

Pricing Loans In Uncertain Economic and Regulatory Environments: A Live Webinar

Presented by Austin Associates, LLC

Presenters:

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Principal

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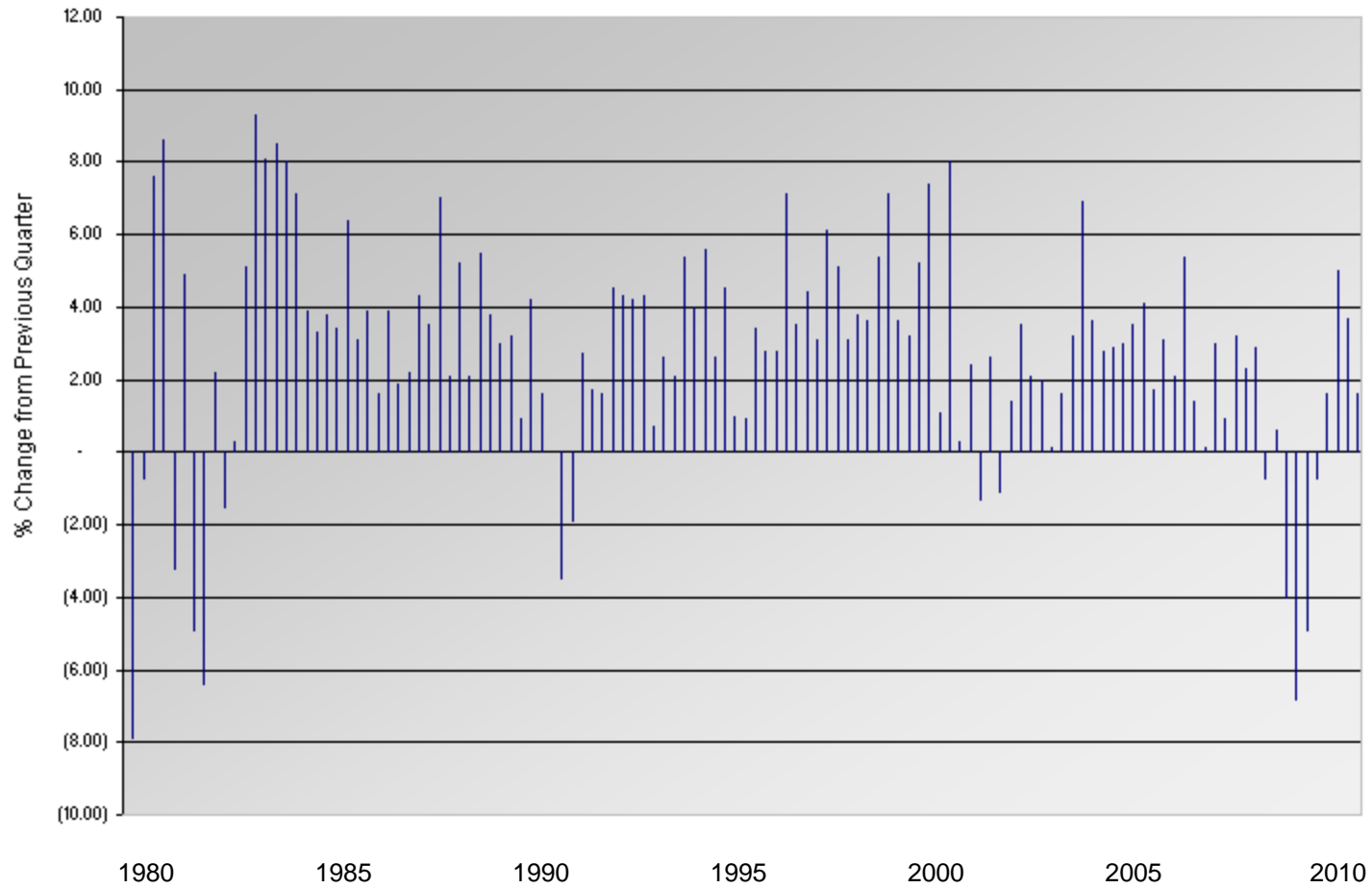
Principal

