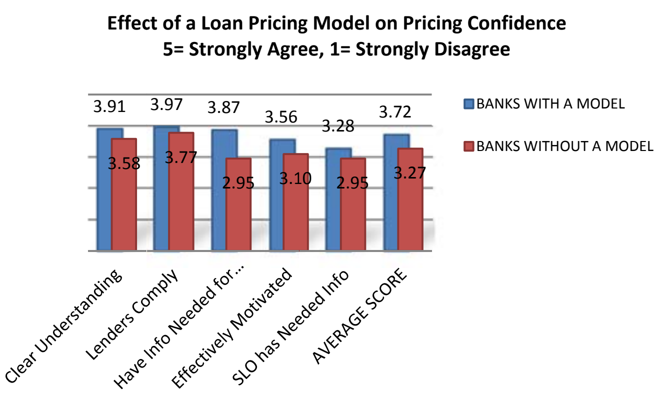
Loan Pricing Model Impacts Lender's Success

Recently, over 175 community bank executives participated in the Austin Associates Survey on Best Practices in Commercial Loan Pricing. Survey respondents represented a broad cross-section of community bankers from across the country, and included executives from banks both large and small, as well as banks that had deep experience with using professionally developed commercial loan pricing systems, internally developed loan pricing spreadsheets, and institutions that are not using any form of systematic loan pricing process.

One of the most notable findings of the survey is that institutions using professionally developed commercial loan pricing tools reported a significantly higher score on the survey question:

"Do your commercial lenders have all of the information needed to be successful at exceeding the return expectations of the bank?"



Institutions using a professionally developed commercial loan pricing tool were significantly more likely to answer this question with the answer of Strongly Agree or Agree, opposed to institutions not using any form of commercial loan pricing model.

Several other survey questions testing the benefits of loan pricing model use were also significantly higher for users versus non users.

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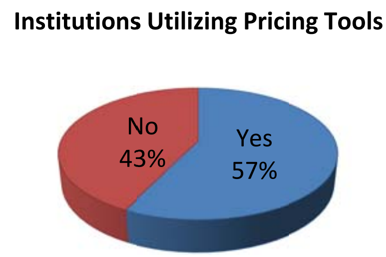
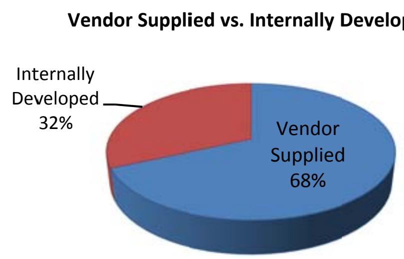
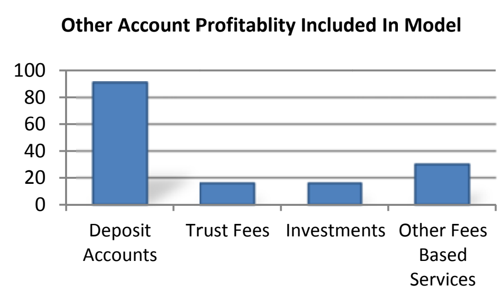
The survey was conducted during the week of June 6th, 2011, and was responded to by over 175 community bank executives from 36 states, representing banks from as small as $50 Million in total assets, to banks as large as $35 Billion in total assets.



Out of the 181 survey respondents, 57% reported using a formalized commercial loan pricing tool within their institution;



of these, 68% use a professionally developed commercial loan pricing system, while the remaining 32% use a spreadsheet that was internally developed by senior executives from their own institution.



From the group of institutions using a vendor provided model, over 90% reported having

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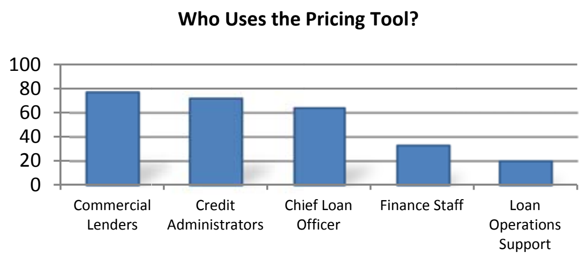
profitability analytics that included deposit account profitability along with the calculation of new loan product profitability in their overall assessment of customer profitability leading up to the determination of new loan pricing.

