant*. As discussed earlier, credit policies of that kind are soon left behind, ignored, or worked around.
- **At worst**, the copied provisions may fit your needs and practices so poorly that they produce disastrous results. And when the examiners look at your problems, those "drop-in" provisions will stick out like sore thumbs.

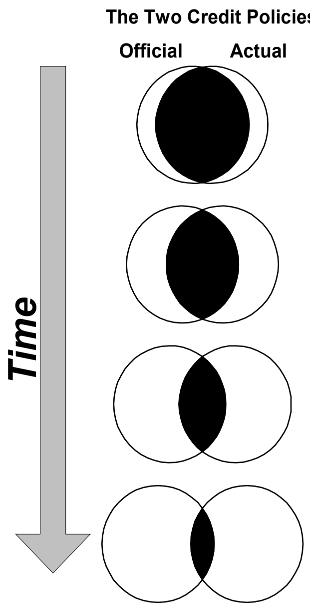
Being successful is a unique characteristic, one that should distinguish you from your rivals. You will not get there if you *rely too heavily on credit policy ideas that have been developed as responses to other markets, cultures, and conditions.*

Out Of Sight . . .

Every bank has two credit policies:

1. **the official document**, where all the guidelines are written down in detail; and
2. the credit policy **credit staff carry around inside their own heads**, the *internalized* version of how to handle credit business.

The one that steers your business is the one that is in your employees' heads. When your bankers get questions from potential or current borrowers, they answer most of those questions from memory, with what they *understand to be* credit policy. And what they promise in those conversations, or at least imply, should reflect your strategic plan for your credit business.



The question then, is how closely those two credit policies resemble one another. **If you do not regularly monitor, review, communicate, and update credit policy, it is only natural for the official version and the actual implementation to drift apart over time.** It is basic evolution, really. You may have had an excellent policy to start with, but after a long enough period of neglect, even the best policy becomes *irrelevant*, if not *harmful*.

If you were to sit next to a banker and eavesdrop, how long could you go without hearing any mention of credit policy? Hours? Days? Weeks? Longer?

Credit policy has to be part of the fabric of routine daily business. If you can quote your credit policy precisely, chapter and verse, but you cannot tell me what your bank is doing to regularly reinforce the purpose, value, and content of that credit policy with front-line staff, your official document is *not* the credit policy that is guiding your business practices.

Spare The Rod . . .

I have already touched on the notion of *consequences*, of finding the right point between being *too flexible* with deviations from policy and *enforcing policy so aggressively* that staff are afraid to use their judgment in credit relationships.

Your approach to enforcement must fit your culture, your vision, your stated goals, and the standards you have shared with your employees. That approach is defined by:

How far can they go?

What will you do about it?

1. your tolerance for deviations from policy, that is, how far you let your staff go before you call them on it; and
2. your methods for enforcing what is in your policy, how you deliver the message that actions have exceeded guidelines.

Tolerance For Exceptions

Tolerance for bending, or working around, the rules of your credit game is one of the defining characteristics of your bank. A lot of institutions get in trouble, sooner or later, because staff are allowed to stretch the rules pretty far before anyone intervenes.

In some organizations, there are areas of policy where it is known that "nobody really does it that way." In others, policy is written so loosely that it is almost impossible to step outside standards. Some organizations are so focused on giving their loan officers room for maximum "creativity" that they will basically revise policy to fit any new situation that lending staff can come up with.

Let's be honest: at some banks, it is pretty much "anything goes"

Still others write in broad generalizations because they believe that's a way to get more "wiggle room" from the regulators. Again, while on the surface they may *seem* to generate relatively few policy exceptions, that has mostly to do with the looseness of their policy. In the end, they don't fool anyone, least of all the regulators.

We'd like to pretend that every bank takes credit policy seriously. But we all know of places where staff who create a lot of exceptions, as they go about their business, are not only *tolerated*, but *rewarded* for their ability to make sure the credit policy doesn't hold them back in any way -- *even when it should!*

That's like driving a car that only has a gas pedal, no brakes. Accidents are bound to follow, and it is no surprise that, sooner or later, such banks get the attention of industry regulators.

