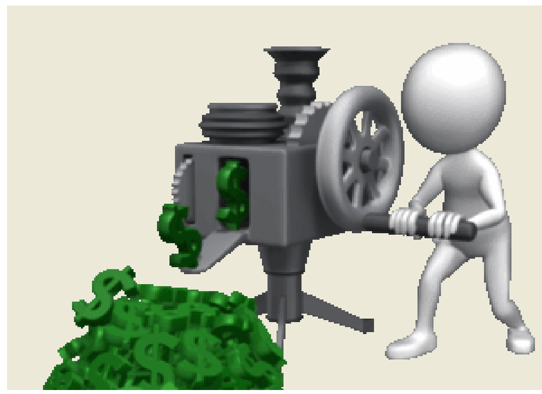
# Six Ways to Achieve ROI on your Commercial Loan Pricing System Investment

By Jeff Morris of ProBank Austin



ProBank Austin published a whitepaper last year describing implementation challenges lenders confront when utilizing commercial loan pricing systems, such as LoanPricingPRO®, the commercial loan pricing solution from ProBank Austin.

That whitepaper contained recommended solutions for successfully overcoming each of several common obstacles that financial institutions encounter when seeking to improve the profitability of their commercial line of business. In case you missed it, the whitepaper is available on our website (www.loanpricingpro.com/resources/whitepapers/navigating-loan-pricing-model-implementation-roadblocks/). This whitepaper provides additional insights into the benefits available to institutions that successfully overcome these obstacles.

## ***Barriers to Successful Loan Pricing System Implementations***

Commercial lending executives often identify two perceived barriers to implementing state-of-the-art commercial loan pricing systems. Cost ranks as the primary objection followed closely by a lack of familiarity with the software's benefits. Like many other challenges and barriers that may be encountered, there are effective solutions to overcome your concerns with attaining an appropriate Return on Investment (ROI) on your loan pricing system implementation. Among our foremost recommendations to clients is to ensure that the investment you make is commensurate with the size and sophistication of your institution.

There are a variety of loan pricing systems that vary greatly in function and price. Modestly priced systems, for example, may not link with your core data. This often leads to gross inaccuracies in measures of customer profitability. Overspending on a system might lock your institution into unreasonably large and / or long term payment streams making the attainment of a fair ROI difficult, or prolonged. The amount of your investment should be tailored to the size of your bank's commercial loan portfolio and to the sophistication and knowledge levels of your lending and finance personnel.

There are a variety of strategies to consider ensuring attaining a reasonable return on your investment in a loan pricing system. We'll cover each of these in the form of short case studies that we've taken from one or more of our existing clients' actual experiences.

## *1. <u>Enhanced Loan Yield</u>*

Quantitative analysis can be easily used to measure the effectiveness of the loan pricing system implementation on a pre-test / post-test basis. The technique used relies on the same Funds Transfer Pricing (FTP) methodology which a robust loan pricing system uses to calculate customer profitability. To illustrate this, we'll use a recent client implementation of LoanPricingPRO® at a $1 billion commercial bank.

This client had a commercial loan portfolio of approximately $495 million, comprised heavily of Commercial and Ag Real Estate loans (71%), and having a smaller allocation to C&I, Line of Credit and Construction loans (29%). The portfolio consisted of approximately 3,000 loans, with an overall average loan size of approximately $175,000. Each loan in the existing portfolio was analyzed for profitability prior to implementation of LoanPricingPRO® to determine the "pre-test" level of net interest margin. Using standard FTP methodology, each individual loan was compared to the US Treasury curve based on its original term at origination, to determine the loan's cost of funding. This cost of funding rate was then compared to the loan's actual yield, with the difference equaling its net interest margin. This same process was used for all loans originated or renewed during the following year using LoanPricingPRO® as the basis for establishing the loan's rate, with the following results:

