DRIVING ALLOCATIONS WITH LOAN PRICING

by Steve Brown

We had lots of good comments on loan pricing from yesterday's newsletter. One area that has a common misperception among community banks is the fact that loans should have the same risk-adjusted return. On the surface, this makes some sense, as if you are trying to achieve a 10% ROE for the bank, then all lending should average above some number that gets the bank a 10% all-in return. Depending on how your bank is structured, this number would usually be somewhere around 13%, but could range from a low of 7% to a high of 20%, depending on the structure of deposits, fee income and operational cost.

However, to require all loans to produce a 10% risk-adjusted return, robs management of a valuable tool to drive profitability - namely, allocation. Of all the strategic decisions a bank makes, one of the most important is loan mix. This single factor accounts for 16% of a bank's ROE and can be the difference between success and failure. While the optimal mix varies according to a number of factors including risk, risk tolerance, return and environment; getting loan allocations in the right ballpark is important.

One way to do this is to set volume limits. To do this, you set and communicate a goal that you want, say $10mm of C&I loans and $3mm of CRE for the month. However, this method proves inefficient for the same reasons why most communist economies don't work - trying to second guess the market is difficult. A better way is to let market forces dictate allocations, but in a controlled manner.

Bank management can set underwriting standards or price hurdles. For example, to add more diversity, banks may decide to increase C&I lending. In addition to adding loan officers or increasing marketing in this area, a bank can raise pricing, increase credit or some combination thereof. Requiring an 18% risk-adjusted hurdle for CRE and a 9% hurdle for C&I, will help change allocations over time. A risk-adjusted loan pricing model is the best way to do this, in order to ensure everyone is on the same page. A model gives banks a way to compare risk and credit across the board. In addition, it allows banks to unemotionally set definitive hurdles that all can understand.

Without a model, banks could still raise pricing, fees or require more deposits on CRE in order to shift allocations, but this is not optimal. This method, no matter how well intentioned, may result in more exposure, not less. While volume may decrease in CRE, just raising pricing may attract the less creditworthy part of the CRE segment so lower credit quality is adversely selected. Only by having a loan pricing model that allows the quantification of risk, are loan price changes effective.

Not having a risk-adjusted loan pricing model to guide your bank in one of its most important endeavors is like trying to drive a car without a steering wheel. You may get someplace, but it might not be where you want. To gain more control, e-mail us about our Loan Pricing Model and we will get you on a free trial.

BANK NEWS

Examination

The FDIC is inquiring into GMAC's newly formed bank (called Ally Bank) for "aggressive deposit-gathering strategies." When we say a bank shouldn't market on rate because it results in a rate sensitive customer base, check out Ally's website and then tell us what impression you are left with http://www.ally.com/index.html .

Taxpayer Ownership

The US Gov't will own 34% of Citigroup after Citi swaps common stock for preferred shares and converts preferred shares held by the Treasury into common stock. The changes would dilute the holdings of existing shareholders by about 76% and boost Citi's tangible common equity to $61B.

TARP Repay List

The following 10 banks have reportedly received Treasury and Fed approval to repay about $68B in TARP: American Express, Bank of New York Mellon, BB&T, Capital One, Goldman Sachs, JPMorgan, Morgan Stanley, Northern Trust, State Street and US Bank.

Banking Industry Stress

A new report from Moody's projects most banks will not be profitable in 2010 (due to loan losses, chargeoffs and ongoing industry stress). Moody's projected 34% of losses would come from credit cards, 26% from residential mortgages, 17% from commercial and 11% in C&I.

Hotel Softness

Analysis from Smith Travel Research through Apr finds the average daily room rate has fallen 10% over the past year, while revenue per available room (RevPAR) has fallen 20% over the same period.

Corporate Risk

S&P reports the number of issuers on its potential credit upgrade list has fallen to its 3rd lowest level on record.

Higher Savings Rates

As of Apr, the personal savings rate as a percentage of after-tax income climbed to 5.7%, up from 4.5% in Mar and significantly above the 0% level 1Y ago.

Gift Cards

US Bank issued its 30mmth gift card, making it the largest gift card issuer and a leader in prepaid cards.