Risk-Based Pricing Can Boost Profitability

lending stress testing strategic planning

Summary: CFIs can lower their exposure while boosting their profitability by pricing commercial loans commensurate with the borrower's risk. We delve into the details of a risk-based pricing model.

Credit scoring of both businesses and consumers is a relatively new phenomenon in the five-millennia-long history of lending. In America's early years, consumer loans were unheard of, though businesses and farmers typically received funding not only for their operations or crops, but also for living expenses until their products were sold or harvested. Creditworthiness was determined largely by word-of-mouth: people well-regarded in society vouched for the financial character of their peers. Luckily for borrowers, credit ratings are based on much more concrete factors today.

In the modern era of commercial lending to small businesses, community financial institutions (CFIs) can limit their exposure and boost their profitability by implementing a risk-based pricing strategy. As we discussed in a previous article, risk-based pricing lets banks set individual loan rates that make sense for each borrower's particular history and circumstances. That includes favorable rates for borrowers with great credit and higher rates for those whose histories include losses or delinquencies.

The benefits of risk-based pricing. By charging a higher interest rate commensurate with the risk, CFIs will be able to more easily cover losses, should a high-risk borrower default on their loan. Riskier borrowers will likely appreciate being able to obtain a loan, particularly if they were earlier turned down by another institution. They'll also be keen for the chance to lower their risk profile by paying the loan back so they can qualify for better rates in the future.

When implementing a risk-based pricing strategy, CFIs should make sure their pricing structure for commercial loans "is granular and dynamic enough to truly capture the risk," says one industry consultant. Otherwise, some very creditworthy borrowers might pay more, while some less-qualified borrowers will get a deal not truly commensurate with their risk that could put the CFI in a very tough spot if they are delinquent.

Finding the right price. Risk-based pricing should be based on reliable algorithms that not only accurately measure creditworthiness, but also don't violate fair lending laws and other compliance requirements. Pricing strategies should also be backed up by robust monitoring systems so that profitability doesn't get eaten up by unnecessary underwriting and collection costs.

Additional parameters to determine appropriate pricing include debt-to-income ratios, business location, industry, and other key metrics — making sure any metrics comply with fair lending laws. For riskier borrowers or those just starting their businesses, CFIs should also determine the personal creditworthiness of the business owner and consider requiring personal guarantees. Also, be sure to consider lending-related costs such as origination, maintenance, expected loss, cost of funds, and taxes when calculating potential offers with this risk-based model.

Pricing strategies should not be based solely on credit risk — CFIs should also consider interest rate risk, particularly when considering making a long-term fixed-rate loan versus a variable-rate loan; as well as option risk if the borrower chooses to prepay a loan early or withdraw deposits early without penalties. Lastly, but perhaps most importantly, pricing strategies should consider the value of the entire relationship with the borrower who may partake in many products and services with your institution. If the overall relationship is highly profitable, then pricing on any one specific loan can be a little more flexible.

To protect your institution from exposure and increase profitability, your CFI can bury the single interest-rate model and use risk-based pricing for business customers. If you'd like to start using the risk-based pricing model, but aren't sure where to begin, we can help you. We have a customer profitability tool, which helps you determine the best loan price, based on the relationship. It is an important tool and getting started doesn't have to be complicated. Contact us today for a demo.

COMPETITIVE AND CONSISTENT LOAN PRICING

Achieve a 360-degree customer relationship view so you can determine the best loan pricing based on your customer data, while driving higher bank profitability. Learn more about our solution for customer profitability to give you that comprehensive perspective.

ECONOMY & RATES

Rates As Of: 09/16/2022 05:45AM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg
3M	3.22	0.26	3.16
6M	3.78	0.46	3.59
1Y	4.01	0.50	3.62
2Y	3.90	0.40	3.16
5Y	3.66	0.31	2.39
10Y	3.45	0.26	1.94
30Y	3.49	0.19	1.58

FF Market	FF Disc	IORB
2.33	2.50	2.40
SOFR	**Prime**	**OBFR**
2.28	5.50	2.32