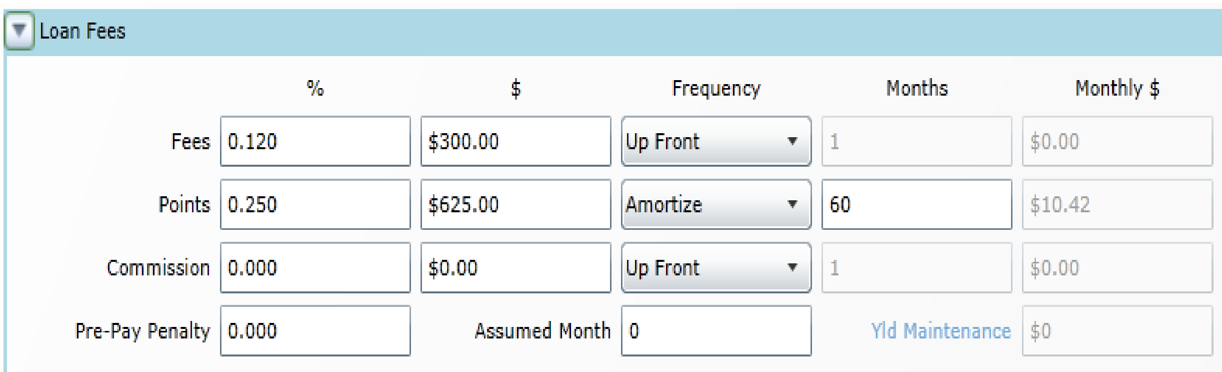
| DESCRIPTION | PRE-TEST | POST-TEST | IMPROVEMENT |
|---|---|---|---|
| Loan Yield | 4.45% | 4.77% | 0.32% |
| Cost of Funding | 1.08% | 1.22% | -0.14% |
| Net Interest Margin | 3.37% | 3.55% | 0.18% |

We are careful to point out that during the post-test period, both the cost of funding, and the average new or renewed loan yield increased, with the net result being an improvement in the net interest margin of 18 basis points. (Note: The post-test period covered a modestly rising rate environment, during which the Fed raised the Fed Funds rate by 25 basis points). During this one year post-test time frame, approximately $145 million of new or renewed commercial loans was priced using the model. No other changes were implemented during this period that could have caused a similar expansion of the net interest margin. The one year impact of this expansion of the margin totaled $261,000, and delivered a double digit ROI, and a very short payback period (less than six months), on an after tax basis. This increase to profitability would not have been attained without implementation of LoanPricingPRO®.

## 2. ***Increased Collection of Loan Fees***

In today's highly competitive environment with historically low rates and generally weak loan demand, commercial loan fees are often sacrificed, or at least underutilized as a tool for increasing profitability. As a general rule, the shorter the loan term, the more powerful the impact of loan fees on customer profitability and ROE.

Nevertheless, loan fees can sometimes be used to secure a preferred level of Return on Equity (ROE) from customers that are very rate sensitive. A high quality loan pricing system will guide lenders toward the strategic use of small but appropriate loan fees in highly competitive loan pricing situations. This will often apply to only a small percentage of new or refinanced loans analyzed by the model. However, it can lead to a significant pick-up in commercial loan profitability when compared to current practices.

