

# RISK-BASED PRICING RECONSIDERED, PART 1

First of a two-part look at Loan Risk Pricing

When the dust of today's cleanup clears, what will risk-based pricing look like?

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For the last several months, there's been an intense focus on credit risk. For community banks, this is the most pervasive risk—the risk to earnings and capital that any loan may not perform according to its original terms. For the enterprise itself, it consists of the cumulative degree of credit risk present in the bank's loan portfolio.

This recent emphasis on credit risk is rekindling interest in the subject of pricing for credit risk.

The issue is usually posed by the direct question of, "How does one price for risk?" However, I think the discussion should start on a more basic level: Can one actually price for risk?

Risk pricing in the past tense

The old-fashioned view—the one prevalent 30 or 40 years ago—was that pricing is appropriately a function of the cost of monitoring a portfolio of loans. As banks are relatively highly leveraged compared to most other types of enterprises, not all credit risks are for banks.

Here's what follows from this line of thinking. Unsecured credit is usually reserved for pristine borrowers, those whose risk of non-performance is objectively very low. Collateral is a way of mitigating credit risk. The cost of administering a loan with collateral is higher than the cost of administering unsecured credit.

There's a certain logic and simplicity in this line of reasoning. And, frankly, it was the way many of us "graybeards" were taught.

For the sake of simplicity, let's concentrate on how we viewed risk on our borrowers' balance sheets a generation or more ago.

Financial leverage, the amount of debt relative to total sources of funds, was one of the primary metrics of financial soundness. Less leverage (or debt) is better than more leverage. The basic measure is the debt-to-equity ratio. The rule of thumb nearly 40 years ago was that this ratio should not exceed one to one. In other words, the borrower should have as much invested in the business as the creditors, including the banks. Debt-to-worth ratios of 1.5 or 2.0 to one or more were a sign of financial weakness, actual or potential.

Why the challenge has changed

Much has changed along the way including the pervasive and pernicious effects of inflation.

Under generally accepted accounting principles (GAAP), carrying value of most capital assets is at historic cost, less any applicable depreciation. Ten acres of undeveloped land acquired in 1955, for example, at \$1,000 an acre is valued at the old cost of \$1,000 an acre even if it now sits abutting the intersection of two interstate highways. A debt-to-worth standard of one-to-one may impose too harsh a measure in today's terms.

Consider, though that the "last in, first out" (LIFO) method of valuing inventory often considerably understates the value of inventories over time. Many car dealers who are in the process of losing their franchises face punishing tax bills as they liquidate inventory that reflects years of LIFO accounting.

My point is this. We need to adapt our judgments to a variety of changed conditions and accounting and business realities. But how do we reliably measure financial soundness on a borrower's balance sheet? I submit to you that the job is very difficult today and that in some cases, maybe we have hardly a clue.

#### Risk pricing and operating risk

Another issue, different but the same in a way, is operating risk. This is the degree of operating leverage in a business and its principal component is the relative degree of fixed costs to total costs.

Recall the accounting definition of a fixed cost—a cost that does not vary directly with sales. Interest on borrowed money fits that definition. So if we see a company with high fixed costs that is in significant part due to interest expense, are we sufficiently sensitized to the presence of high financial leverage?

My own experience is that a generation of bankers was never thoroughly taught how to make that distinction. They understand that a debt to worth ratio of one to one is probably too restrictive a standard today and that two or three to one may be fine. But today's lenders should not ignore or minimize the impact of high operating leverage on the borrower's ability to produce sustainable earnings performance.

#### How risk pricing will change

We are in a period in our economic history of massive deleveraging.

This means that increasingly, sources of funds will shift in proportion away from debt in the direction of equity. Debt is already declining in relative terms.

As this process continues, lenders will have to develop new standards of assessing the capital adequacy of borrowers. There will likely be more emphasis on collateral—how it's valued, how it's monitored, how liquid it is, and a host of related considerations.

At the same time, lenders will need to focus on operating earnings and that means more analytical attention to the borrower's financial statements.

As banks move into this new environment—actually a rather old one not experienced in many years—we need to look at what it costs to adequately monitor collateral and analyze financials to effectively abate the inherent risks in lending.

Modern practice also needs to consider the role of equity as a bank funding source and the degree of stress we place on our equity accounts as we fund loan growth on a loan-by-loan basis.

This will be the subject for next week's installment.

Meanwhile, chew on this--and provide some feedback:

Do you feel that your banks currently give sufficient analytical consideration to the costs of administering credit in today's environment?

About Ed O'Leary:

Veteran lender and workout expert O'Leary spent more than 40 years in bank commercial credit and related functions, working with both major banks as well as community banking institutions. He earned his workout spurs in the dark days of the 1980s and early 1990s in both oil patch and commercial real estate lending.

O'Leary began his banking career at The Bank of New York in 1964, and worked at banks in Florida, Texas, Oklahoma, and New Mexico. He served as a faculty member and thesis advisor at ABA's Stonier Graduate School of Banking for more than two decades, and served as long as a faculty member for ABA's undergraduate and graduate commercial lending schools.

Today he works as a consultant and expert witness, and serves as instructor for ABA e-learning courses and a frequent speaker in ABA's Bank Director Telephone Briefing series. You can hear interviews with Ed about workouts here. You can e-mail him at [etoleary@att.net](mailto:etoleary@att.net). O'Leary's website can be found at [www.etoleary.com](http://www.etoleary.com).

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