September 29, 2010



Economic Environment

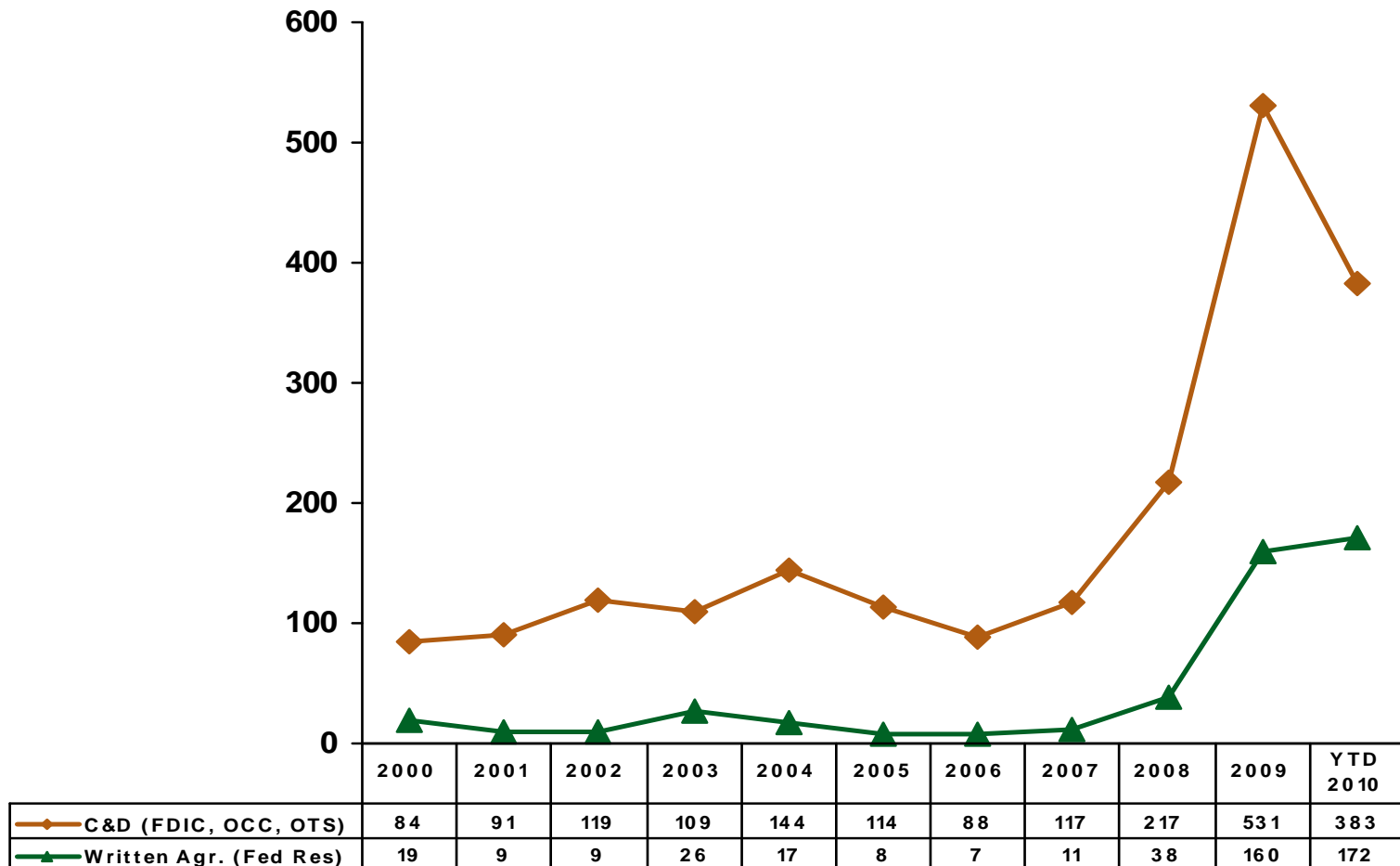
Change in Real GDP



Source: Bureau of Economic Analysis

Regulatory Enforcement Actions

C&D Orders & Written Agreements Issued by the FDIC, OCC, OTS & Federal Reserve



Note: YTD 2010 through September 23, 2010. Number of C&D Orders based on the most recent data as provided by each regulatory agency. Totals shown do not net out those orders which were terminated or modified.

Regulatory Environment

Example Language in MOU's, C&D Orders, etc.

“Within 60 days...submit...a written plan...to strengthen board oversight of management...to improve...control over...credit risk management...”

“The plan shall include...the responsibilities of the board of directors to establish appropriate risk tolerance guidelines and risk limits;”