Greatly fewer institutions reported having the capability of including items such as Trust Department Income, Investment Sales, or Other Fee Based Services in their calculation of Total Customer Relationship profitability, occurring as infrequently as 15 – 30% of the time.

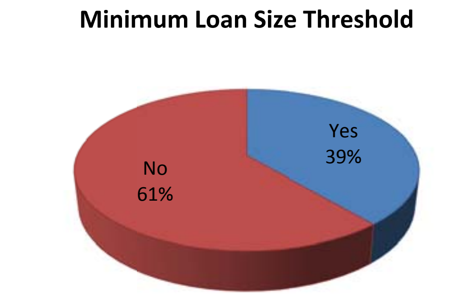


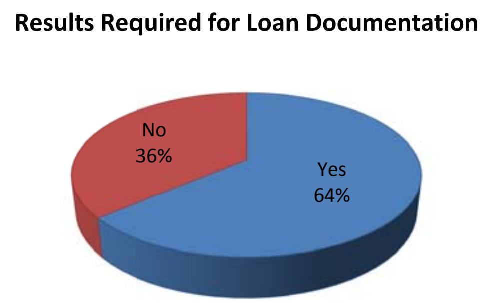
Use of the commercial loan pricing tool, when present, was very broad based among commercial lenders, commercial credit administrators, and the chief loan officer (76%, 71% and 64% of the time, respectively), and to a lesser degree by members of the finance staff and loan operations support staff (33% and 20%, respectively).

We viewed this as a very positive finding that in the vast majority of the cases (76%) commercial lenders were using the tools themselves, presumably on their own deals and customer relationships.

We assume further this means that commercial lenders are reasonably knowledgeable in the proper use of the tool and skilled at interpreting the results of the tool's outputs, but as in the case of any system designed to assist the bank in improving customer satisfaction and bank wide profitability, there is always room for improvement. For example, we would questions why, for institutions having a model, use by commercial lenders isn't 100%?

This leads us to the results of another interesting question that we asked in the survey – "Does your institution have a policy regarding the required use of the model for all new loans above some minimal dollar threshold?"





Approximately 39% of institutions with a model answered yes to this question, and of these 64% require that the reports from the system be included in the standard loan file document.

Our interpretation of these results is that most institutions using a model are still somewhat lax in requiring use of the commercial loan pricing system by their lenders – they are not "forcing" compliance with use of the model, but are operating more in the direction of "strongly encouraging" model use.

Looking further at this data leads us to conclude that a small subset of banks are still allowing the

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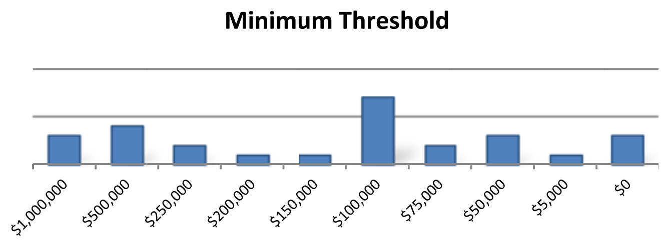
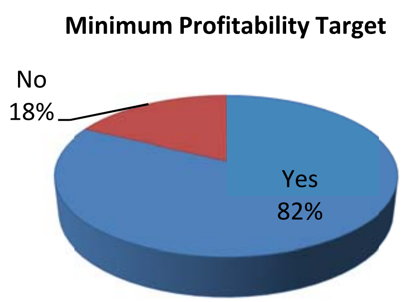
use of the loan pricing model to be more "voluntary" in nature and not a strict requirement of the bank's internal policy regarding loan pricing.