The key first steps in enforcing policy are to commit to the standards you documented -- standards which are appropriate to your culture and your strategic vision -- and to intervene quickly and visibly when actions stray outside of guidelines.

The "How" of Enforcement

The "how" of these interventions also has a significant impact on behavior. *Publicly rewarding but secretly scolding* individuals who stray from policy is a common, and *highly ineffective*, approach. Conflicting messages rarely influence individual behavior, when staff see little public commitment to maintaining standards.

Either rewarding transgressors for their creativity, or punishing them severely, can weaken your credit policy

On the other hand, more draconian, *punitive approaches* can destroy their capacity for judgment and creativity in credit relationships. Bankers quickly learn to cover their actions, to hide *behind* policy, rather than *use* it to build stronger, more profitable business. A credit policy approach that is dominated by *fear* is rarely productive, efficient, or successful in the long term.

Strangely enough, *the punitive approach makes you vulnerable to serious mistakes.* Credit staff follow the letter of the law, so they can't be yelled at, and avoid using their judgment to make better decisions. To put it bluntly, you will make bad loans that *technically* fit policy, when staff are afraid to think for themselves.

When following credit policy is "their" job, not "our" job

One of the crucial elements in all of this is the "who" of enforcement. When deviations and exceptions are solely the responsibility of the specialists -- analysts, administrative staff, credit review -- lending degenerates into a cat and mouse game between loan officers and their "enforcers." Holding staff closer to credit policy requires the interest of their own supervisors, not just colleagues in a separate function.

If front-line staff don't regularly hear about policy and their institution's expectations for following it, directly through their own management communication chain, it won't much matter how brilliantly written and conceived your credit policy may be.

Getting It Right!

Given the typical issues and flaws discussed above, how can you avoid going astray? How do you get your credit policy right?

1. **Know your roles.** Policy does not succeed or fail based on the work of the individual or team that does most of the writing. Knowing everyone's roles in developing and working with policy enhances the results you achieve for your bank.

It takes all four steps to get it right

2. **Prepare the ground.** Take a step back to define the purpose of your credit policy. What role does credit policy play in your banking business? What expectations does it establish for banker behavior?

3. **Get the right inputs.** If you don't have the right perspectives flowing *into* your credit policy development process, you aren't going to get the right *outcomes*. Relying on a few narrow inputs, or the wrong inputs, leads to credit policy that is irrelevant to everyday business practices.

4. **Plan ahead for effective output.** Don't let communicating, monitoring, and enforcing credit policy be afterthoughts. If you *separate* those steps from the credit policy development process, you could be wasting your effort.

Know Your Roles

The specific details of who does what in carrying out policy, enforcing its provisions, monitoring and reporting exceptions, and the like, varies with the structure of the individual organization.

I don't want to tell you how to set up your org chart! What I do want to do is to make sure you approach credit policy development and implementation with some explicit consideration of key roles in your bank's credit business.

The Board of Directors

The Board has ultimate responsibility

Credit policy is the responsibility of the Board. Without the full engagement of the Directors, and explicit guidance from them, the most talented staff in the world can't create a credit policy that will support your strategic plan and help you achieve your goals.

And if you take shortcuts that lead to problems in your banking business down the road, it won't matter whom you "point the finger" at.

The regulators will point *their* fingers squarely at the Board!

Senior Management

Senior management "makes it happen." They communicate regularly with staff to keep policy visible and relevant. They review data on compliance with guidelines, they listen for information about what is working and what is not, and they take action to continuously enhance the benefits a sound credit policy

Senior Management "makes it happen"

brings to their credit business.

Management connects the vision of the Board to the execution by the staff . . . in *both* directions!

In other words, senior management communicates Board views and expectations down the management chain. But they also recognize situations where credit policy review and revision may be required, and bring those to the Board for action.

The Front Lines

The staff that "live" the credit policy in their dealings with customers, and with colleagues, have obvious responsibilities to know, understand, embrace, and apply the policy.

These are the people who actually determine what the bank's *de facto* credit policy is, regardless of what is written down.

