THE LOAN PRICING MODEL AND X-RAY VISION

by Steve Brown

For bank managers still making loan decisions based on historic data, may we suggest some forward looking x-ray vision this holiday season? Credit is getting tough out there and the best way to thrive is to become smarter than the competition. When bankers tell us loan "pricing is set by our competition" or "our lenders would never use a model," the reality is no tool can add more value to a bank's bottom line than a loan pricing model.

While there are many loan pricing models available to banks, ours happens to be the only one we know of calibrated to community bank lending, profitability and prepayments. More importantly, ours gets daily updates of interest rates and monthly updates of credit performance. This is important because rates, optionality and credit can change dramatically. Without a model, how are you going to know that the risk to furniture stores, title companies, office buildings and retail centers is increasing; while credit risk to apartment buildings, dentists and home owners associations are decreasing? The reality is no two loans are alike. Although one may have a NIM of 3% and another of 1.5%, on a risk-adjusted basis that 1.5% loan may be a more profitable investment (taking into account the potential defaults in the future). This is why banks need a model to gain more clarity.

An interesting observation we have made over the past year is how much our model has become a training tool for lending officers. Inevitably, instruction on the model becomes a training session on how to enhance the profitability of loans. Increasing maturities, requiring deposits or moving to a hybrid fixed/floating structure can all be ways to increase risk-adjusted ROE. With more than 13mm variations to a typical loan's structure, there is simply no way a loan officer can calculate value without a model.

As the Fed cuts rates, curtailing prepayments is on every loan officer's mind. For example, take a fixed rate CRE loan of 6.75% with a 10Y term and a 25Y amortization. This loan structured without prepayment protection has an expected life of less than 4Ys and delivers a risk-adjusted ROE of less than 5%. By simply adding prepayment protection (such as using a yield maintenance provision), the expected repayment term extends to 7Ys and the new risk-adjusted ROE is 24%. This makes sense, as the amount of cashflow from that loan has more than doubled and the cost of originating the loan remains the same. Commercial borrowers prepay when they have excess funds in order to optimize capital structure and reduce financing costs. Prepayment value in C&I loans reflects the option value depending on the market conditions, borrower's creditworthiness and the need to change capital structure and reduce costs. Understanding the value of duration, fees, prepayment penalties, deposits and costs allows for better negotiation with borrowers. Leveraging our consulting group's expertise and data gathering, the model also has a unique feature that assigns indirect and direct costs for originating and maintaining loans.

Basel II compliant, the model employs a risk-based approach to assigning capital. An ideal platform to ensure consistency throughout your organization, the model allows users to have a common set of criteria for assessing the relative value of one loan to the next. Changes to an area's population, income, property values, rents, supply, FICO scores and industry risk are all taken into account within the model to provide the market's best estimation of the probability of default and potential loss for each loan.

Now that you have set a loan budget for 2008, you need a pricing model to give you the vision on how best to achieve your goals. The model comes with a contract that is cancellable at any time, offers unlimited use and can give a bank the forward looking view it needs to see what other bank's don't.

BANK NEWS

M&A

Four Oaks Fincorp ($683mm, NC) will acquire LongLeaf Community Bank ($57.6mm, NC) for about $13.4mm, or roughly 1.6x book.

Writedowns & Cuts

Washington Mutual is reporting it will write down the value of its mortgage unit by $1.6B and lay off 6% of its employees, as deteriorating credit conditions continue to take a toll. The company also slashed its dividend to 15 cents a share from the current 56 cents, a move estimated to save WAMU $1.4B.

More Expensive

FNMA has increased the fee it charges to guarantee mortgages it purchases by 0.25%, as the company tries to compensate for increased risk.

2008 Economy

The latest survey of Wall Street economists' projects 4Q GDP will slide to 1% as housing continues to negatively impact the economy. In 2008, meanwhile, consumer spending is projected to see its slowest pace in 17Ys, GDP is projected at 2.3% for the upcoming year and inflation is expected to drop slightly to 1.8%.

Expensive Security

A study finds the average cost of data breach incidents in the financial services industry climbed 21% this year to $239 per compromised customer record. By area, 49% were caused by a lost laptop and 40% by third parties.