

The importance of credit culture commerce essay



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The purpose of this essay is to reach a better understanding of credit culture as well as to identify its role and importance within the banking environment. It is not an exhaustive summary of researched information.

What is Credit Culture? Why is Credit Culture a crucial element in the credit risk management process? And what are the essentials of Credit culture?

In his New York Times' article, Saltmarsh (2007) refers to Dr Udo Reifner, a professor of economics and law at the university of Hamburg who said 'Credit is good. It needs to do good ... but credit needs to be supervised'. This statement implies that there must be a crucial element underpinning every credit and lending decision. Based on the study of the risk profiles of more than one thousand banks over the past nine years, Barrickman (2003) has established a significant increase in their portfolio credit risk. This increase resulted from cyclical fluctuations as well as from banks willingness to take riskier decisions in order to grow their respective portfolios and maximise their earnings. Osborne (2008) explains that with the credit crunch, the bankruptcy applications rose which lead to the demise of several banks. The collapse of each lending institution is based on a different cause, however it is possible to establish a common ground for their failure: a strong credit culture has not been effectively established and implemented by their CEOs and board of directors during the credit risk management process.

It is a strong credit culture that determines a bank's survival and profitability. Hence, credit culture is also an important element of the credit risk management.

Credit culture defined

First of all, what is Credit Culture? And how can we define this concept?

There are various way to define Credit Culture. According to Caouette, Altman and Narayan (1998), credit culture refers to the collection of principles, actions, deterrents and rewards within the lending organisation. Credit Culture is also ' the institutional priorities, traditions and philosophies' surrounding lending or credit decisions (Sathye et al, 2003). These two definitions can be the foundation of a more narrow definition of credit culture such as the sum of the unique characteristics of a lending organisation's behaviour and its extension to the credit area. It is a concept that needs to rigorously be developed over time and communicated in an effective way. A strong credit culture represents the spirit behind the rules of the lending organisation. It encompasses tangible written procedures and policies as well as intangible ones such as ideas, skills, standards, traditions, attitudes and philosophies.

Evolving Banking Practices

The banking business is extremely risky. Banks are provided funding from the accepted demand deposits. Then, they issue credit for the financing of businesses, including long-term project finance (La Porta et al. 2000).

In order for banking to be successful, it needs to be undertaken in a supportive market environment because the banking business has significantly changed from both a regulatory and industry perspective.

In fact, banking has gradually evolved into an extremely competitive business. Each lending entities has developed specific practices

underpinning their risk management frameworks. Some risk management practices are too complex too be randomly and effectively implemented within the lending organisation. What is the role of the credit culture in banks' risk management frameworks?

Credit culture is often taken for granted by many lending institutions. However, based on historical examples, the credit culture's role and importance are not to be underestimated. In fact, communist governments have previously attempted to create government-owned lending entities to promote economic growth, savings and investments. These attempts have been unsuccessful due to a lack of credit culture in centrally planned economies. Without a sound credit culture, the credit risk has not been managed effectively. In fact, banks in centrally planned economies rarely conducted a rigorous credit risk analysis. Also, the borrowers' debt service capacity were not properly evaluated (La Porta et al. 2000).

It is essential to mention at this point that the credit culture's role within a lending institution is to guide all the banking operations. It gives a structured and disciplined approach to the credit and lending decisions in order to align strategy, people, processes, technology and knowledge (McManus, 2004). Successful banks have developed a strong internal credit culture where loans are made only when the capability of repayment is rigorously demonstrated. The capability of repayment can take distinct forms. However, nowadays banks tend to rely more on cash flows as opposed to security. Prior to approval, credits are all subject to a scrutinised analysis of the customers' repayment capability. This is an ongoing process even following the approval of the advance because any client can be subject to credit migration.

The Essentials of Credit Culture

According to the former chairman of the Credit Policy Committee and Chief Lending Officer of Citicorp and Citibank in New York, a strong credit culture is based on the ability of the CEO to support and promote good lending and credit decisions. How can this process be successfully achieved?