The front lines have a lot to contribute to more effective policy

- **In banks where credit policy is working poorly**, loan officers may view the policy as a major obstacle to getting their work done, as a burden or obstacle and nothing more. They may find themselves in constant conflict with other staff who "call them" on their deviations from policy, who catch them in the midst of their creative "workarounds."
- **In banks where credit policy works well**, front line staff understand the role policy plays in the bank's overall strategies for success. They acknowledge that it is more efficient to work with policy than to constantly try to circumvent it. And they come forward with suggestions to colleagues and supervisors in regard to provisions that are difficult to implement, confusing, or in apparent contradiction to other provisions in the same policy.

In the best run banks, the front lines contribute a great deal to the ongoing refinement and enhancement of credit policy.

Prepare The Ground

Your credit policy is your strategic plan for your credit business!

As such, crafting an effective credit policy, one that will help your business, means being aware of the credit policy's position, or role, in the overall business. Crafting a policy (or copying one) without consideration of your overall goals, resources, tools and systems, and culture, is an invitation to failure.

Don't leave your credit policy developers guessing at what the policy is supposed to do for your banking business

Credit policy that is created without a sense of its position within the larger business -- including values, culture, and shared assumptions -- quickly becomes irrelevant, and often works *against* stated goals of the organization. Indeed, when banks merge, many times the physical task of combining their written policies is easy, but the melding together of the *different cultures reflected, in part, by the content of and their attitudes toward credit policy*, is much more difficult.

Too often, the person or team charged with drafting or revising policy gets little guidance. They may assume they are supposed to:

- **Just keep the regulators off your back.** Incorporate all the examiners' recommendations without further consideration. Try to "teach to the test," thinking of the regulators, rather than your own staff, as the true "audience" for the policy.
- **Spell out every possible hazard** in your credit business, producing a checklist of things to avoid, and nothing more.
- **Present a vision of preferred customers and practices** that lead to optimal results. Craft a policy that goes *beyond* what *not* to do, one that encourages productive business practices.

There are many other ways to define the task of writing your credit policy. The point is, your Board of Directors must clearly define what they want in a credit policy.

The credit policy your staff develop will only be as good as the direction you give them in the first place

You will get what you ask for. Perhaps more than any other factor, *the failure to ask for the right thing* is, in our experience, what eventually leads to credit policy problems

In the most successful institutions, the leadership doesn't take shortcuts in defining the task of creating, and maintaining, a helpful and effective credit policy. They know that every hour they invest in stating the task clearly will pay them back many times over, reducing the inefficiencies, confusion, morale issues, and eventual regulator attention, that come with an irrelevant credit policy that is divorced from actual business practices.

If you take no other advice from this white paper, take the time to prepare the ground for those who develop your credit policy.

Get The Right Inputs

Once you have properly set the stage for the staff writing your credit policy, they will gather information from a variety of sources. *A common error is get input only from a narrow range of sources.*

Many institutions collect only *negative* perspectives on how policy is working. Their main inputs come from people who deal with problems that arise when policy is not followed: credit analysts, credit review and audit functions, and other players in loan administration. (Similar input comes from bank examiners.)

When you limit your inputs to the specialists who identify and address *failures* to adhere to policy:

Many banks draw all their ideas for policy from a very narrow range of sources, with poor results

- **Other staff don't take ownership.** When credit policy is the exclusive purview of a specific function, other players just see it as one more checklist to work around.
- **You only get one side of the story.** You identify situations where policy is not followed, but *it is all too easy to assume that policy is not followed because someone is taking shortcuts, is lazy, or perhaps devious*. Sometimes policy is not followed because the policy is so detached from the current demands of the marketplace and the bank's culture that it is almost impossible to pursue the institution's stated goals and strategic vision and apply the policy at the same time.

It is difficult to build a successful business on purely negative information. **A bank whose staff know *what to do* will outperform a bank whose staff only know *what not to do*, every time.** If all your revision data are based on what went wrong, you're unlikely to craft a credit policy that will help you become a market leader.

Creating a truly effective credit policy is a complex process. Whether you're doing it for the first time around, or doing a major overhaul, you need inputs from a lot of sources. (Revisions should require less work, but a range of perspectives remains valuable.)

Both *internal* and *external* sources of feedback and ideas can enhance your credit policy.