“The program shall...address...standards and criteria for assessing the credit quality of loans, including a discussion of the factors used to assign appropriate risk grades to loans;”

“Operating with inadequate risk management systems for the level and complexity of the bank’s risk profile. Operating with inadequate net interest margins.”

Pricing Loans Profitably

- Key factors that determine loan profitability
 - Pricing loans on a risk-adjusted basis
 - Allocating appropriate levels of capital
 - Determining proper ROE hurdle rates
- Impact of other loan, deposit and fee-based products
- Implementing structured pricing policies

Key within
current
regulatory
environment

Pricing Loans Profitably

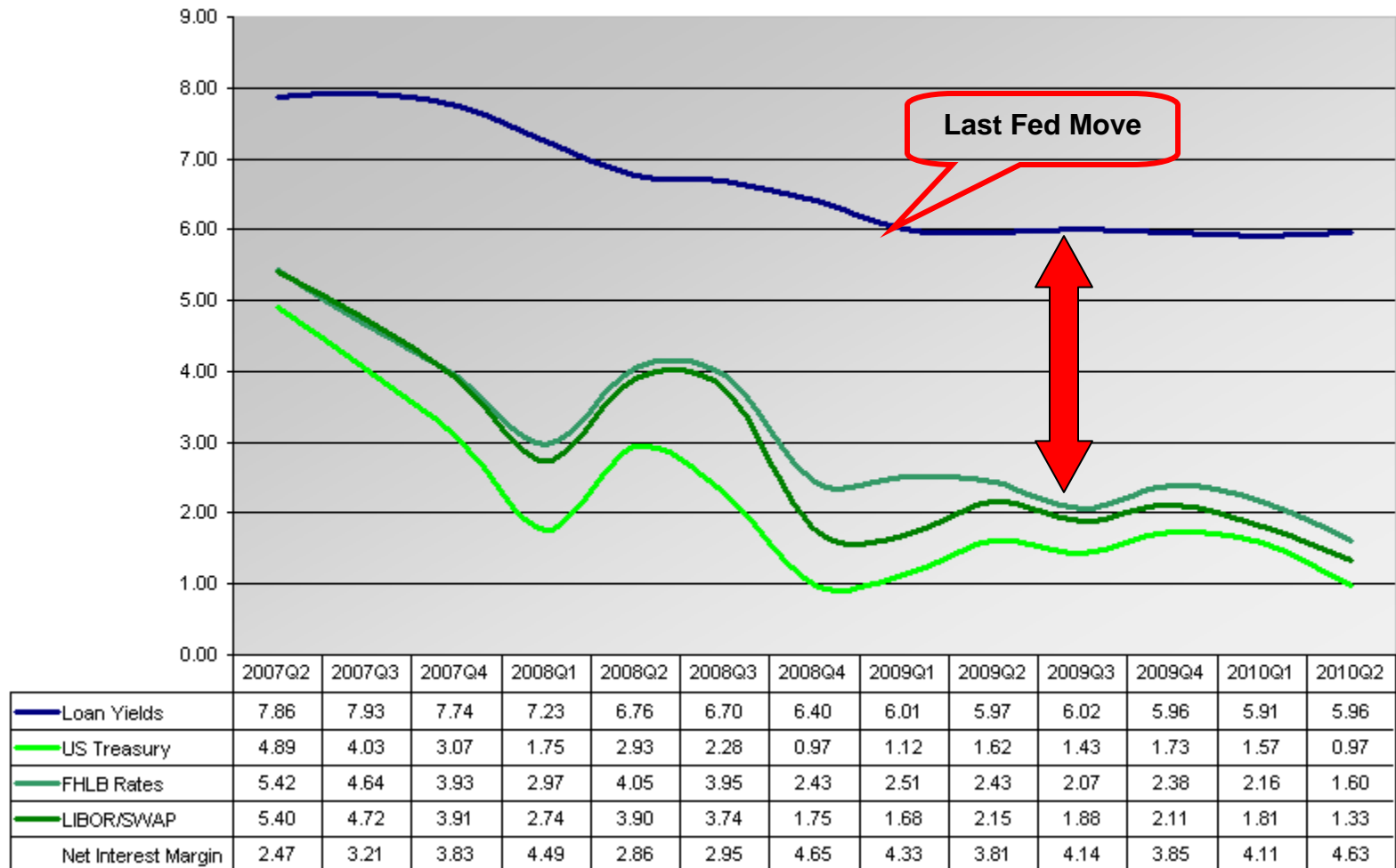
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Determining Loan Profitability

