NEVADA BANKERS ASSOCIATION

INVESTING IN NEVADA TOGETHER

NBA News and Information

August 2021

Three Key Areas Impacting Customer Profitability

As we return to normal, several factors are impacting our local and national economies, which will continue to affect bank profitability. By reviewing customer profitability regularly and comparing trends over time, you and your client-facing teams can respond to prospects faster with more rational pricing to win deals. To guide you with this review, we provide you with three key areas impacting customer profitability.

1. Credit costs
With more regulatory scrutiny on community banks' pricing decisions, community banks should remember the importance of a risk-adjusted approach to pricing. Even though your bank may not have much control over actual credit charges, with risk-adjusted pricing, you can help ensure your institution is appropriately compensated for the risk it is taking on.

Risk-adjusted pricing means that the credit risk perspective is included in your credit pricing decisions. In practice, a community bank can apply an expected loss rate when pricing a loan, based on its reserve rates or CECL rates, to capture the institution's history and expectations. If the community bank's actual loss history is minimal, as an alternative, a probability of default (PD) and loss given default (LGD) can be applied, based on various elements of the loan, the current environment, and industry values.

Most lenders intuitively consider sources for repayment in the event of default, when structuring a deal; however, not all consider the difference in pricing. Do you have a justifiable, objective price difference between a grade 4 with an operating account and a grade 2 without, given the same credit structure? Community banks should consider LGDs based on the type of collateral as well as the loan-to-value (LTV). Reassessing and updating LTVs can be costly, but performing this exercise on larger transactions and on weakening renewals allows you to better assess the risk of new deals and for the existing portfolio.

2. Noninterest expenses and noninterest income
Community banks have adopted digital services and a wider adoption is expected to continue. Although it is difficult to have much impact on overhead and office infrastructure in the short term, it may be time to analyze and address your office space needs for the long run. How and for what services offices are currently being used should be examined and compared with your customer trends. Changes to a community bank's physical infrastructure may involve difficult discussions with the board and staff, but the decisions made now could impact your institution's longevity and long-term profitability.

Looking at the fee side, community banks have made some improvements in generating fee income in the last couple of years. However, they still lag larger institutions in fee collection. For many, lower fees have been a client acquisition tool; designing, implementing, and collecting fees remains a tactic for most community banks this year. Fintechs have put a lot of competitive pressure on retail banking to reduce fees and transactional costs and the pandemic has only accelerated this trend.

3. Interest income

While consumer prices are rising, weak loan demand and excess liquidity have pushed many loan rates below 4%, with some banks offering sub-3% rates to retain their best customers, depending on the region. Comparing now to the Great Recession, the interest rate curve is flatter with excess balances at the Federal Reserve Bank earning 10bp versus 25 bp during the Great Recession. Rates are low, but for every loan officer pitching lower rates for their best customers, do they actually know who the bank's best customers are? Having objective data on client profitability helps compare loan officers' pricing strategies.

In a recent round table discussion on profitability, one CEO noted that using a profitability tool increased employees' general understanding of how banks make money, generating fewer exceptions, and greater company support for financial goals. Earning interest income is easier having the right tools.

As always, taking a holistic view of profitability and pricing can provide flexibility to compete for the business. A holistic perspective will include looking at all loans, deposits, and all other services the customer has with your institution. This especially helps when your institution cannot compete on interest rate alone.

To continue this discussion on profitability or for more information, contact Jay Kenney.

Jay Kenney
SVP & Southwest Regional Manager for PCBB | pcbb.com | jkenney@pcbb.com

Dedicated to serving the needs of community banks, PCBB's comprehensive and robust set of solutions includes cash management, international services, lending solutions, and risk management advisory services