Internal Inputs

In many institutions, especially smaller ones, a single person is given primary responsibility for writing and updating credit policy. But, *a proactive, positive strategic plan for your credit business demands a broad range of inputs from within your own institution.*

Whether one person, or a small team, does most of the work on credit policy development, *your business will benefit from consulting people who wear these kinds of hats*:

Useful inputs can be found all across your organization, not just in a couple of specialized functions

- **Front-line lenders:** What parts of credit policy trip them up again and again? What parts simply don't make sense to them? What parts, frankly, do they do their best to work around?
- **Analysts, underwriters, credit review, audit and administrative functions**: What patterns of exceptions do they deal with most frequently? What are the trends? Looking back over a couple of years, have the areas where exceptions come from changed? Or is it the same picture, year after year?
- **Marketing:** What kinds of customers, industries, individuals, businesses, are likely to figure prominently in the bank's portfolio in the next few years? What products, and what loan structures, will be getting more play in the near future?
- **Human resources/training/employee communication:** How will people learn about changes to credit policy? Who is responsible for ensuring that policy issues are visible and internalized by lending staff? How will they learn to better implement credit policy? How will feedback be delivered?
- **Managers and supervisors:** Front-line staff know what is important: *whatever is important to their bosses!* What steps will you take to ensure that credit policy is a regular topic in the usual chain of communication? Will managers be held accountable for the use, and abuse, of credit policy by their direct reports?

- **Systems, technology, administrative staff:** How will the exceptions be logged and tallied? Who generates reports? What constraints do available systems put on your ability to track credit policy compliance? How can technical staff help you take advantage of a strong credit policy?

Official job titles and department names associated with each of these areas will differ widely from one organization to the next. But if you can find the people who wear these hats, engage them in credit policy development, earn their buy-in, and rely on their support for credit policy as it is rolled out, your credit business will definitely benefit.

External Inputs

Your internal resources will *generate ideas* that can make your credit policy more effective in driving a successful credit business. Often, advice from external resources can help you determine *which* ideas are most appropriate for *your* situation.

Most institutions gather external perspectives from one or more of the following:

Outside resources bring objectivity to help you evaluate the ideas and issues raised through your internal inputs

- **Bank examiners.** Their reports may specify or highlight particular sections of existing credit policy, or suggest additions or changes to credit policy. They also point to processes and standards that need adjustment, and you may find that credit policy is the best way to do that. Feedback from examiners is undoubtedly valuable, but knee-jerk application of everything they say may not lead to the best results for your bank.

- **Other banks/boilerplates.** Very simply, looking at what others have done gives you another perspective on what you are doing. Unfortunately, of the three options, this is the one that carries the greatest risk of unsatisfactory outcomes for your own institution.

- **Professional outside help.** Consultants experienced with your kind of institution, and with the credit business, can help you sort out which ideas make the most sense for your credit policy. They can also help collect input, due to the anonymity they can bring to the process. The most important *caveat* related to external consultants is to make sure you are working with someone who will help you craft what *you* need for *your* circumstances, rather than apply a cookie-cutter solution from somewhere else.

It can definitely be helpful to incorporate external perspectives as you develop your credit policy. Working only from internal inputs relies too strongly on history that may no longer apply, on existing turf wars between different functions in your organization, on looking at what has happened in the past to the exclusion of setting a strategic plan for your *future* credit business.

So let's consider how you can benefit from each of the external resources mentioned above.

Bank Examiners

In many banks, credit policy has grown to its current state through the accretion of recommendations, over the years, made by bank examiners. More often than not, one of the symptoms I see in institutions where credit policy really isn't working is the *knee-jerk incorporation of these recommendations*.

Certainly, we work in a regulated industry. No doubt, when an examiner's report says you have to have something in your policy, it will have to find its way in there.

But most of what you learn in these reports, and through the regulatory review process, can truly be called *recommendations*, rather than *orders*. Problems arise when banks regard bank examiners as minor deities, and their recommendations as infallible pronouncements from the Oracle.

Unthinking adoption of everything the examiners mention is a shortcut to a complex, self-contradictory policy that will never really work for you

Here are just a few suggestions about how to deal with recommendations from examiners:

- **Identify where you already address the topic.** When an examiner's report suggests an area of concern, identify *all* the areas in the *existing* policy that touch on that concern. Then adjust those sections to maintain a consistent policy. Simply plugging recommendations into your credit policy, year after year, will create a document filled with internal contradictions that no one will be able to apply effectively.