- Net Interest Margin
- Provision Expense Allocation
- Capital Allocation
- Operating Cost Allocation
- Loan Size

Determining Loan Profitability

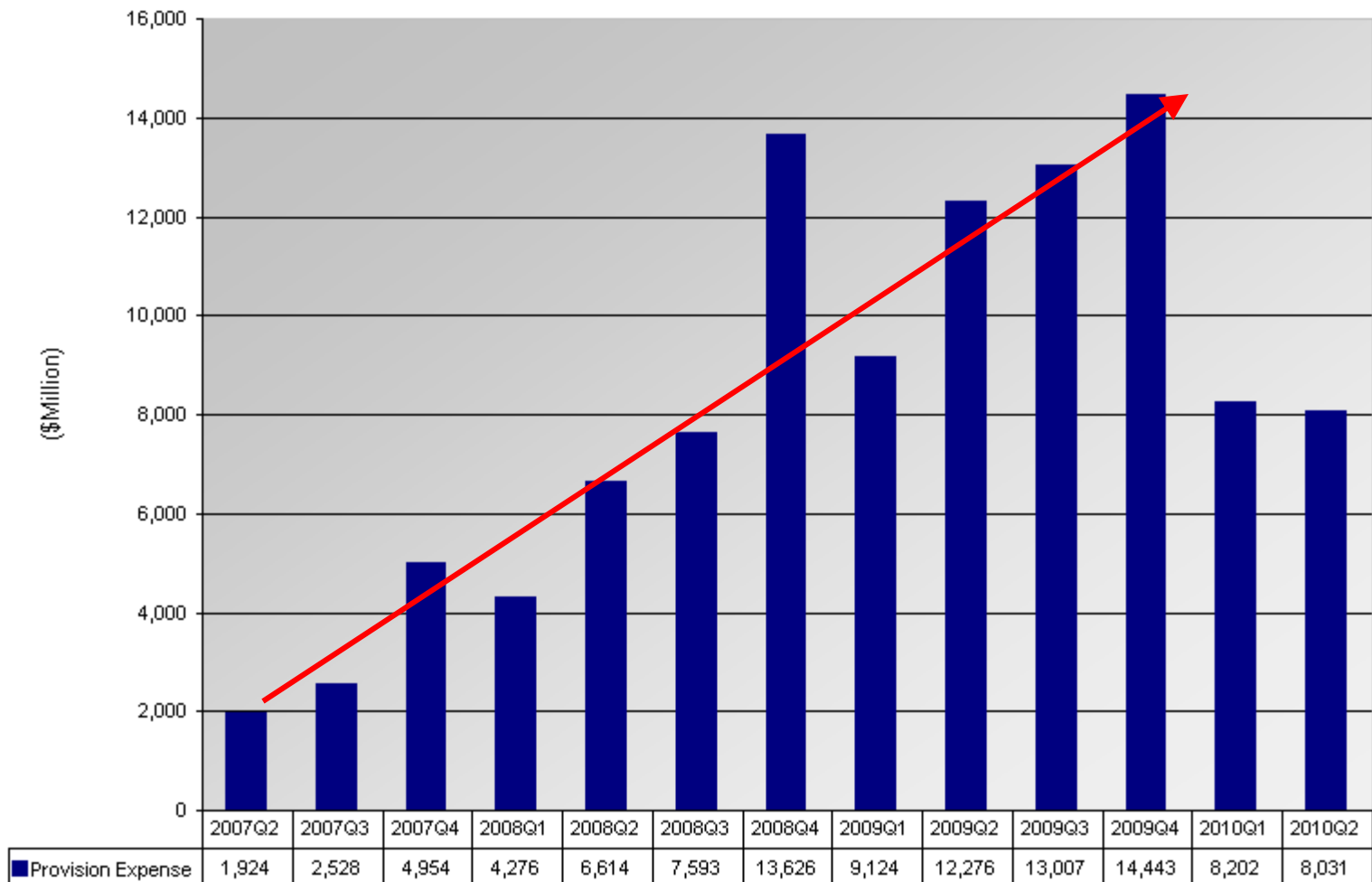
Loan Net Interest Margin



*Assumes 3 year average cost of funding

Determining Loan Profitability

Total Provision for Loan Loss



Source: SNL Financial

Note: Aggregate for all US banks < \$10B in assets

