LOAN PRICING

by Steve Brown

Given the feedback to last week's columns, we would like to clear up a misconception Â– the factors that go into loan pricing are not linear and do change over time. That statement has wide ranging implications and is yet another reason to utilize a robust loan pricing model. While we will be discussing this at our High Performance Bank Workshop coming up next week in Las Vegas, understanding the interplay between loan components and how they change, can help a bank better manage profitability. Since loans are affected by many factors, understanding their interaction can be difficult. The easiest way to see this is by thinking about a 5Y fixed rate loan. Whether this loan is matched-funded or not, because of the shape of the forward curve, it will be more or less profitable given a point in time. A rise in short-term rates will make this loan less profitable (unless interest rate risk is managed exactly) in the earlier years and more profitable later (if rates drop). The problem is that when rates drop, the loan also has a higher probability of repayment. If you chart the loan's value against profitability, a concave trend appears (profitability is different in various years, peaking and then decreasing). Items like capital, prepayment penalties, reset dates and other factors all play an important roll. A 3Y loan may be profitable, but a 5Y loan may not be, simply due to how fees, rate and optionality interact. Conversely, an unprofitable loan with a prepayment penalty that keeps the loan on the books for a longer period of time also hurts value. Being able to model a loan's cash flows and see how different attributes affect profitability is extremely important. Additionally, a loan may be profitable today, but not in the future. Multifamily lending is a classic example, as the sector currently enjoys low delinquencies and positive economic trends. By next year, the outlook for multifamily lending may change (although not predicted to do so), creating a less profitable risk-adjusted return on equity. For banks that are having concentration issues, or have a credit view different from the market, risk factors (like predicted credit defaults) or pricing should be adjusted. Because banks are gaining a better understanding of how changes in the credit market affect return, we are seeing many more become active managers of their loan portfolios. When profitability turns downward due to a rising cost of funds, greater delinquencies or even slower appreciation, managers can sell down or incent certain borrowers to pay off (thereby reducing exposure). Active managers may take their loans that are declining in profitability and conduct a marketing campaign to waive prepayment penalties as a "thank you." A more common tactic used by banks is to send an offer to extend the maturity of a loan, in exchange for a fee. This may get the borrower thinking about refinancing sooner than he normally would, but more likely results in the borrower taking the offer. The additional fee (usually 50bp) compensates the bank for the declining risk profile and returns the loan to its previously profitable level. Next to deposits, loan profitability is the most important element in bank management. Understanding loan component values is a competitive advantage.

BANK NEWS

Acquisition

Sterling Financial ($8.0B, WA) will acquire the parent company of Sonoma National Bank ($1.4B, CA) for about $335mm, or 2.86x book.

Acquisition

Atlantic Southern Financial Group ($492mm, GA) will acquire First Community Bank of GA ($73mm, GA) for an undisclosed amount.

Expanding

TCF Financial ($14.3B, MN) said it will open 50 branches in AZ within the next 10Ys.

Exiting

Pacific Crest Savings Bank ($148mm, WA) reported it has sold off its mortgage banking division for an undisclosed sum. The mortgage division accounted for almost 67% of the bank's gross revenues last year.

Payment Changes

Wells Fargo will integrate its ACH system with its account reconcilement system in order to let business customers track checks that have been converted to ACH transactions. Once integrated, the system will allow a "Fraud Filter" to sift certain ineligible items and allow a manual pay or return decision.

Massive Capital

In a highly unusual move, a group of bankers in NC are close to raising $100mm in capital for their new proposed bank. Typically, de novo banks are funded with about $10mm in capital, so the amount is staggering. The proposed bank, TrustAtlantic Financial, expects to purchase an existing bank and infuse it with capital and a new mission.

Competition

Bank of America said it purchased health care technology company HealthLogic Systems for an undisclosed sum. BofA said the acquisition will help the Bank support health care providers moving to automated patient processing of bills and claims.

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