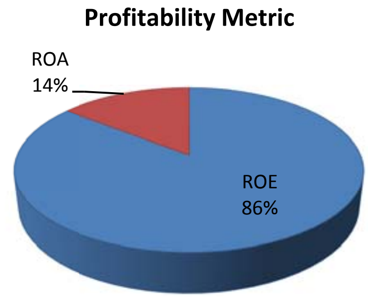
For banks with a strict requirement to use the loan pricing model, the minimum new loan size for which a loan pricing system report must be generated and included in the loan file was



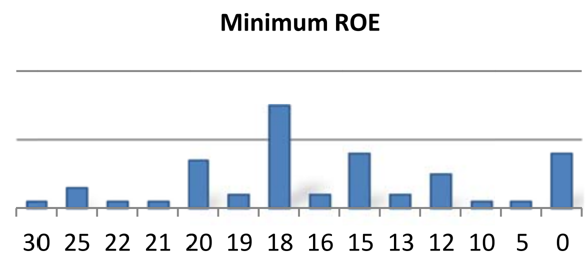
$100,000, most commonly (this was the minimum threshold for about 26% of the bank's responding – which was highly represented by smaller banks that participated in the survey). The second most frequent response given to this question was $500,000 (about 15% of respondents who, predictably, represented larger banks).



We asked a question of banks using a formal model, concerning whether or not they were giving minimum profitability targets to their lenders for use with the model, and found that 82% of institutions were providing this type of direction.



Of this group, the vast majority (86%) are using ROE as the profit metric associated with the minimum profit target, so naturally we wanted to know what minimum target-level ROE lenders were being directed to achieve. The most common answer to this question was 18%, (given by 27% of respondents), with the next most common answers being 15% (the answer given by 14% of respondents) followed by 20% (13% of respondents).



We were interested to see how many institutions using loan pricing models provided their lenders with broad based customer profitability reporting on a consistent, ongoing basis.

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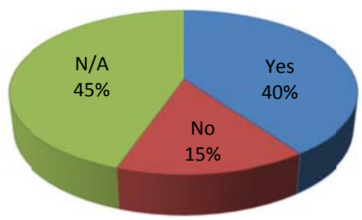
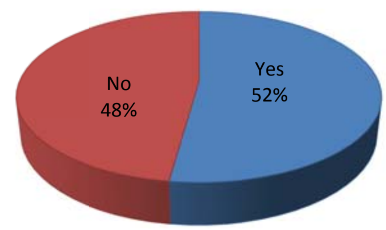
Customer Ranking by Profitability

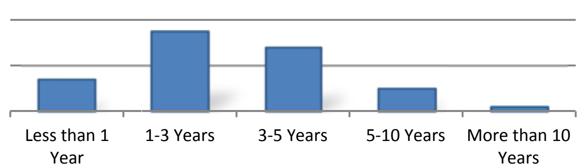


Ever Evaluated Implementing a Model



Survey respondents claimed that this occurs in only 37% of the cases and that when it does occur, only 40% of those reports provide a rank ordering of customers in any form of profitability (i.e. ranked in descending order of ROE or dollars of profit). We viewed this as one of the areas most fertile for process and profitability improvement within institutions using models, as the old axiom continues to be true – only which, which gets measured, gets managed.

Pricing Tool Has Been Used For

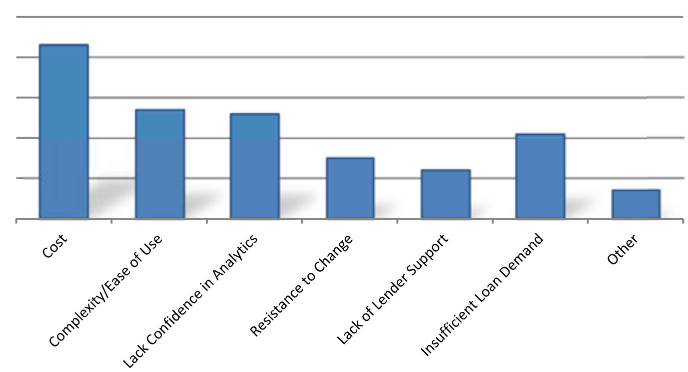


Finally, we asked survey respondents that use a model, how long the model had been in place in their organizations; the most common answers were between 1-3 years (38% of respondents) and between 3-5 years (31% of respondents). Only 3 institutions responding to the survey said that their models had been in place for over 10 years.