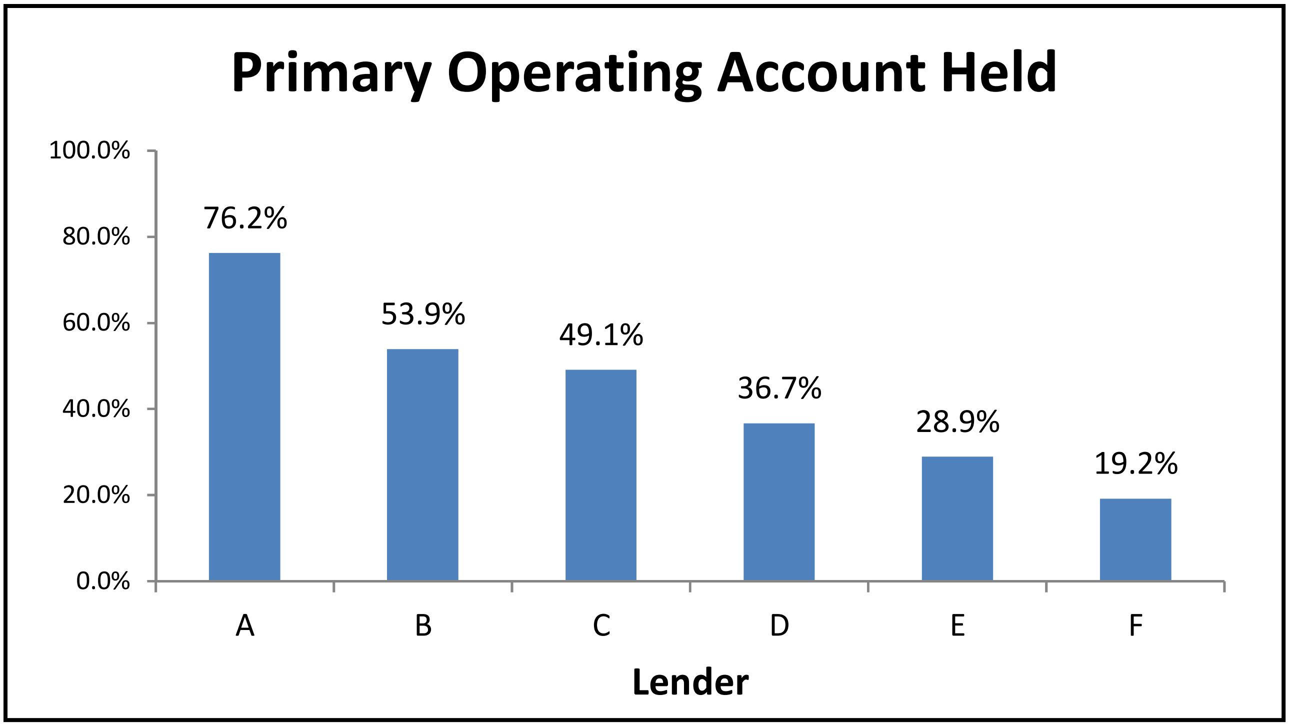



In the case of a $350 million community bank, with a $250 million commercial loan portfolio, that implemented LoanPricingPRO®, approximately 400 new loans were analyzed using the model each year, with some 300 new loans actually being originated. Using the model as a guide, this bank applied a nominal loan application fee ($300) to all new loans, with a strategy of slowly increasing this fee over time. In addition, the bank began charging a standard 25 basis point fee which was often eliminated after negotiating the final rate. In many instances, the removal of fees was displaced by a small increase in loan rates.

Over the course of one year, this bank determined that they collected an additional $275,000 in loan fees through these two combined strategies even though the increase in loan fees collected per new loan was less than $1,000. On an after-tax basis, this strategy, supported by ROE analysis through the model, more than covered the cost of the system purchase, in less than six months.