- **Filter every recommendation through your strategic plan and business conditions.** People who work in regulatory functions *have* to generalize. They encounter certain problems and situations again and again, and their corrections take on a generic flavor. But you have to work with particular industries, geography, local economic conditions, shareholder pressures, and business strategies of your own. View their comments through the lens of your own business vision to satisfy both regulatory requirements *and* your own business strategies.

- **Prioritize.** Some recommendations are stronger than others. Make sure you get the big ones right, and worry about the rest of them later.

The bottom line is that you need to apply your judgment to evaluate examiner recommendations in the same way you evaluate the internal inputs discussed above. In almost every institution, there are several options available for implementing any given recommendation in regard to credit policy.

Boilerplates, Templates, History, and Rivals

For some banks, their source of external "objectivity" is *someone else's* fully formed credit policy. That "someone" could be another bank, or it could be a generic boilerplate or template.

Or it could be someone within your own organization who happens to have some experience with credit policy. Perhaps that staff person came from another bank, and brought their knowledge of credit policy with them. But *transplanting another bank's credit policy wholesale into your own culture will rarely produce the outcomes you are looking for.*

Some banks just want to "get it done." They may copy, or buy, an existing credit policy, into which they insert their own names, and then roll it out with minor editing.

I've already touched on this approach, so I won't belabor the point. Just keep in mind that when you lift your policy, more or less intact, from an external source:

Examples from elsewhere can give you good ideas. They cannot give you an effective credit policy.

- **You cannot achieve better results, with this policy, than your competition**. You can't use the same policy and somehow magically produce superior results in your own bank.
- **You may not even know whether the policy was really working well elsewhere.** We tend to copy what we have access to, not necessarily what has been proven successful.
- ***Your* credit policy is *your* strategic plan for *your* credit business.** Would you just copy someone else's strategic plan for your entire company and let it drive your business?

Outside Professional Help

Some institutions get that helpful objectivity by hiring it. Now, it should be obvious from the above discussion that I am not in favor of engaging a consultant to write your credit policy *for* you.

What role, then, can consultants play in your credit policy development? They can:

An outsider's perspective and knowledge can improve both the speed of the development process and the quality of the result

- **Provide an objective perspective.** The various players within your organization tend to see only their own views of any given issue. An external eye can sometimes sort out which concerns are real issues for the bank, and which are basically turf issues among different functions.
- **Bring attention to issues.** Sometimes it is easier to get everyone involved to take advice from an external source. Recommendations may have a different currency with bank leadership, and even front-line staff, from an outsider who gains no benefit from favoring one point of view over another.
- **Compare your approach to others they have experienced.** A consultant who has seen the same credit policy issues tackled in a variety of ways can introduce options that may work for you, but that will not arise, typically, from your internal inputs, or from boilerplate products. Just as importantly, they can help you evaluate whether or not ideas that worked well elsewhere really fit your culture, values, or strategic plan.
- **Anonymously gather input.** Some of your staff might be reluctant to raise issues with their own supervisors, or to discuss

conflicts that have arisen out of credit policy and its implementation. An outsider, however, can gather input while preserving anonymity, making it more likely that you will be able to uncover, and fix, provisions of the credit policy that are confusing or difficult to implement.

- **Keep things moving.** In between visits from the examiners, it can be difficult to make credit policy development a priority. Policy can lie dormant for ages, only to be revised in a desperate hurry when significant problems arise or external reviews loom on the horizon. An outsider can drive the process to ensure that policy development moves along in an orderly fashion, so your credit policy gets the time and attention needed to produce optimal results.

