Rate Reductions And Profitability

lending performance customer profitability

Summary: While financial institutions usually focus on new customers to enhance profitability, overall profitability is a multi-dimensional process and existing customers can definitely help too.

It has been said that each American will eat about 6,000 pizza slices throughout their life. We love pizza, so that number seems low. That is also good news for pizzerias and the community financial institutions (CFIs) that serve them, as this love will keep many of these businesses profitable. Speaking of profitable, our focus is on customer profitability today.

When it comes to profitability, the emphasis is often on new deals and new clients. This makes sense in one way, especially for relationship managers/loan officers. However, overall profitability is a multi-dimensional process, and existing customers are eager to do more things with you too. In short, you have to focus on new deals, new clients and on existing ones to truly maximize your opportunities. Our profitability discussion today is one that is less common - loan modifications.

Now that rates have declined and seem stuck at pretty low levels, it provides opportunity to reduce your risk. Many non-stressed borrowers have asked for modifications to their existing loans and doing so can lock in that customer for a longer period of time. That keeps competitive wolves at bay and gives your team more time to cross sell additional services. Some customers are looking for reduced interest rates, some for extending repayment terms. But, rest assured, nearly all customers are either actively or passively looking at options with other institutions.

So how do you manage these requests and still remain profitable? First, review the current profitability of the customer and where they rank in comparison to the rest of your customers.

If the customer is just barely profitable on a risk-adjusted return basis, there may not be much room for movement in pricing. Would the risk-adjusted return on the credit with the modification still fair better than securities though? Also, while pricing out these adjustments, remember to put some fees on the table. You might give up a little margin on the rate reduction, but that doesn't mean you can't offset part of that.

If the customer is a highly profitable one, making some concessions may be reasonable to maintain that relationship. In regards to the acceptable risk-adjusted return hurdle, keep in mind the alternatives. Looking at the market today, loan rates have fallen, but deposit rates have only moved slowly. If margins on new deals are tighter, it may be reasonable to adjust that ROE hurdle to keep a profitable and strong credit on the books.

When looking at modifications, there are also certainly the other kind that surface related to borrower financial stress. These are normally discussions for the credit team, but how you manage these customers also impacts profitability. It would be a good exercise to stress cash flows and susceptible markets within the portfolio and identify any at-risk borrowers. Could a modification now be beneficial to stabilizing that credit and maintaining cash flow and profitability well into the future?

In this low rate environment, maintaining returns will require a multi-dimensional approach. Reviewing your customer profitability regularly will ensure that you are ready for these conversations both with the customer and your credit and lending teams.

WEBINAR: GENERATING UPFRONT FEE INCOME THROUGH HEDGING

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