The complete survey was actually two different surveys combined together as one – banks that have a model were asked the questions discussed above, however, there was a separate set of questions designed specifically for banks that do not currently have a model in place.

For the banks that answered "No" to the question "Does your institution use a commercial loan pricing tool…" over half of these respondents (52%) said that they had evaluated the possibility of using a model, however had not yet made the decision to implement such a system.

Barriers for Implementing a Pricing Tool



The primary reasons cited for not implementing a model included factors such as Cost (63%), Complexity (40%), Lacking Confidence in Analytics (38%). (Note: %'s sum to more than 100% because respondents were encouraged to "check all that apply"). Lesser causes for not implementing a model included factors such as Insufficient Loan Demand (31%), Resistance to Change (21%) and Lack of Lender Support (18%).

While we recognized the distinction that just because your institution may not use an

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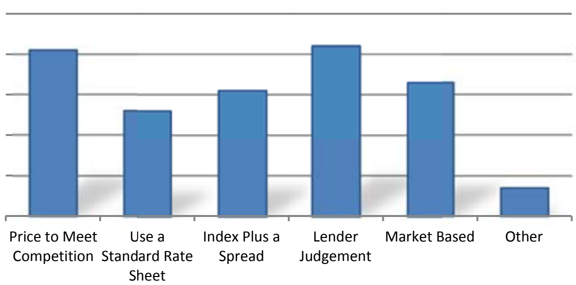
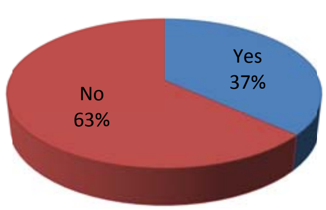
internally developed or professionally written piece of software to evaluate the pricing of new loans, this does not necessarily mean that your institution does not have a "loan pricing process" per se, be that as formal or informal as that might be. For this purpose, we asked the institutions without a model, further questions about the way in which they price new loans in the absence of a formal loan pricing system.

How is Loan Pricing Determined?



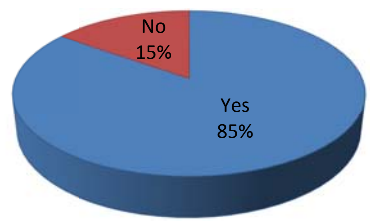
The top three answers given to this question included 1.) relying heavily on lender judgment, 2.) pricing to meet the competition, and 3.) "market-based pricing". Less common answers included methods such as using an index plus a spread, and use of a standardized rate sheet.

Does Your Institution Attempt to Calculate Customer Profitability?



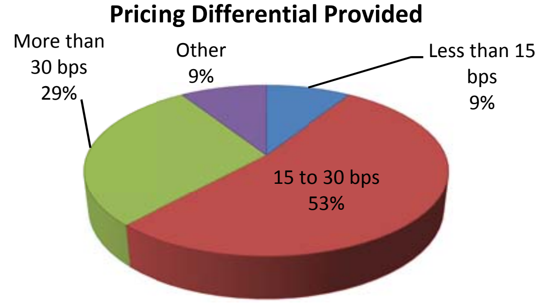
Fully 63% of institutions not using a model told us that they made no effort internally at calculating a customer's profitability when pricing new loans. Of the remaining 37% who did make some level of effort at calculating a customer's profitability to be used for pricing new loans, the following factors where commonly considered; a credit for funding rate on deposits, recognition of direct fee income, and an allocation to the provision for loan loss. Less commonly, these respondents mentioned use of the following additional factors, including, a cost of funding rate on loans, and an assignment of operating costs.

Better Prices for Large Depositors



Approximately 85% of institutions not using a model stated that, in general, customers that provided large depository balances typically received better rates on loans than did customers that had little to no depository balances.

Pricing Differential Provided



The most commonly mentioned range of rate differential on loans awarded to clients with large depository balances was said to be between 15 – 30 basis points (53% fell in this category), with the next most commonly mentioned differential being more than 30 basis points (29%), while 9% of banks stated that their loan rate differential based on deposit balances was less than 15 basis points.