Make sure your consultant writes your policy with you, not for you, and that the bank's business is more important than the consultant's business

An outsider can be a valuable resource in crafting an effective credit policy. All the same, *there are some cautions to be observed in working with an external resource on your credit policy*:

- **Beware of consultants who offer you a credit policy before they know your bank.** This is known as "a solution in search of a problem," and is more likely to provide you with additional problems, rather than fewer.
- **Judiciously review how the consultant positions additional services.** For example, a consultant may be able to help you with communication or training after the credit policy has been developed. If that option streamlines your implementation, that could be a good thing. If the consultant is using the credit policy as a lure to get you to invest in a multitude of additional services, you may want to be more cautious.
- **Determine who will do your next credit policy review**. Are you looking for someone who will come in on an annual basis to help review and tweak your credit policy? Or are you looking for someone who will help you set up a credit policy development process that you can implement yourself, using internal resources, in subsequent years?

Regardless of how you end up working with an external resource, **credit policy is *your* responsibility in the end**. Experienced outside help can do a great deal to improve your development process, to get you started on a project that is stalled, and help you fit your policy to your goals and needs.

But at the end of the day, *their role* is to provide options and *your role* is to select the best alternatives for *your* own institution.

Plan For Effective Outputs

Time and again, I have seen banks make the same mistake: they work hard to craft a truly useful credit policy, and assume the job is done when the policy is written. But their work has just begun.

Careful development of a well thought out, well written credit policy is just one part of the job. *Communicating* the credit policy, and *maintaining its visibility* on a routine basis, are just as important contributors to your overall success.

This is where so many institutions drop the ball. They send out an announcement that the policy has been updated, or they run through training sessions on the new credit policy, and that's where everything stops. Loan officers, analysts, and administrators then hear little more about it, *except* when problems arise.

Countless banks abandon any return on their substantial investment in policy development when they leave communication and reinforcement of policy to whim and chance

When bank management rarely mentions credit policy, the credit policy drifts into obscurity and irrelevance. Over time, *the gap between the documented and implemented credit policies* wastes resources and generates friction between functions, e.g., loan officers and underwriting, and the credit policy begins to hurt, rather than help your business.

The market leaders, the ones who know how to use their credit policy to drive their credit business, know that the only way to maintain credit policy as a living guide to business activity is to **explicitly manage communication around the policy**. These successful institutions:

- **have effective systems** for monitoring credit policy exceptions and identifying trends;
- **regularly share the data they collect with everyone** involved in the lending process, and their managers;

- **incorporate an explicit communication schedule** into the credit policy project itself -- e.g., monthly targets for reinforcing the role of the credit policy through internal communications such as e-mails, newsletters, or staff meetings;
- set **explicit plans for collecting feedback** from parties to the credit process on how the credit policy is working, and where provisions of the policy are confusing or difficult to implement;
- **establish a schedule and responsibility for regular review** and, if necessary, updating of the credit policy;
- **set criteria for events, external or internal, that can trigger an off schedule review and update** of the credit process.

A credit policy that is a well-kept secret, or at best a distant memory, will eventually get you in trouble. Don't waste all the effort you put into crafting the best possible credit policy by failing to take the last, crucial step of developing an explicit communication system around the policy.

Where Do You Go From Here?

What will produce a relevant, real-world credit policy that will continue to be effective for your bank right through your next review cycle?

You may assign primary responsibility for development to an individual, or assemble a project team to work on the credit policy. In either case, the developer(s) will look at what you currently have and what you need, and then draft a policy for review and approval. The development project is most effective when executed in a Board> Developers> Management "sandwich".

In other words:

1. The **Board of Directors prepares the ground**, "sets the stage," to optimize outcomes from the project. They establish the role of policy in proactively setting expectations for behavior.

2. The **individual or team developing the policy gathers inputs and drafts** the policy. They define and document those expectations for banker behavior

3. Finally, **senior management rolls out** the new credit policy, and **maintains its effectiveness** through regular communication and review.

Does your "sandwich" have too much "meat," too little "bun"?

In my experience, the "sandwich" at most banks has too much "meat." In other words, too much of policy development and implementation is left to the project team, with too little support from bank leadership before and after drafting the policy.

Let's briefly put some of the topics I've discussed into the "sandwich."

Board Of Directors: Prepare The Ground

Before policy development even begins, the Board should:

- **Agree on the role of credit policy.** If you cannot get over the thought that credit policy is a necessary evil, rather than a useful business tool, you can skip the rest of the suggestions.