Determining Loan Profitability

Net Charge Offs / Total Loans

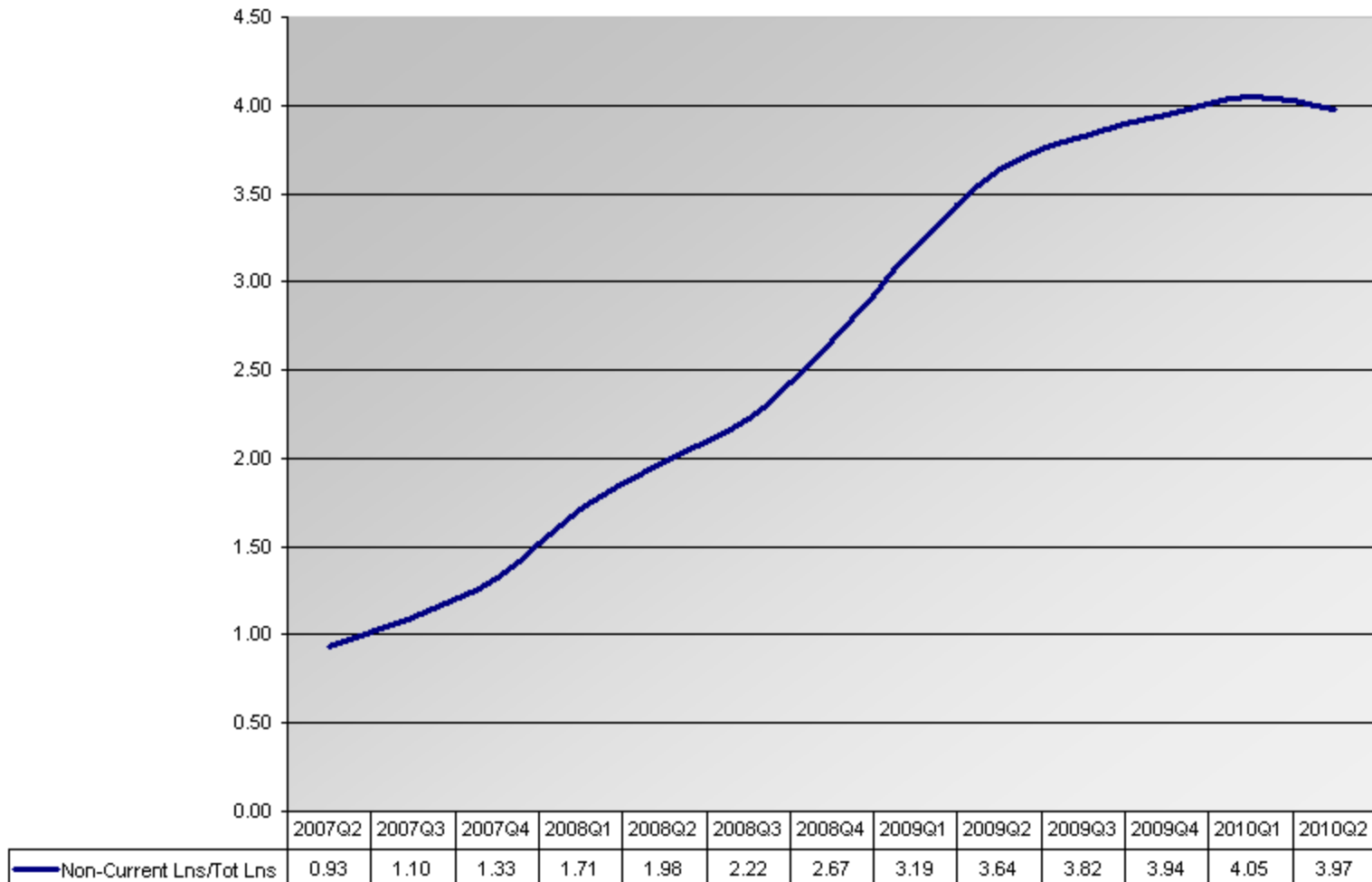


Source: SNL Financial

Note: Aggregate for all US banks < \$10B in assets

Determining Loan Profitability

(90 Day Past Due + Non-Accrual) / Total Loans

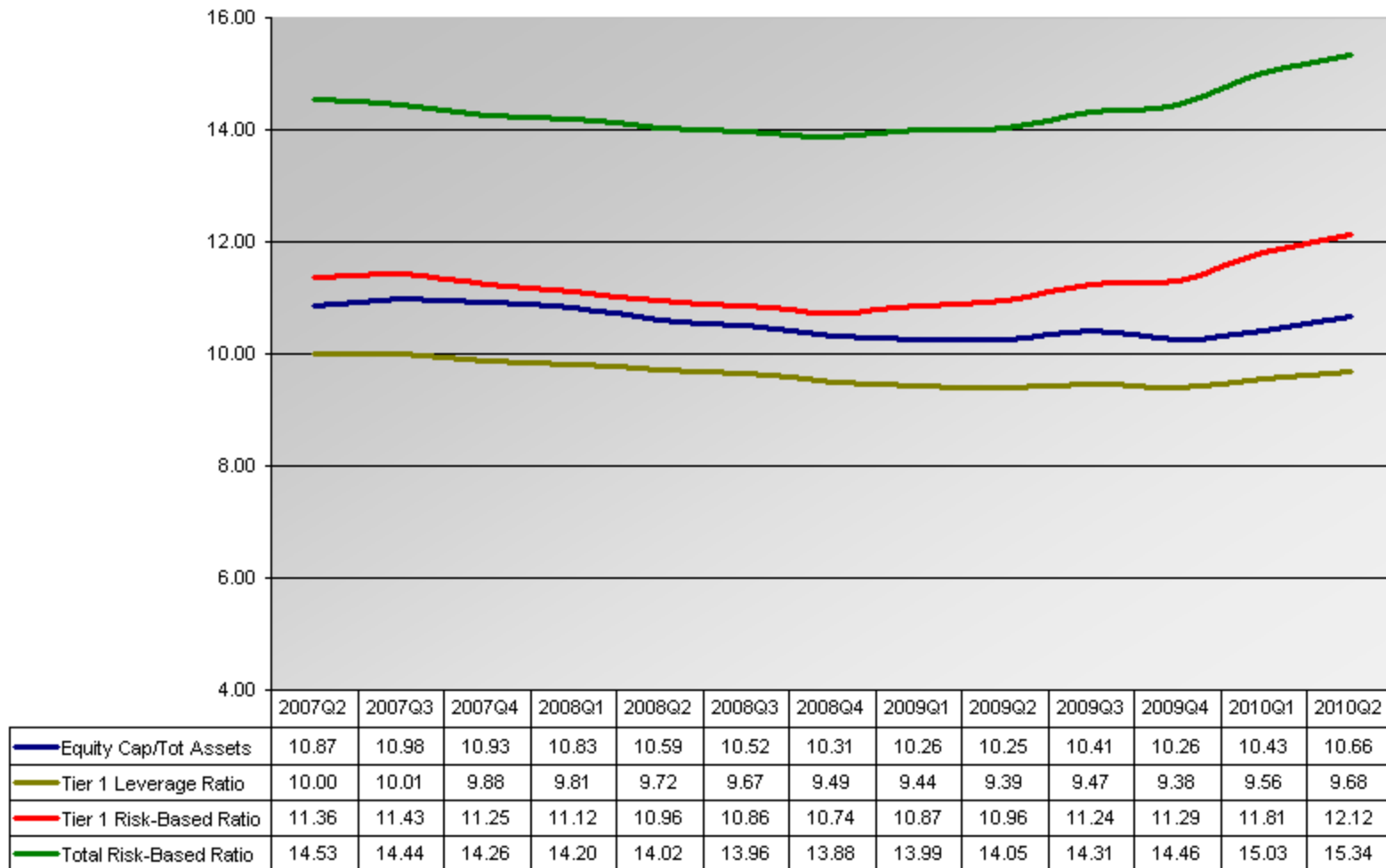


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Determining Loan Profitability

