Loan and Relationship Pricing Practices

by Thomas A. Hannagan

A s the largest point of contact between pilot and airplane, the seat of the pants is where most reactions of the plane are felt in response to pilot action. “Flying by the seat of your pants” is still a valid tool for pilots—but generally when bolstered by an array of sophisticated instruments. That idea relates to loan and relationship pricing practices, and this article presents the case for a loan pricing “instrument panel.”

T here’s a great divide in commercial loan pricing between those banks using a thorough and systematic pricing approach and those that continue to fly by the seat of their pants. Assuming every reader agrees that a systematic approach is best and every bank is already using such an approach, I could write my conclusion here and publish possibly the Journal’s shortest article ever. But I know that while all very large banks use it, only 10-20% of all banks do. Many of you find value in a systematic approach but know your institutions don’t have that instrumental panel up and running yet. This article is for you.

Rationale

In a nutshell, the rationale for systematic commercial loan pricing: improved loan yields and margins, more fee income, stronger earnings, better credit risk management, and more profitable customer relationship management. Those all sound like desirable outcomes, but let’s go a level deeper.

A consistent pricing methodology avoids numerous questionable practices in loan pricing by lenders. One questionable practice is demonstrated by lenders who typically do not include any costs associated with the risk of the loan in their pricing. This omission encourages bad credits to borrow at the same price that are being used to entice better credits.

Another such practice is evident in lenders within the same organization who make a wide variety of assumptions about what it costs the bank to originate and maintain borrowers. Lenders typically don’t have good personal knowledge about what it costs to run the commercial banking organization. They may be estimating something, pulling a number out of the air, or using the rules of thumb used at a previous bank—probably just as ill-founded.

A third questionable practice occurs when lenders associate too

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large an earnings credit with corresponding balances. They don’t take into account all factors associated with deposit profitability. They know less about deposit profitability than loan profitability—if that’s possible!

Consistency gives bank executives and lenders the ability to compare returns across borrowers, credit risk grades, and loan types.

Consistency in analyzing commercial loan return is critical to any meaningful measurement of the lending process, loan officer performance, customer profitability ranking, or the coaching and development of loan officers.

A $1 billion bank in the Southeast found that this strategy put its management in a better position to rank the profitability of lending opportunities on a risk-adjusted basis. It allowed bank management to determine where they should allocate its resources. This bank found a direct correlation between using a risk-adjusted method to allocate funds and seeing net loan losses steadily decline—from over $3 million in 2002, to $2.5 million in 2003, to $1.6 million projected for 2004.

Loan pricing gives an institution the ability to ensure coverage for the inherent cost of credit risk associated with different risk grades of loans. Thus, risk-adjusted loan pricing leads to better risk management. Once a bank has collected profitability data by loan, it can analyze risk-adjusted profit performance from many points of view—for an officer’s portfolio, for a geographic segment, by industry, by loan size, or by credit grade.

A $1.1 billion bank in the Mid-Atlantic area started systematizing its loan pricing in 2003 and now sees yields on commercial lending 117 basis points above peer average, representing a 47-basis-point improvement. During this same time period, the bank also experienced a 7% gain in increased loan volumes, so it is not sacrificing volume for profit. It is getting more of both. With a commercial loan volume just under $100 million, those 117 basis points are providing an annual $1.1 million in added net interest margin and operating income.

A $1.4 billion metropolitan bank in the Midwest recently invested approximately $185,000 in software and consulting to install a pricing system. They were looking for a minimum annual 20-basis-point improvement in yields and margins on a commercial portfolio of $466 million. This gain would move the bank’s yields up to peer average. The gain amounted to $932,000 in added interest income annualized. The five-year net present value of that gain is $4 million—a gain that did not even include continued growth in the size of their portfolio or getting to above-peer-average yields, both of which are quite likely to happen. Not a bad return on investment for a process improvement that required no hiring of staff!

Risk-based pricing of loans assists in meeting various auditor and regulatory requirements. Such requirements include credit risk differentiation, the logic behind loss provisioning and the bank’s justification of its allowance account balance. Banks that have and use a risk-based model for loan pricing decisions also have the documentation to prove their pricing strategy is based on risk and other internal economic factors.

A $27 billion bank in New England turned to risk-based pricing, in part to comply with a regulatory requirement that a bank its size must have an independent pricing capability to participate in syndicated loans. This bank has net loan losses that are below industry averages and still declining. Commercial loans are also increasing in volume—up 14% for first half of 2004. Yields are above peer average, even though improved profitability was not the bank’s main motivation for using loan pricing.

Bank executives like the idea that their loan pricing model gives their lenders better knowledge about pricing options and that the quickness of arriving at a price can serve to enhance their responsiveness to loan requests. The model is used as a simulation tool, letting the lender know early in their sales process what kind of price/fee/balance combinations will meet or beat bank return guidelines. Their
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Loan Pricing Lessons

- Executive involvement is critical to a successful transition to loan pricing.
- The transition to relationship pricing must support bank's strategy.
- Every key aspect of configuring a loan pricing system can be accomplished.
- Perfection is an (expensive) illusion, but logic and intuition will carry the day.
- Any loan and relationship pricing system will continue to evolve over time.
- The implementation needs to be thoughtful—it is an educational journey.
- The supporting logic underlying the system needs to be explained and documented.
- Loan pricing is an addition to the bank's lending culture—not a replacement.
- Profitability can be part of the goal setting and performance measurement process.

The 2004 RMA Annual Risk Management Conference began each day with keynote addresses and featured speakers. Then participants selected sessions geared to community banks or to regional and large banks. Thomas Hannagan offered the session “Pricing for Risk—Driving Profitability” as part of the community bank track. At Baker Hill, he focuses on assisting banks with the successful planning and transition to consistent risk-based relationship and loan pricing.

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