THE 3RD DIMENSION OF LOAN PRICING

by Steve Brown

When it comes to loan pricing, what everyone learned about supply and demand in school needs some refinement. While it is true that as a bank increases its loan spreads, demand to borrow from that bank decreases, what is not factored into such an action is risk-adjusted return. Unlike other consumer products, where setting price is merely a function of understanding price and volume sensitivities, lending has another component - credit.

When banks increase pricing, creditworthy borrowers of superior quality have another option to paying a higher rate - go elsewhere. Borrowers that are less creditworthy and have fewer borrowing alternatives have fewer options, so they end up staying with the bank. Over time, banks that increase loan pricing to customers may suffer from this "negative selection" process and end up with more borrowers carrying higher default rates. Recent credit performance in the residential mortgage market, residential construction market and even the SBA arena all indicate banks may have poorly priced risk. Conversely, banks that tend to be more aggressive on price, tend to attract customers that exhibit lower probabilities of default and lower loss given defaults.

Let's take an example. If your bank originates 100 loans for $1mm each at 6.0% and 2 of them default, then your default rate is 2%. If you assume a 50% recovery rate for any loan that defaults, then a bank would roughly have a risk-adjusted return on equity of approximately 7%. If a bank raises its rate on these loans to 7.0%, our analysis finds the average community bank will probably only originate 80 loans, of which 2.5% will go into default. Further, loss given default on those loans will go to 60% due to higher LTVs and lower guarantor FICO. This pushes the risk-adjusted return on equity down to 1.5%.

As you can see, loan profitability is often counter intuitive. This is a real world example of a Chicago-based bank that believed they were increasing profitability by raising loan pricing. The reality is - the opposite occurred.

The solution to this problem is to do 3 things. First, get a risk-adjusted loan pricing model so you can have a feel for how volume, price, default and loss given default affect profitability. Without one, it is impossible to gauge how price, size, maturity, business line, collateral, amortization, fees and prepayment penalties all interact. For one bank using the model, increasing loan department profitability was merely a function of reducing pricing and going after larger loans (over $1mm). Further, loan profitability is not just about price. Extending maturities, instituting prepayment penalties and focusing on cash flow as opposed to collateral, will allow many banks to decrease their credit spreads while still maintaining highly profitable loans.

Second, get more granular in pricing so that risk and return are more closely aligned. By having just 2 or 3 pricing categories, banks run the risk of skewing the mix to higher priced, but lower credit quality loans. On this front, we recommend doing away with pricing categories entirely and pricing all loans to a specific risk-adjusted ROE. This gives banks a near-perfect correlation in risk and return and an unlimited amount of pricing buckets. If you want to stick with specific pricing categories, then depending on your market, most community banks do nicely with 5 to 10.

Finally, management and staff need to be trained on how to track, monitor and adjust loan pricing so that demand and credit can be better understood and used for future pricing decisions. Each market faces a variety of competitors and it is important to understand how they are pricing to come up with a strategy.

Loan pricing is one of the most complex endeavors that a community bank undertakes each day and most won't get it right all the time. However, by having a better appreciation for how price, volume and the 3rd dimension of credit interplay, banks can be directionally right more often than not.

BANK NEWS

Jobs Pain

HR firm, Challenger, Gray & Christmas reported businesses announced 19% higher job cuts in January than the same period last year. Meanwhile, the number of planned layoffs jumped 69% over the prior month.

Debit Card Promotion

Sovereign Bank introduces their debit card promotions. Retail customers that use their card 6x within the next 60 days will receive $50 in gas coupons. Businesses that use their card 6x will receive gas credit for $200. The move is design to change behavior by getting customers to start using their debit cards.

Bank Stocks

The KBW Index of the 24 largest U.S. banks and thrifts fell 25% in 2007. Meanwhile, the S&P 500 banking sector index fell 20% last year.

Interesting

Analysts say HSBC may have interest in buying French bank Societe Generale. It is reportedly attractive to the French government and if it were to occur, it would create the world's largest bank.

Expected Now

A prominent equity analyst said he expects banks will cut dividends further in 2008, as they deal with writedowns and the need to increase loan loss reserves.