In his *Credit Policy: The Anchor of The Credit culture*, Mueller (1994) has provided twenty essentials of good banking that could be applied to any institution regardless of its size:

Continuous commitment to excellence.

Implementing a logical framework for daily decision-making.

Risk taking based on a uniform and consistent approach.

Use of a common credit terminology.

Use the bank's credit experience for the business cycle perspective.

Predominance of the bank's objectives over any individual profit goal.

Open and straightforward communication at all levels.

Monitoring of every transaction's effect on the bank.

An integer portfolio including few exceptions.

Individual responsibility for decisions and actions taken.

Balance of long-term goals with short-term views.

Respect of credit foundations.

Logical reality checks against market practices.

Advocacy of independent judgement over common instinct.

Constant awareness of the bank's risk taking parameters.

Pragmatic approach to budgeting and markets.

Understanding the bank's expectations and the reasons motivating its policies.

A structured credit system based on warning capabilities.

Early identification of problems and a policy of zero tolerance for surprises.

The Foundations of A Strong Credit Culture:

In order for a Credit Culture to play an effective role in the credit risk management, its underpinnings should be clear and solid. The policies, processes, behaviours and auditing should be clearly defined and communicated amongst the individuals within the lending organisation.

The policies represent the philosophical and legal framework for the daily decision making process. The credit officers are guided by these policies with the aim to achieve and balance the bank's earnings objectives.

The processes are the operational part of the credit strategy and extension. They include all the mechanisms necessary to the integrity of the credit application and its follow up (McManus, 2004).

The behaviours embody the norms and values adopted by the lending institutions' employees. The credit officers should work towards the best representation of the banks' policies and the best answer their clients' need in a low risk high return framework. The credit officers should only be able to make few well- documented exceptions in order to protect the bank's interest.

Auditing is a process by which the adherence to credit policies, processes and behaviours is ensured (McManus, 2004).

It is essential to note that whenever new graduate lending officers join a bank, they are introduced to the institution's Credit Culture through their graduate training program (Sathye et al, 2003). However, the intangible parts of each lending institution's Credit Culture such as their unique philosophies and attitudes are taught through an active day to day interaction and communication with experienced lending officers.

How to Analyze a Bank's Credit Culture?

According to McKinley (1990) a diagnosis of a bank's credit culture can be made following the identification of three distinct elements:

The Credit Culture Vocabulary:

The senior credit officers and the credit policy officers need to identify all the descriptive statements they perceive the most applicable to the organisation's Credit Culture.

In case the officers' perception does not match the ending institution's goals, it means the lenders are weakening the bank's credit policies.

The Credit Culture Profile:

McKinley (1990) has identified four major Credit Culture profiles:

- Value driven
- Immediate performance driven
- Market/share production driven
- Unfocused

The Credit Culture Profile helps the organisation pinpointing which of the four cultures, or a combination of them, is dominant in the lending institution. The Credit Culture Profile can be readjusted to help the firm reach its short and long-term objectives.

The Credit Culture Elements:

The Credit Culture Elements are the seventeen elements which make a strong Credit Culture. These elements are classified in four groups:

- Commitment
- Communication
- Incented behaviour
- Lines of business management

The lending officers must identify which of these four categories is deficient and how to overcome those weaknesses in order to strengthen the Credit Culture for the intended credit policies.

This diagnosis is straightforward since it identifies areas easily known by the bank's lending officers'. Once the analysis is completed, it offers a good overview of the current Credit Culture and what actions to take to improve it and align it with the bank's objectives.

The Role of the CEO in Credit culture:

Conclusion

Taking into consideration the complex and extensive nature of the banking business, it can be stated that the Credit Culture plays a more important role than ever in lending institutions.

It is essential to note that Credit Culture embraces all the factors related to credit quality, credit extension, and recurrent cyclical patterns and sequences (Birchwood, 2012). Moreover, a disciplined and strong Credit Culture represents the foundation of credit risk management since it guides all the credit and lending decisions.

Besides, since a strong Credit Culture puts the milestones for an effective management of credit risk then it gives the firms a competitive advantage in the marketplace. Hence, it can be concluded that a strong Credit Culture defines a bank's survival and profitability.