Capital Ratios

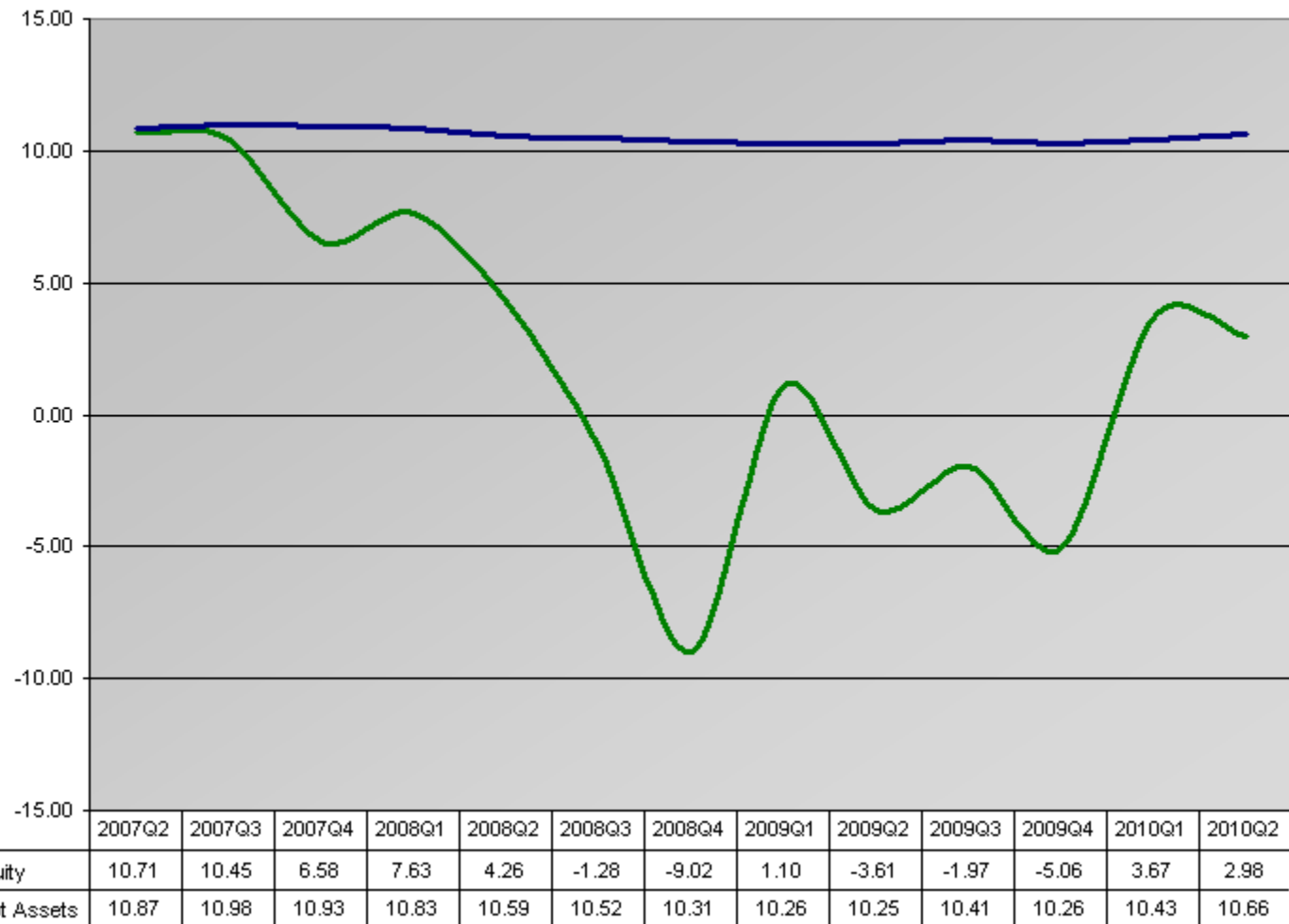


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Determining Loan Profitability

ROE Versus Bank Capital

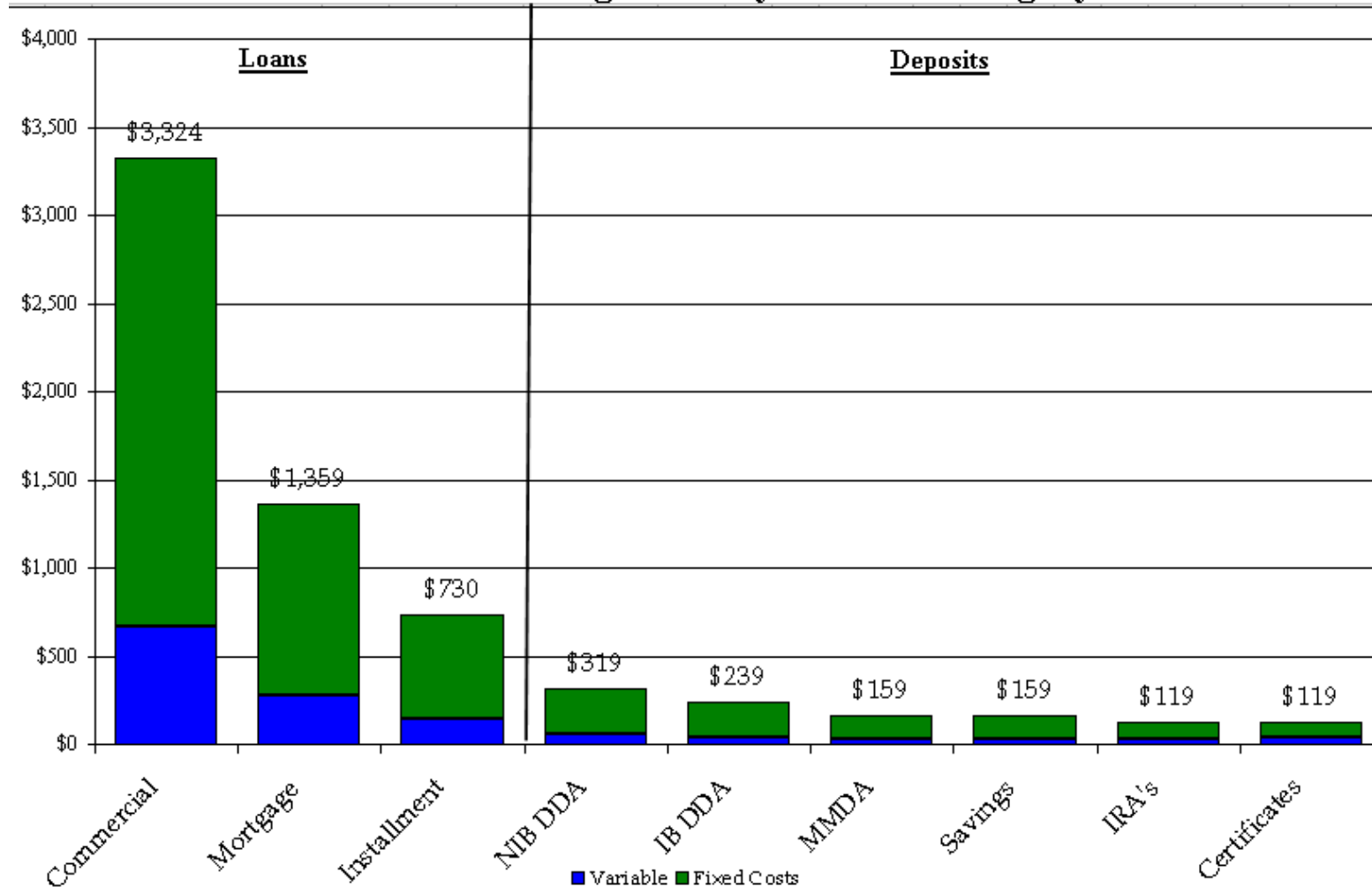


Source: SNL Financial

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Determining Loan Profitability

Annualized Average Cost By Product Category



Determining Loan Profitability

Sample Loan Income Statement

	Total (\$)	Loan ROA (%)	
Avg Bal \$489,982.08			
Interest Income	\$26,949.01	5.50%	
<u>Interest Expense</u>	<u>\$5,438.80</u>	<u>1.11%</u>	
Net Interest Income	\$21,510.21	4.39%	
<u>Provision for Loan Loss</u>	<u>\$5,000.00</u>	<u>1.02%</u>	
Net Int Income after PFL	\$16,510.21	3.37%	
Non-Interest Income	\$0.00	0.00%	
<u>Variable Expense</u>	<u>\$795.37</u>	<u>0.16%</u>	
Operating Margin	\$15,714.84	3.21%	
<u>Fixed Expense</u>	<u>\$860.28</u>	<u>0.18%</u>	
Net Income before Taxes	\$14,854.56	3.03%	
<u>Taxes</u>	<u>\$5,050.55</u>	<u>1.03%</u>	
Net Income	\$9,804.01	2.00%	ROE 20.01%

