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Price Points

The importance of loan pricing discipline

While a healthier, if not completely reinvigorated, economy has been a welcome development after years of torpor, many institutions have nevertheless found that it hasn't necessarily been the magically fertile environment for profitability that they might have hoped. Sustained low interest rates and high regulatory costs have combined to keep things tight, while the seeming potential of technology-fueled opportunities has in many cases been undermined by the staffing and security expenses that have accompanied it.

As a result, more and more institutions are looking to their loan portfolios for the boost in profitability they so desperately need in the coming year (see "Getting Priorities Straight" on page 3 of this issue). But Bob Lallo, a managing director at Darling Consulting Group, Inc. in Newburyport, Mass. doesn't think the lending outlook for 2015 is a particularly encouraging one, which he believes could lead to some poor decision-making in an especially important area – how loans are priced.

"Because people don't see a lot of robust natural growth in the markets, I get concerned that we could see a lot more aggression with respect to pricing," he says. "I think it's going to be tough, so being good at these things and having your arsenal full is really important to make sure you're getting whatever value you can out of those deals."

Common Concerns

If an expanded loan portfolio is only as good as its ability to deliver value, then pricing certainly stands as one of the biggest factors to consider. Lallo says that the most common mistakes that many institutions make with respect to pricing tend to fall into one of several broad decision categories, including size, structure and credit.

One of the primary concerns in this type of atmosphere, he explains, is what he calls "me-too" pricing – sacrificing discernment and a sense of self in an effort to grow at any cost. But when an institution loses focus of what works for its own situation and just tries to keep up with the competition, the added lending activity may wind up doing a lot more harm than good. In many cases, avoiding this pitfall simply means making sure everyone in the institution has a clear idea of what the goals are and how they're going to get there.

"When it comes to considering rate and structure, in a lot of cases, some community bankers over the years have been more order-takers than outbound salespeople," Lallo says. "If you're an order-taker kind of institution and you're just reacting to the lowest rate that Bank ABC down the road did, you can get pretty upside-down in a hurry and you're not going to be successful. So banks really need to change their thinking and get educated about this. Do your people have a real idea of the different kind of structures, and what are you using as a resource?"

Model Lenders

One of the resources that most institutions will turn to, of course, is a pricing model. But here again, Lallo says, it's not just a matter of running blindly into a flurry of new lending with the results that a model spits out. The key to the usefulness of any model is having a clear idea of how it's built and what the results are really telling you.

"The obvious benefit of a model is that it can help quantify the lending decision, so you're prepared strategically to go into a deal and you can get buy-in on the

continued on page 2

deal because everyone understands what the model is," he explains. "It gives some insight into what a deal is really worth. But the question is whether a bank understands the assumptions and whether they're appropriate. Two different banks may have two very different ROEs on their loans, but those numbers don't really tell me much until I know the assumptions that went into their models and how those loans were priced to get to those ROE figures."

In other words, models can be helpful – almost necessary, in fact – to make sure that everyone is on the same page in determining whether a loan makes sense for all involved. But ideally, they shouldn't necessarily be the main driver of that decision.

"Models are tools, and tools by their very definition are not absolute," Lallo says. "They should not be seen as the end-all, be-all of any decision. I've seen deals passed on because there was a flaw in the way a model was used, and that was unfortunately the end of the discussion. The best environments that I've seen have tended to put their lenders in a position to be as entrepreneurial as possible, with the ability to question things and indulge the possibility for some give and take. Without that, there's a risk that you make a bad decision."

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Bob Lallo
Managing Director
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New Ways of Thinking

So as institutions begin to look at ramping up their loan portfolios again after what may have been a long market-imposed fallow period, Lallo thinks they'd be well-served to make sure they've kept up with the changing times, gauging their overall lending cultures before putting on a push for more loan volume. This means broadening the responsibilities of loan officers, and equipping them with the education they need to look beyond just piling up impressive new loan numbers.

"It's not just a matter of 'go out and get $50 million worth of loans' without any guidance or education as to what works for this particular bank – you have to be a lot more strategic than that," he says. "As recently as five years ago, the lending environment was a lot different from today – I could be just an order-taker and I could get decent rates on loans, but to get the business in an economy that's this sluggish there's a lot more involved. Community banks can't really compete on rates or be the low-cost provider, so they have to try to be better than that. If you're praying that things get better in the economy and don't change what you're doing on the loan side, that's a really risky proposition." FMU