GETTING ON THE GREEN WITH LOAN PRICING

by Steve Brown

Two years ago the number one complaint that we received about our Loan Pricing Model was that it priced loans "too high" for the market. That was true at the time, as banks that used the model under a disciplined approach, missed out on originating a lot of loans. When bankers said "too high," what they really meant was too high, given the competition that doesn't use a loan pricing model. We were repeatedly asked what good the model was if a bank didn't book loans and let the competition take them away? The answer is that banks using the model would be in a better position today.

Banks that utilize their competition to price are similar to golfers that learn to play by looking at the person next to them. If she takes out a 5 iron, then you take out a 6 iron to be "better" - regardless of how you swing, where you are or where you are going. The reality is that every bank has a different cost structure and every loan has a certain amount of risk in it. The trick is trying to figure out how much risk.

Here is a real world example from just yesterday. A bank wanted to make a 5Y loan on an existing office building at a 7.0% fixed rate. That sounds pretty good from a "gut feel" standpoint given the current market. It sounded even better to those who have a basic pricing model and calculate return based on FAS 91 reserves and an 8.5% capital allocation. That is because doing so produced a discounted cash flow ROE of 15.3%. However, if you originated this loan, it will be like pulling out a pitching wedge to try and drive 200 yards - you may come up a little short.

You see, that loan costs something to originate. So, after one adds in fully-allocated costs (marketing, sales time, underwriting, etc.) the return drops to 13.9%. By allocating the true cost of capital, the return drops to 9.8%. If one actually looked up the risk for that property type in that zip code, it would become known that office rents are dropping. After taking into account that risk, the loan produces a risk and cost-adjusted ROE of only 5.3%. This is far below the 15.3% the bank thought they were going to get. In 2006, many banks produced a 15.0% return by under-pricing loans because there were no defaults. However, as defaults have now increased, those same banks are producing a 5.0% ROE or less.

The correct pricing of loans is the #1 thing banks can easily do to ensure profitability, as it accounts for almost 20.0% of return. Capital has become much too dear just to "guess" what a return is going to be. Many banks have gone out of business, or are going out of business, because they failed to properly take risk into account when pricing loans. Instead they guessed, won the loan and paid the price. In contrast, banks that stayed disciplined to risk-adjusted pricing produced controlled growth. They continue to be better off today then the competition.

A risk-adjusted loan pricing model like ours can pay for itself with a single loan. Pricing credit correctly is a major part of banking so why wouldn't you want the best information? If Tiger Woods came up short on every green, he would be out of a job in no time. Considering how inexpensive our loan pricing model is and that you can cancel the contract at any time, why wouldn't you want the power and knowledge? Trust us, the course has only gotten longer, the wind has kicked up and the rough has grown. E-mail us back and we will get you on a trial, so you can see how a risk-adjusted loan pricing model can help your future.

BANK NEWS

TARP Repay

The Fed announced that it is in receipt of capital plans for 10 of the 19 financial institutions that underwent the Gov't required stress testing and will announce which ones may repay the TARP.

Still A Problem

The number of unsold homes on the market nationally at the end of Apr increased 9% from the prior month to about 4mm. That is about a 10 month supply at the current sales pace or more than double levels more typical of economic expansion (about 4 months).

Commercial Lending

This sector overall fell 24% in 2008 compared to 2007; however the portion controlled by banks dropped only 11%.

Default Risk

A recent analysis by Fitch projects about 70% of modified subprime loans will become delinquent within 12 months after begin modified. Even loans where principal amounts were decreased by more than 20% saw re-default rates as high as 40% after 12 months.

Credit Cards

Consumer borrowings dropped $15.7B or 7.4% in April following a $16.6B or 7.8% fall in March, the largest declines since 1990.

Room To Improve

A survey by IBM found 74% of bank customers felt the marketing materials their banks send them were irrelevant to the products they used or the financial decisions they made.

Rising Commerical Risk

A recent study finds the number of commercial borrowers at least 30 days late on their payments has soared 400% over the past 12 months. As of the 1Q, delinquencies on commercial and apartment loans have climbed to 1.85%, the highest level since 2001.