Pricing Loans Profitably

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Risk Adjusted Pricing

STEP 1

- Determine normalized level of provision expense for each loan product
 - Factors that affect normalized levels:
 - Historical charge-offs and recoveries
 - Change in specifically allocated reserves (FAS 114)
 - General reserve allocations by loan category (FAS 5)
 - Loss Given Default (LGD)

Risk Adjusted Pricing

STEP 2

- Apply factor(s) to adjust normalized provision expense up or down based on:
 - Credit grade of borrower
 - Underlying collateral on requested loan
 - Industry Sector of Borrower
 - Loan to Value Ratio

Risk Adjusted Pricing

Example:

Step 1 – Commercial RE with normalized allocation of 1%

Loan Product Selection

Commercial Retail

COMMERCIAL - REAL ESTATE LOAN

Loan Parameters

Loan Structure

Loan Amount (\$) \$1,000,000.00

Fixed Rate (%) 6.000

Fixed Term 36

Adj Rate (%)

Reprice Frequency

Convert After:

Amort Per/Term 180

Loan Fees (Non-Interest Income)

Provision, Credit Quality, Funding Cost

	%	\$	Frequency
Loan Loss Provision	1.000	10000.00	Up-Front
Credit Quality	SATISFACTORY-MONITORED (4)		

Risk Adjusted Pricing

Example:

Step 2 – Apply credit factor(s)

Select a Product

GRADE	DESCRIPTION	FACTOR
1	EXCELLENT (1)	0.25
2	GOOD (2)	0.75
3	SATISFACTORY (3)	1.00
4	SATISFACTORY-MONITORED (4)	1.50
5	SPECIAL MENTION (5)	5.00
6	SUBSTANDARD (6)	15.00
7	DOUBTFUL (7)	55.00
8	LOSS (8)	100.00

Resulting provision expense allocation

(Loan amount) x (normalized pfl) x (credit factor) = total pfl

Grade 3 (\$1,000,000) x (1.00%) x (1.00) = \$10,000

Grade 4 (\$1,000,000) x (1.00%) x (1.50) = \$15,000

Risk Adjusted Pricing

Effects of Credit Grade on Loan Yield

	Loan amount	Loan Yield	Yearly Profit	ROE%
Grade 3	\$1,000,000	5.00%	~\$19,500	19.50%
Grade 4	\$1,000,000	5.20%	~\$19,500	19.50%

The Grade 4 Loan is charged a higher provision expense, thus it requires 20 bps more in yield to achieve the same ROE as the Grade 3 Loan.

Risk Adjusted Pricing

Determine yield adjustment required

	Yield Adjustment	Loan Yield
Grade 1 vs. Grade 3	-15 bps	4.85%
Grade 2 vs. Grade 3	-10 bps	4.90%
Grade 3	-----	5.00%
Grade 4 vs. Grade 3	+20 bps	5.20%
Grade 5 vs. Grade 3	+50 bps	5.50%
Grade 6 vs. Grade 3	+100 bps	6.00%

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Proper Capital Allocation

STEP 1

- Starting point for allocating capital to products
 - Understand current bank capital ratios
 - Allocate capital to products based on risk weighting
 - Example: bank has a current book capital/asset ratio of 10%

Product	Risk Weighting	Capital Allocation
Commercial Loan	100%	+/-10%
1-4 Family RE	50%	+/-5%
DDA Account	N/A	+/-2%

Proper Capital Allocation

STEP 2

- Adjust starting capital allocations based on:
 - Credit grade of borrower
 - Underlying collateral on requested loan
 - Loan to Value ratios

Important: Total allocated capital to all products on both sides of the balance sheet should EQUAL and not exceed the bank's total capital levels.

Proper Capital Allocation

Example Allocation Table

PRODUCT CODE	DESCRIPTION	ALLOCATION
1101	TERM LOAN	10.00%
1102	LINE OF CREDIT	10.00%
1103	FINANCIAL LETTER OF CREDIT	5.00%
1104	CONSTRUCTION ONLY	10.00%
1105	CONSTRUCTION TO PERM	10.00%
1201	OWNER OCCUPIED 1-4	5.00%
1301	CONSUMER - TERM	10.00%
3101	BUSINESS CHECKING	2.00%
3102	BUSINESS MMDA	2.00%
3103	BUSINESS NOW	2.00%
4101	STATEMENT SAVINGS	2.00%
5101	COD COMMERCIAL	2.00%

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Setting Profitability Targets

The best way to set a target is to first analyze where you're currently at.

