Checking The Ingredients In Fritos & Loan Pricing

by Steve Brown

On the airplane not too long ago, we sat with a marketing supervisor for Frito Lay. We extolled our undying love for Frito Pie, that combination of chile, meat and cheese poured over a pile of Fritos and eaten with a spoon. In a time when "new and improved" often means added sugar or cheap ingredients, we were interested to learn that Fritos have not been "improved" since they were created in 1932. They still only have three ingredients, corn, oil and salt. Recently McDonalds made an effort to explain why its french fries have 19 ingredients and how each one improves the product. While we respect the difficulty McDonalds has in serving a consistent product for so many restaurants, we do wonder how something rather simple like a fried potato could have become so very complex.

Ingredients are important. Without the correct mix or when shortcut substitutes are used, the overall product is almost always diminished.

We got to thinking about the ingredients that go into pricing fixed rate loans. It seems like pricing fixed rate loans should be a no-brainer. Just see what the competition is doing, undercut that rate by a little to win the deal and you're done. Or add a little calculation taking into account the bank's cost of funds and any deposits the borrower may keep in the bank. While simplicity is good, we would recommend a more robust process than this.

To begin, some banks determine a fixed rate by adding a spread over a short term floating rate like 30 day Libor. The problem with doing so is that there is a duration mismatch when you use a short-term rate to determine long term rate targets. This is especially compounded in a very low rate environment like we are in now. One issue is that the fixed rate is almost always going to be too low.

Others use a spread over the bank's cost of funds. One problem here is that the duration mismatch comes up once again. Many banks will use a current cost of funds, again a short term metric, to determine a long term rate. This means the bank is not accounting for interest rate risk that comes with the mismatch. Again, this is especially true in the current environment of very low cost of funds with most deposits sitting in non-maturity deposits. The interest rate risk inherent in this scenario could exponentially increase the level of risk on the balance sheet.

Still others use a spread over Treasuries or FHLB Advances. The idea is to avoid a duration mismatch, so a bank uses a spread over longer term Treasury rates or FHLB advances rates. This is a little better, although pricing ignores the unique characteristics of these instruments that may or may not have anything to do with either your bank or your customer. Yet another risk of this approach is that many banks make the error of not pricing a loan using an index of appropriate duration. They do not take into account prepayment risk, expected life, amortization or even credit risk. This can skew results.

In the end, the safety and soundness of the bank depends on a pricing process more sophisticated than a competition survey or a cocktail napkin calculation. The best idea of all is to use a risk adjusted pricing model like PCBB's ProfitIntel, but if your bank hasn't made that step, or if the pricing model you are using does not take these metrics into account, then be sure to review your pricing strategy for completeness and to ascertain it will do the job in a changing interest rate environment.

The recipe for Fritos may not entirely offer a guide for pricing loans in that more than 3 ingredients probably need to be considered. One thing that does apply is that having the correct ingredients is very important.

BANK NEWS

M&A Activity

1) Achieva Credit Union ($1.2B, FL) will acquire Calusa Bank ($166mm, FL) for $23.2mm in cash. 2) The parent company of American State Bank ($746mm, IA) and American Bank ($280mm, IA) will acquire Community Bank ($42mm, IA) for an undisclosed sum. 3) Bank of the Ozarks ($6.8B, AR) will acquire Bank of the Carolinas ($386mm, NC) for $65mm in stock. 4) First Bank ($2.4B, TN) will acquire Northwest Georgia Bank ($282mm, GA) for an undisclosed sum.

BSA Fine

In the first of its kind, FinCEN hit digital currency exchanger Ripple Labs with a $700,000 fine for BSA violations. Ripple reportedly operated as an unregistered money service business for a time and did not comply with AML laws.

Mobile ATM

The Daily News reports a bank in Poland (Idea Bank) has rolled out a new service that lets people use an app to call a car with an ATM in it to their location. Kind of takes Uber and banking to a whole new level.

Tax Hikes

The Wall Street Journal reports about 12 states are considering significant tax increases for 2015, as they try to address ongoing financial challenges and refill coffers drained during the crisis.

Oil Pressure

The latest Fed Senior Loan Officer Opinion Survey finds banks expect delinquencies and charge-offs on loans to oil and natural gas companies to deteriorate somewhat in coming periods given lower prices.

M&A Difficulties

A Bank Director survey of executives & directors that asked respondents that had done an acquisition while they were on the board what the most difficult aspects of the most recent acquisition were found these among the highest: post merger integration (60%); assessing credit quality issues at the acquired institution (40%); negotiating the price (35%); cultural compatibility (34%); social issues (30%) and thorough due diligence (27%).