## 3. ***Compensating Deposits***

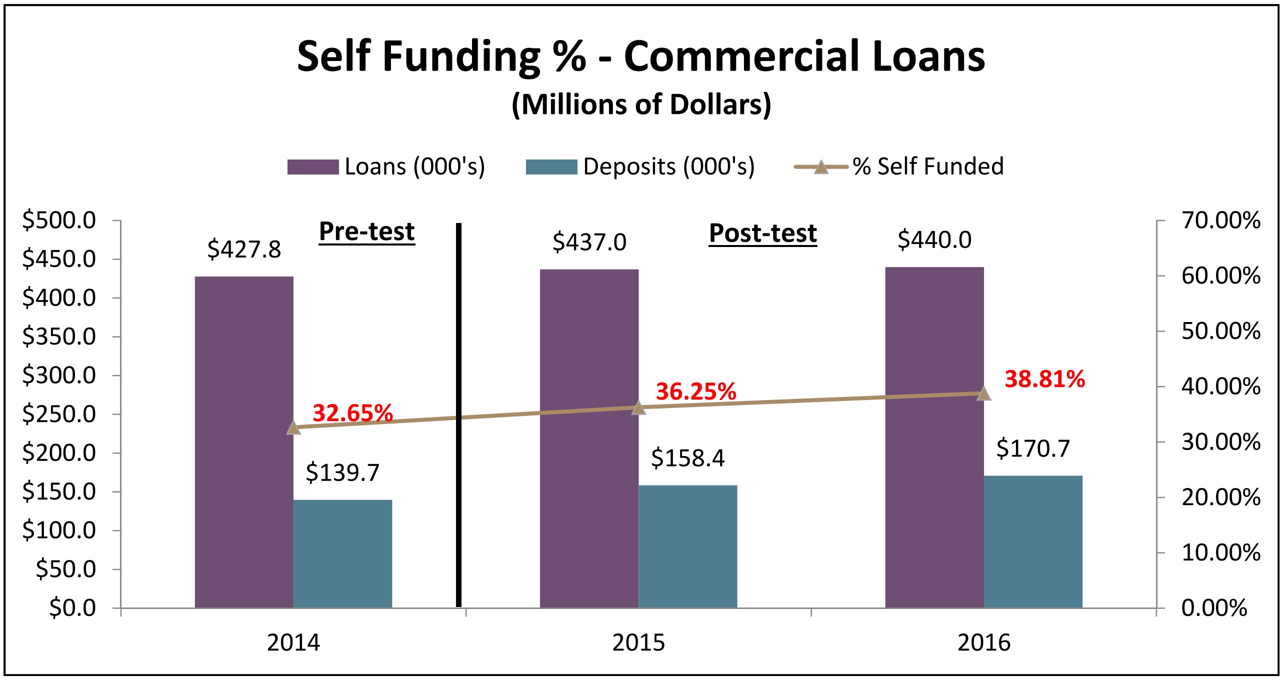
Banks, historically, have attempted to require compensating balances to boost overall profitability of a commercial loan relationship. If these compensating balances are sufficient and priced appropriately, more attractive rates can be applied to the loan. Generally the smaller the loan request the greater the impact will be of this compensating balance strategy.




For this example, we'll use another client with $905 million in total assets. This client tracks what they call the "self-funded" ratio of commercial customers as well as the percentage of borrowing customers that maintain their primary operating accounts with the bank. These statistics are tracked both on a bank-wide basis, and on an individual lender basis. The self-funded ratio represents the long-term dollar balance of deposits maintained at the bank by commercial borrowers.

When dealing with loan applicants that did not have their primary operating accounts with the bank, lenders were encouraged to provide commercial loan applicants with two rate quotes, one based on the rate given a loan only relationship, and a second, lower rate, based on the presence of a compensating deposit balance (usually the borrower's primary operating checking account). In most cases, the second rate was between 15 – 25 basis points lower, so that a large majority of applicants opted to move their checking account in exchange for the lower loan rate.

The bank tracked their performance on the basis of the self-funded ratio for the first 24 months following the routine implementation of this strategy, as shown below:




When the applicant already maintained their primary operating account with the bank, a firm commitment for a fixed minimum dollar balance was obtained, (usually targeted as a percentage of the outstanding loan balance and normally representing a 10 – 25 percent increase in average deposit balances over past history – i.e. "new money"). Two years following the implementation of this new pricing policy, the bank increased its self-funded ratio from 32.65 percent up to 38.81 percent. The ratio during 2017 continues to increase.