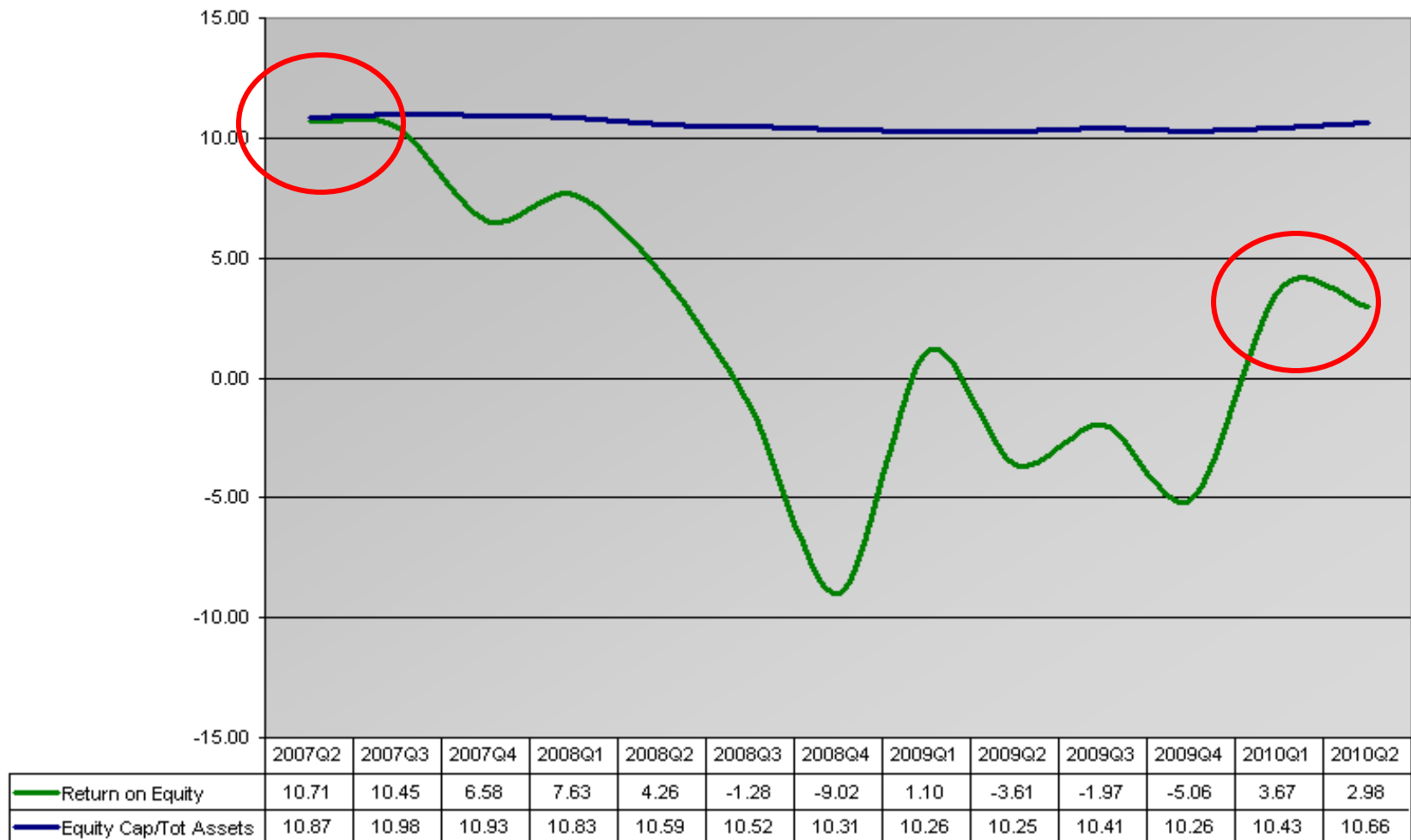
Product Profitability – The Process

- Gather detailed extract data from the core system
- Determine the profitability of each product by:
 - Applying a funds transfer pricing mechanism
 - Allocating provision expenses, fee income, expenses, and capital

At the end of the process you should know the current ROE for loan, deposit and treasury products.

Setting Profitability Targets

ROE Versus Bank Capital



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Bringing it all together

Once the underlying assumptions and targets are determined, they can be applied in your loan and relationship pricing practices

Disadvantages of analyzing new loans on a stand alone basis:

- Often times can't meet the bank's hurdle rates
- Lenders can't be competitive because they need to quote an above market rate to meet the bank's target
- Lenders are taught to only bring new loans to the bank without recognizing the potential value of the complete relationship

Bringing it all together

Advantages of analyzing the complete relationship:

- Teaches lenders to be more relationship driven
- Allows lenders to be more competitive on new loans because of the value of the potential and existing other business
- Allows the bank to adopt a structured pricing approach for both loans and deposits

Example: Bank target is 20% ROE

- Two scenarios
 - \$1,000,000 loan @ 5.25% fixed for 3 years and no deposits
 - \$1,000,000 loan @ 5.00% fixed for 3 years w/ DDA account

Bringing it all together

Results: 20% ROE target

Loan only – doesn't meet target

	Average Balance	Profit	ROE %
Loan 1	\$979,552.45	\$19,072.56	19.47%
Loan 2	\$0.00	\$0.00	0.00%
Loan 3	\$0.00	\$0.00	0.00%
Others	\$0.00	\$0.00	0.00%
Total	\$979,552.45	\$19,072.56	19.47%

Loan at lower rate with deposit – exceeds target

	Average Balance	Profit	ROE %
Loan 1	\$979,134.53	\$17,445.57	17.82%
Loan 2	\$0.00	\$0.00	0.00%
Loan 3	\$0.00	\$0.00	0.00%
Others	\$100,000.00	\$3,085.25	154.26%
Total	\$1,079,134.53	\$20,530.82	20.55%

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Structured Pricing Policies

Why consider adopting a pricing model

- Instills a structured relationship based pricing approach within your organization
- Shows examiners that the bank is serious about using the proper tools to manage their loan and deposit pricing
- Increases profitability of the bank by pricing towards well established targets
- Quantifies pricing decisions. Takes the guesswork out of pricing

Summary of Key Points:

- Base loan pricing on full customer relationship profitability
- Price for risk
- Set ROE targets for Improvement over current performance
- Reassess risk and loan pricing at each re-pricing opportunity
- Monitor ROE performance by lender – track improvement over time

Q & A