COST OF PRODUCTION

by Steve Brown

Essentially, a bank is a manufacturer of credit and financial services. Like a manufacturer of computers, cars or the iconic iPhone, a bank must take into account its cost of inputs, both direct and indirect. Instead of electronics and polymers, a bank uses credit and documentation as raw materials. To stay in business, a bank must understand the true cost of its product. It must also be able to mark it up in order to produce a certain return above its cost of capital to compensate investors for the appropriate amount of risk. Top performing banks understand what the cost is to produce a dollar of credit. It is no surprise that many banks inefficiently price their product causing them to take a loss on some product and miss out on revenue for others.

If you are a user of the latest release of our Loan Pricing Model, you already have access to the most recent loan origination cost data that the industry has to offer (just updated last month). If you utilize our Relationship Profitability model, you know exactly what your allocated costs are. If however, you are not a user of either of these two models, then we can at least help you approximate your cost of loan origination.

By thinking in terms of credit manufacturing, banks can see why the old concept of match funding can get you into trouble. Funding is just another input and is fungible. This input should no more be matched up with a particular loan than labor, electricity or rent should. All inputs, from that first dollar of a DDA balance to the next FHLB advance, to the branch structure to the CEO's time need to be taken into account.

By way of example, take Apple's iPhone. Similar to funding for a bank, the largest single cost to the iPhone is the touch screen at around $35. It wouldn't make sense for Apple to just use the largest input as a basis for pricing, no more than it does for banks to just focus on their cost of funds to price loans.

For Apple, total direct materials add up to around $245. Indirect costs, such as marketing, overhead, breakage and liability adds another $87 per unit. Apple then prices the iPhone at $399 (for the 8GB version) and combined with its revenue share with AT&T, achieves a 30%+ margin.

We have seen many bank CFOs shrug their shoulders and argue that, "Hey, my branches are a fixed cost that we have to pay even if we don't make loans. Why figure them into loan pricing?" The answer is all sales have to pay for overhead; otherwise the bank is headed out of business - If not the next loan then what product do you allocate overhead cost to?

Since a bank is the sum of its parts, it must take all activities into account when pricing its goods and services. Banks can start with their FASB 91 loan cost data. This handles a majority of a loan's direct cost. For indirect charges, banks can approximate this amount by taking their effective cost of funds, a portion of the cost of their customer aggregation network (to include both branches and online effort) and add the correct allocation of overhead expenses. As a rule of thumb, a bank can estimate the cost of their network and overhead by applying a factor to their direct expenses from a multiple of 2.5 to about 4.0x. For example, a bank with a 65% efficiency ratio would multiply their direct expenses by almost 4 times. A bank with a 55% efficiency ratio, can multiply their direct expense by a factor of 3.

In dollar form, it costs the average bank around $25k to originate a commercial loan, $37k for construction and $7k for a consumer loan. To handle a new loan from an existing relationship (as in the financing of a different project), the cost is about 50% of the above dollar amounts. For renewals/extensions, the cost is about 15% of a new origination amount. If you are keeping score, these numbers have gone up by 6% so far in 2008, due to higher infrastructure costs.

The reality is banks need to take all costs and risks into account in order to properly price their goods and services. Banks that ignore loan acquisition costs and just look at the cost of a single input on the margin, will quickly find that they are mis-pricing their loans.

BANK NEWS

OCC Reg O Clarification

The OCC put out an interpretive letter on loans to borrowers that then subsequently become bank executive officers are grandfathered for existing loans with regard to Reg O compliance.

Rebate Checks

The first of the Stimulus rebate checks will hit community banks electronically today for an estimated $2mm in new balances.

Retirement Savings

A new WSJ/Harris poll finds that almost 25% of adults who are actively planning for retirement have prematurely tapped their retirement funds.