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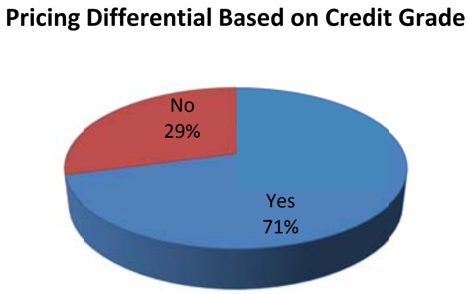
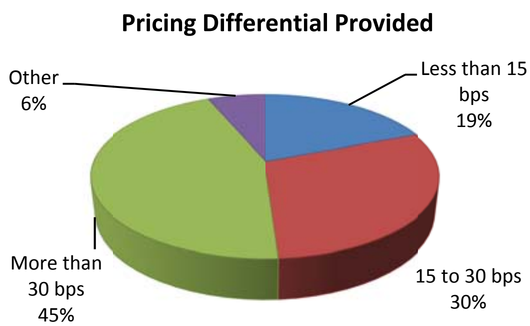
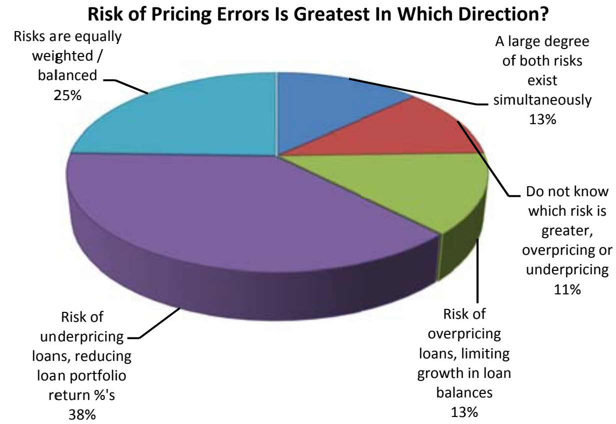


Even without the use of a formalized commercial loan pricing system, 71% of respondents stated that they did differentiate in loan pricing between borrowers with different credit grades.



Forty five percent of respondents stated that the average differential between a client with a credit grade of 3 versus a credit grade of a 4, was more than 30 basis points. A rate differential of 15 – 30 basis points was cited by 30% of respondents in this group, while another 19% provided a rate differential in this situation of less than 15 basis points.

Banks that had no formal commercial loan pricing system in place recognized that they were incurring a number of different risks by operating without a model, however 11% of these respondents could not (or did not) know which risks impacted their organization the most (either the risk of under-pricing or the risk of overpricing).



Within this group, 38% of respondents stated that they felt the greatest risk that they encountered from not using a commercial loan pricing system was the risk of under-pricing loans they actually made thereby reducing the level of return on their existing loan portfolio.

Another 13% of respondents stated that they believed their greatest risk was in overpricing their loan offers and thereby losing highly profitable customer relationships that they should have either won or kept, reducing the balances of highly profitable commercial loans for their bank, as well as the loss of any related, profitable depository or other fee based accounts or business.

Fully 38% of respondents claimed that the risk of overpricing and under-pricing without a commercial loan pricing system in place were either equally weighted (25%), or that a large degree of both risks existed simultaneously (13%).

Austin Associates' greatly appreciates the insights provided by both our clients and all the other community bank participants in this survey, we highly value your opinions, and look forward to continuing to work with you, as we have for over 45 years, in improving the quality and the profitability of your community banking practices.

If you have any questions or comments regarding any of the answers or analysis of the survey results discussed above, or if you would like assistance in either improving your current loan pricing practices, or implementing the Austin Associates' Commercial Loan Pricing System in your institution, please feel free to contact either **Jeff Morris** or **Andy Morgan** at **(419) 841-8521**, or via email at **jmorris@austinassociates.com**, or **amorgan@austinassociates.com**, or visit our website for more information at **www.austinassociates.com**.