Based on the bank's product profitability analysis, the bottom line net income impact of this policy change and the growth in balances was approximately $97,000 in 2015, and rose to approximately $164,000 in 2016. These policies were well supported by the ROE / RAROC calculations included in the bank's loan pricing system (LoanPricingPRO®), and would not have been achieved without the discipline provided by the consistent use of the system.

### 4. ***<u>Decline in Lost Opportunities</u>***

Financial institutions using LoanPricingPRO® usually have a higher batting average when measuring the number of new loan clients against the total number of requests.

The next case study client is a $500 million commercial bank with a commercial real estate loan portfolio of approximately $135 million. Individual CRE loans within this portfolio range in size from $50,000 - $2 million, with an average loan of approximately $300,000. The portfolio is comprised of approximately 450 loans, and the most common term is 5 years. Due to the bank's normal loan turnover rate, roughly 20 percent of the portfolio, or about 90 loans, are up for repricing / renewal each year.

In addition, the bank's sales efforts to grow the portfolio mean that another 250 prospective new loans are evaluated each year, with around 20 new loan applications taken each month. Of these, some percentage do not meet the bank's underwriting standards, or for other reasons are not desirable, (i.e. customer requesting too long of a loan term, collateral is outside the market area, industry concentration, etc.). Based on the client's previous years' experience, approximately 14 percent of initial new loan applications, or about 35 loans, were declined due to credit worthiness, and another 15 loans (six percent) were not considered due to loan terms deemed to be unfavorable. This left about 200 loans that the bank wished to compete for within its market area. A significant portion of these remaining loans were lost to other competitors, and a few loan applications were withdrawn by the prospective borrowers.

The bank compared its previous year's performance to its first year using LoanPricingPRO®, noting the following differences:

| | Previous Year | Current Year |
|---|---|---|
| ➢ Total loan applications analyzed by credit | **250** | **265** |
| ➢ Declined due to credit | (35) | (37) |
| ➢ Declined due to other terms | (15) | (18) |
| ➢ Acceptable loan applications considered | **200** | **210** |
| ➢ Lost to regional / national banks | (37) | (35) |
| ➢ Lost to other community banks | (65) | (59) |
| ➢ Lost to credit unions | (23) | (26) |
| ➢ Lost to alternative financing alternatives | (29) | (28) |
| ➢ Applications withdrawn / not acted upon | (17) | (23) |
| ➢ Number of new loans closed | **29** | **39** |
| ➢ Overall win/loss percentage | 14.5% | 18.6% |
| ➢ Additional loans closed | +10 | |
| ➢ Dollar value of new loans closed | $3,000,000 | |
| ➢ Incremental Profit (over five year term) | **$185,000** | |

The client found that, as a result of using their new loan pricing system, which supported a more disciplined pricing analysis and negotiating process, the bank's overall Win/Loss percentage was improved. The majority of the improvement resulted from offering more competitive rates that still met the bank's ROE threshold. Results were also improved by substituting fees or compensating balances to meet ROE targets, and by having ROE targets that were correctly established in relationship to the bank's current portfolio earnings levels and marketplace dynamics.

The bank found that their "batting average" improved from below 15 percent to more than 18 percent, equating to a pick-up of approximately 10 new loans in the first year. At an average loan size of $300,000, and an average ROE of 15 percent, this improved closing rate translated into almost $45,000 of additional profit in the first year, and an estimated $185,000 of additional profit over the 5 year term of these loans. The bank also found that a high percentage of these new loans came with additional relationship-based deposit balances, which further increased profitability by $12,500, per year. The combined effect of this new business, over the average five-year term of the new CRE loans, increased the cumulative profitability of the bank by $247,500.

