RELATIONSHIP PROFITABILITY

by Steve Brown

It is possible employees in your bank are doing the exact opposite of what your shareholders want them to do. Take turning down loans because they have a low net margin as an example. As we have said in the past, margin and bank return are only slightly correlated. As such, turning down a low margin loan makes about as much sense as basing your lending decision on a coin toss. Before you turn down that 5% 10Y loan, consider the relationship that is attached to it. Then consider how well a sub-2.50% net interest margin loan has performed over the last 10Ys. It is likely those relationships not only had the best credit quality, but also generated above average deposits and fees. On the other side of the coin, wider margin loans that were booked may have looked good up front, but they were negatively adversely selected (creating credit problems), or had spreads that were above average (and were at risk of being refinanced away). In 2Q 2011, most of the refinancing we are seeing are loans with positive risk adjusted returns. These are being systematically refinanced by large and small banks alike - many of which use relationship profitability systems to better manage customers. Banks that put floors on high quality loans without prepayment penalties or some other relationship lock are risking customer refinancing.

This is another reason why we offer BIGProfit, an online relationship profitability system that allows community banks to see the risk-adjusted return of a relationship. If you don't have a relationship profitability system, we highly suggest you get one. Consider that for about the cost of less than 1 employee, it allows you to better manage relationship profitability and steer the bank in the direction you want. Is that 2.50% margin loan worth the risk or not? Without a relationship profitability system, you won't know how credit risk, optionality, deposits and fee income play into the risk-adjusted return. Contained within BIGProfit is a loan pricing model that looks at the historical performance of every community bank loan we can get our hands on, the entire 1.7mm SBA universe and the whole universe of publically reported commercial mortgages. This is more than 3mm loans that form the backbone of the model and help correlate key factors such as debt coverage, LTV, loan type, etc, to interest rates, optionality, cost to administer and credit. Our model devours data and forms statistical projections of the loan's probability of default and loss given default. Banks get a granular view into relationship profitability even down to the zip and NAICS code level. The model has also been validated by a 3rd party audit firm.

The results provide banks with a clear view into current and future profitability of account relationships. If that 2.5% margin loan is not profitable by itself, you can answer the question - what type of fee business, deposit balances or product usage is needed to make it profitable. Almost equally important is that BIGProfit gives managers retention strategies so above average return loans can be retained against the competition.

At the risk of being overly Machiavellian, without a profitability system, it is difficult to compete with a bank that has one. Large banks leverage their systems to poach the clients they want, while many community banks are just guessing about the overall relationship profitability. Given how hard loan growth is to come by these days, working profitability strategies is one of the few ways to achieve a high ROE. To find out more and see a demo of BIGProfit, email us and start counting more profitability coins.

BANK NEWS

Interchange

The Fed will issue its final ruling on debit card interchange next Wednesday that will take effect Jul 21.

Auditor Regulation

The PCAOB has issued a concept release that would require auditors to provide their discussion and analysis, identify high risk areas and indicate how the auditor addressed any risks surfaced. The release is intended to improve investor protections and comments are due Sep 30.

Regulatory Warning

The FDIC is warning banks to be careful about third party payment processor (TPPP) deposit relationships. A typical TPPP deposit customer of a bank uses its deposit account to process payments for its merchant clients. The TPPP receives lists of payments to be generated by the merchant clients for the payment of goods or services and initiates the payments by creating and depositing them into a transaction account at a financial institution. The FDIC warns banks to conduct strong due diligence and understand the risks of such accounts, an increase in activity from abusive telemarketers, deceptive online merchants and organizations that engage in high risk or illegal activities.

US Money Funds

Regulators are growing increasingly concerned about the amount of European bank debt owned by US money market funds. In aggregate, the funds hold about $1T worth of Eurozone financial paper and regulators are worried about the impact a Greek default could have.