Clearly setting the task, and the ground rules, greatly enhances the work of your project team

- **Link key facets of credit policy to the bank's strategic plan**. What is the role of credit, what are your standards and values?
- **Designate internal and external inputs into the credit policy development process**.
- **Identify the individual or** team **that will develop the policy.**
- **Communicate key requirements, standards, goals, and strategies related to the credit policy**.

Developers: Craft Policy

Once they have received direction from the Board, the designated staff handle the bulk of the writing work.

- **They gather information from chosen inputs, internal and external.** Some of that information comes from past monitoring and standard reports. But *anecdotal information* from staff directly involved in, or affected by, the credit policy can be

Developing effective policy requires planning beyond the writing to consider later roll out, communication, and monitoring

crucial to developing a policy that will remain relevant to your bank operations.

- **They draft a credit policy based on those inputs, along with the guidance received from the Board, to create a strategic plan for the credit business**.
- **They identify systems and processes for monitoring** implementation and use of credit policy, for tracking exceptions, and for reporting the data.
- **They propose explicit revision plans:** a review schedule, and the conditions that would trigger an off schedule revision.
- **They propose an ongoing communication plan** to ensure that the official policy, and not just the *de facto* policy, regularly comes to the attention of the bank's credit staff.

Senior Management: Long-term Implementation

Thinking that the process ends with the writing of the policy is a major, although common, mistake.

Senior management must get further involved, to:

If you think the policy is done when the writing is done, you've probably wasted a lot of time and resources

- **Roll out the credit policy** through announcements, training, adjustments to systems, and so on.
- **Commit to maintaining ongoing communication**, integrating a communication schedule into management objectives.
- **Schedule the next regular policy review and update**.

Does that all seem obvious? I can tell you, from the experience of myself and my associates, that relatively *few* banks manage to work through the *entire process*. That's why so many of them have credit policies that are temporarily relevant and effective, but that slowly fade into the background and become detached from the actual business practices of the credit operations.

Diligence, commitment, and *routine* are among the most powerful tools in using the credit policy to drive a more successful business. When your official credit policy is regularly in the minds of your loan officers, credit analysts, underwriters, administrative staff, and bank leadership, your customers, your shareholders, and your employees all benefit.

A living policy keeps you in touch with changing conditions and practices, and guides credit behavior towards strategic objectives. It helps you follow your map, to stay on the right road.

Keeping the issues I've discussed in mind throughout the year can save you from the pain of a major policy overhaul, forced upon you by external pressures.

And that will show its value as *you* take advantage of sound credit opportunities, while *your market rivals* are scrambling to update their documents and processes, to get control over all their exceptions and inefficient processes, and to keep their examiners happy.

About Jeff Judy & Associates

Jeff Judy is a nationally known trainer in financial services, widely hailed for his energy in the classroom, and his willingness to "tell it to you straight," to help people in banking build a true picture of their practices and opportunities. With a team of longtime associates, he serves the banking industry through consulting with individual banks and holding companies; through seminars on a wide range of topics in commercial and consumer lending, safe credit practices, and relationship development; and through his published articles and interviews, including his bi-weekly e-zine on banking and training, *Jeff's Thoughts*.

In the boardroom, *Jeff Judy & Associates* helps financial services institutions become leaders in their markets. Jeff and his team strongly believe that simply following the competition is a path to mediocrity at best, and to serious business problems at worst.

As a consultant, Jeff promotes truly effective strategic planning and culture development, in which a uniquely tailored credit policy and appropriate processes play pivotal roles. He believes that a clear vision encompassing market and business conditions; organization goals, expectations, and values; and effective application of resources, explicitly documented and shared throughout the institution, is a powerful source of competitive advantage.

Jeff's Associates add special expertise in credit policy, portfolio management, credit process, risk management, culture analysis and development, credit analysis, training, and communication, to name a few key areas. He has the flexibility to apply just what is needed to the unique challenges and opportunities of any particular client.

Jeff believes that market leaders leverage the required elements of our business -- policy, compliance, reporting, and so on -- into competitive advantages over their rivals.

If you would like to turn your credit policy into an *advantage*, rather than an *obstacle*, for your credit business, please contact *Jeff Judy & Associates* to discuss how we can help you.