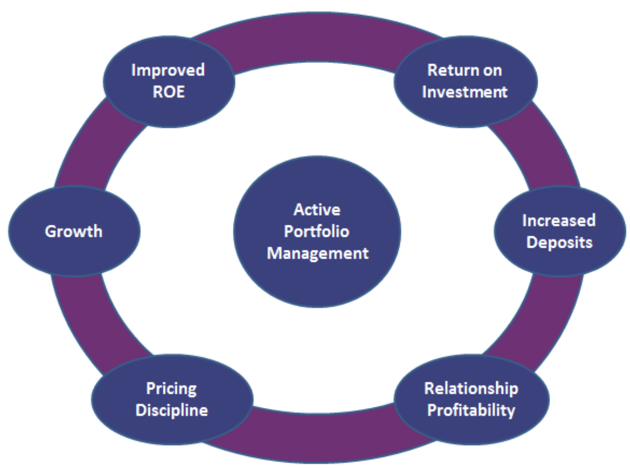
## 5. ***Active Portfolio Management***

When implementing a commercial loan pricing system with an interface to the institution's core data systems, significant new reporting capabilities are attained. Banks are able to report on and track trends in commercial loan officers' portfolios.

For example, senior management is now able to provide full customer level profitability reporting to commercial lenders, ranking lenders' customers by account size, yield, dollars of profit, ROA and ROE. Most organizations that utilize this new more comprehensive reporting regimen, choose to rank lenders' overall portfolios based on the risk adjusted return on capital (RAROC) produced by each individual lender's customer group or portfolio. These RAROC totals include all loan and deposit relationships these customers have with the bank.

Once this information becomes available, it is much easier for individual lenders to allocate their time to the outcomes that will have the most substantial impact on the profitability and returns of their portfolios. Moreover, it is much easier for senior management working with these lenders to communicate goals for improving profitability. Tracking trends quarter to quarter becomes much easier, as effects of new loan business, enhanced pricing, increased fee collection, and growth in related deposit portfolios can be easily monitored and measured.

Lenders will have hard data on which customers within their portfolio are responsible for generating the greatest share of profit (i.e. Top 10 most profitable customers). Time spent building and securing these relationships becomes a top priority for each lender. They will also be able to clearly delineate any customers that have larger loan and deposit balances, but which may be mispriced and not providing adequate returns. Lenders may wish to develop strategies for adjusting these customers' pricing upon the next occurring renewal date, or discuss with customers the addition of operating or other accounts to the bank.




Enabled with this very powerful information, senior management teams and lenders may more effectively collaborate to incrementally improve the ROE of their largest commercial portfolios. To understand the potential impact of these improvements, imagine a commercial lender's portfolio that is currently comprised of $30 million of commercial loans and $7.5 million of core deposits.

Using customer, product and officer level profitability information provided through the loan pricing system, this total portfolio can easily be improved from an overall return of 13.5 percent to 14.5 percent, resulting in an incremental profit of $32,000. If each lender in the institution were able to attain this modest level of improvement, the overall impact to the institution would be substantial. These improvements can be achieved with or without providing financial incentives to individual lenders involved in managing each portfolio.

## 6. ***Improved Discipline, Accuracy & Pricing Consistency***

As has been shown, it is possible for senior management teams and lenders working together and aided by an accurate and appropriately calibrated commercial loan pricing system, to significantly improve the return performance and growth rate of the commercial lending client base.

Critical to the accomplishment of this valuable and worthwhile effort, is the commitment of senior management to using an objective process for consistently pricing all new business relationships and loan renewals.  When each new loan and existing relationships are re-priced on the same objective analytical process as is offered by the RAROC approach, a basis for improvement in operating performance becomes actionable in a manner not available to bankers without a reliable loan pricing system.

In nearly every financial institution today there exists senior managers who have suffered through difficult, expensive and ultimately unsuccessful implementation attempts at installing a commercial loan pricing system.

Multiple reasons for these past failures exist, including the use of arbitrary and inappropriate ROE targets, lack of a sound basis for the profitability assumptions used in the model, and the lack of senior management commitment to stick with the effort in the face of lender resistance and pushback.

Despite these circumstances, the enhanced profitability and portfolio growth that can be attained outweighs the obstacles and costs of investing in these systems.